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WESTERN BALKAN COUNTRIES BEFORE AND AFTER THE GREAT RECESSION (2000-2014)

Abstract

The main goal of this paper is to analyze the economic transition process in the Western Balkans (WB) in the period between 2000-2014. In this period, countries made radical political changes and economic reforms. They opened up to global trade, became increasingly export-oriented and expanded the role of the private sector. They also fulfilled criteria regarding convertibility of the current account, interest rates liberalization, price liberalization and small-scale privatization. However, reforms, such as large-scale privatization, competition policy and governance and enterprise restructuring, have still been delayed.

In all WB countries except in Serbia, the inflation rate during this period is low, which is very big achievement taking into account the history of hyperinflation at the beginning of the transition. Furthermore, from the

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year 2000 onwards, the countries under review also made progress in real convergence, but the gaps in terms of income per capita relative to the euro area, remain large. In comparison with the 90s when the high political risk has been the main barrier for more foreign direct investment inflows, after the year 2000 foreign investors have become increasingly interested for this region.

Key Words: Western Balkan, economic transition, market economies.

JEL Classification: E24; E31; F16; F31; F32

Introduction

In the countries of Western Balkan (Macedonia, Serbia, Montenegro, Bosnia and Herzegovina, Croatia, Kosovo and Albania) the transition to a market economy, in comparison with the more advanced countries in Central and Eastern Europe (CEE), has evolved under more difficult conditions. These countries are still lagging behind the New Member States of the European Union in terms of economic transformation and income levels. The new member states that joined EU in the period from 2004-07 have on the whole been more successful than the Western Balkans in consolidating economic reforms, integrating into the world economy and attracting foreign investment. This situation in the WB is due to a different factors, such as greater physical distance from the Europe's core and many institutional and cultural factors that pre-date communism.

But, if we analyse the history, it is interesting to underline that at the end of the 80s SFR Yugoslavia was the most developed and largest country in SEE, primarily due to its longer experience with market-oriented economic reforms and greater openness of its economy. At the time of the break-up of Yugoslavia in 1991, all its successor states generally had less distorted economies than the centrally planned economies in the CEE[5].

However, we have to emphasize that while the rest of Emerging Europe transitioned peacefully from communism into market economies, many Western Balkan countries in the 90s coped with conflicts, civil unrests, sanctions and blockades, which affected their integration with in the EU. The

[5] IMF (2015).

wars and political unrests distracted substantial foreign investment, significantly slowed the economic reform and the privatization of property, which had social implications on employment. Most economies experienced severe recessions, because of collapsing of the trade which had been large within the Yugoslav Federation.[6] On the other hand, Albania, was nearly completely autarkic at the time it began to open up from its self-imposed isolation in 1991. According to this, in the Western Balkan region, most of the problems of transition, such as high inflation, a substantial fall in real GDP, a rise in unemployment, have been of much greater scope than in the CEE countries.

However, over the last 25 years, the WB countries have experienced a notable transformation. The progress after 1991 has been evident in every country. They opened up to global trade and became increasingly export-oriented, furthermore they expanded the role of the private sector and began to build institutions needed to support a market system. The result of these efforts has been a significant rise in incomes and living standards, as well as enhanced macroeconomic stability.

The main goal of this paper is to analyze economic transition process in the Western Balkans and to determine the degree of nominal and real convergence in the period between 2000-2014. In the first part we analyze the degree of macroeconomic stability, as a condition for joining the EU and we make comparative analysis of the price and exchange rate stability in these countries as well. In the second part, we examine the degree of real convergence in the WB countries and the relations between GDP and unemployment rate, which are major concern in these countries. In the third part we put focus on the external imbalances in the countries of this region and the impact of foreign direct investment on these economies before and after the Great Recession. At the end, we describe the success of the implementation of transition processes, which is monitored by macroeconomic indicators, developed by the European Bank for Reconstruction and Development (EBRD).

1. MACROECONOMIC STABILITY IN THE COUNTRIES OF WESTERN BALKAN AS A CONDITION FOR JOINING THE EU

During the accession to the EU it is essential to achieve and preserve macroeconomic stability, seen, above all, in stable prices and exchange rates.

[6] Uvalic (2010).

Without a stable macroeconomic environment it is impossible to fulfill the conditions required for the European integration, but it is also impossible to achieve a faster economic growth. According to the Maastricht Treaty, the price stability is related to the three best performing Member States in term of price stability. The same applies to the fluctuations in exchange rates, which are determined by the multilateral arrangement, known as ERM II (Exchange Rate Mechanism II).

Almost all WB countries in the past faced hyperinflation episodes. The country that has had highest and longest inflationary pressures was FR Yugoslavia, which in the year 1993, had one of the highest hyperinflations ever recorded in economy. After the split between Serbia and Montenegro in the year 2006, the inflation in Serbia was at around 11 per cent. In order to escape from inflationary pressures within FR Yugoslavia, Montenegro, introduced the German mark as legal tender, and later on the euro. This contributed to substational low level of inflation. In Kosovo, where the euro has also been used as legal tender after mid-1999, inflation remained relatively high, but has also been reduced to low levels after the year 2003 and in some periods this country faced with deflation[7]. In the table below the annual inflation rate in the period between 2000-2014 for separate WB countries is represented.

Table 1. Inflation, consumer prices (annual)

Year	Macedonia	Serbia	Montenegro	Bosnia and Herzegovina	Croatia	Kosovo	Albania
2000	6,61	71,12	n.a	n.a	4,61	n.a	0,05
2001	5,20	95,00	n.a	n.a	3,77	n.a	3,11
2002	2,31	19,49	n.a	n.a	1,68	n.a	7,77
2003	1,10	9,88	n.a	n.a	1,75	-1,08	0,48
2004	0,93	11,02	n.a	n.a	2,05	-1,05	2,28
2005	0,16	16,12	n.a	n.a	3,32	-1,39	2,37
2006	3,21	11,72	2,92	6,12	3,21	0,62	2,37
2007	2,25	6,39	4,38	1,51	2,86	4,36	2,93
2008	8,33	12,41	8,76	7,42	6,09	9,35	3,36
2009	-0,74	8,12	3,47	-0,39	2,40	-2,41	2,28
2010	1,51	6,14	0,65	2,188	1,04	3,48	3,55
2011	3,90	11,18	3,45	3,67	2,25	7,34	3,45
2012	3,32	7,33	4,14	2,05	3,42	2,48	2,03
2013	2,78	7,69	2,21	-0,09	2,21	1,76	1,94
2014	-0,28	2,08	-0,71	-0,93	-0,201	0,43	1,63

Source: Authors' calculations based on World Bank Country Database

n.a(not available)

As we can see from the table above in all WB countries except in Serbia the inflation rate is low, which is very big achievement taking into an account the history of hyperinflation at the beginning of the transition.

[7] World Bank Country Database

During the analyzed period, Serbia was the only country which fell behind the regional trend of disinflation. In the last year of observation Macedonia, Montenegro, Bosnia and Herzegovina and Croatia had disinflation, while inflation rate in Serbia, Albania and Kosovo was very low.

Low and stable inflation could not be achieved in any different way than by stabilizing or fixing the exchange rate. With the exception of Croatia and Serbia, which chose managed floating and Albania which chose floating exchange rate, but with a tight monetary policy, other Western Balkan countries have chosen a more or less fixed exchange rate system: Macedonia chose de facto fixed exchange rate to euro, Montenegro unilateral euroization, Bosnia and Herzegovina currency board pegged to euro. This policy contributed to dramatic disinflation and succeeded in accomplishing price stability in a longer period of time[8]. But, we have to take into account that while these policies were successful in reducing inflation, they have not assured longer-term economic development and a fast catching-up with the more developed European countries.

2. REAL CONVERGENCE IN THE WESTERN BALKAN COUNTRIES

The economies of Western Balkan have witnessed significant economic improvement in the period between 2000-2007. This growth was driven more by ample global liquidity and unsustainable capital inflows than by real progress in the economic reform.[9]

As we can see from the table below the period before the year 2008 can be qualified as a rather successful in terms of stable and robust growth. But, as the crisis caused tighter credit conditions, the growth in these countries after the year 2009 significantly declined. In the table, we can also note the significant differences in growth levels within the group.

[8] Belke and Zenkić (2007)
[9] European Commission (2009)

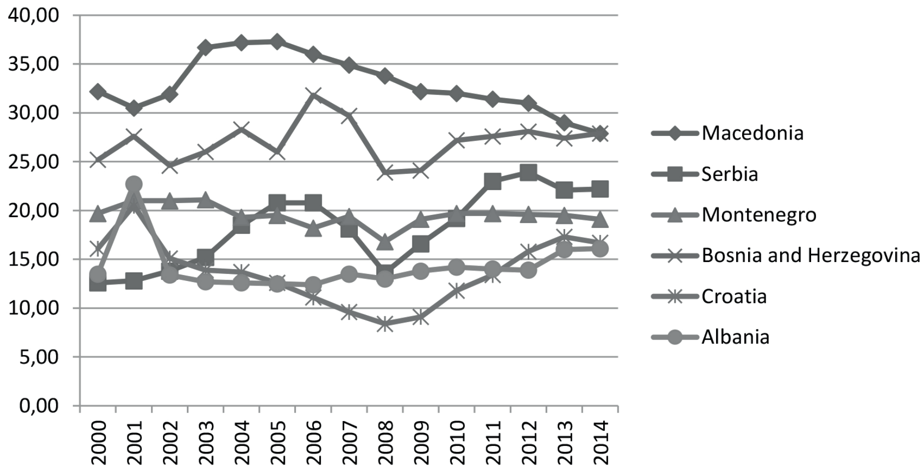
Table 2. GDP per capita growth (annual %)

Year	Macedonia	Serbia	Montenegro	Bosnia and Herzegovina	Croatia	Kosovo	Albania
2000	4,55	7,76	3,10	5,50	3,77	n.a	6,67
2001	-3,08	4,99	1,10	4,40	3,43	26,97	7,94
2002	1,49	7,12	1,90	5,30	5,24	-0,70	4,23
2003	2,22	4,41	2,50	4,00	5,56	5,98	5,77
2004	4,67	9,05	4,40	6,09	4,08	2,61	5,71
2005	4,72	5,54	4,19	5,00	4,16	6,03	5,72
2006	5,14	4,90	8,57	6,52	4,78	4,50	5,43
2007	6,47	5,89	10,66	5,98	5,15	7,29	5,9
2008	5,47	5,37	6,92	5,59	2,05	2,64	7,53
2009	-0,36	-3,12	-5,66	-2,72	-7,38	3,34	3,35
2010	3,36	0,58	2,46	0,84	-1,70	3,31	3,71
2011	2,34	1,40	3,23	0,96	-0,28	4,62	2,55
2012	-0,46	-1,01	-2,72	-1,21	-2,19	2,81	1,42
2013	2,67	2,57	3,55	2,8	-1,06	3,44	1,11
2014	3,78	-1,81	1,78	0,78	-0,36	1,22	2,17

Source: Authors' calculations based on World Bank Country Database

However, the high GDP growth rate in the most of the countries has been insufficient to alleviate the problem of very high unemployment. Even though all governments have undertaken measures to create new jobs for laid-off workers, to stimulate private sector development and to facilitate the entry of new private firms, the WB unemployment rates have still been the highest in Europe (see chart 1).

Chart 1. Unemployment, total (% of total labor force)



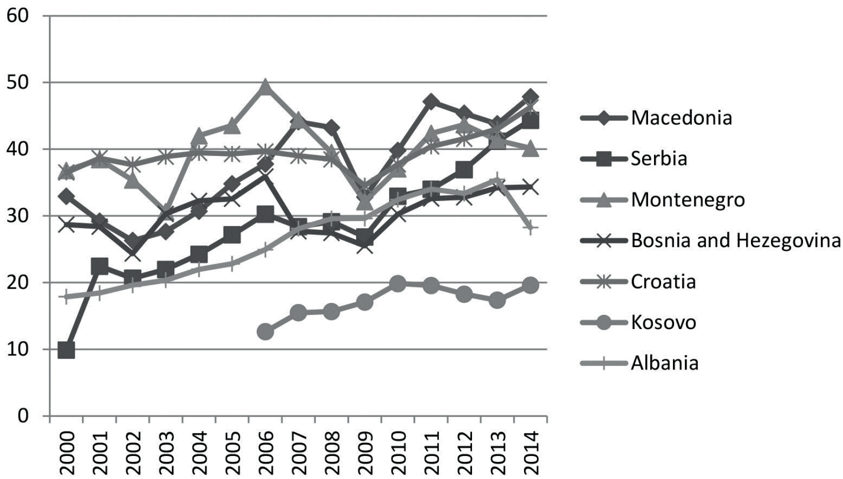
Source: Authors' calculations based on World Bank Country Database

From the chart above we can see that the labour market performance shows significant disparities across countries. Bosnia and Herzegovina and the Republic of Macedonia had the highest unemployment rates in the year 2014 both of them 27,9%, whereas unemployment levels were significantly lower in Croatia (16,7%) Albania (16,10%) and Montenegro (19,10%).

3. EXTERNAL IMBALANCES IN THE WESTERN BALKAN COUNTRIES

As we mentioned earlier, as the WB countries transitioned toward market-based systems, the economies have become increasingly export-oriented. After a decade of declining or stagnating exports, caused by the break-up of the Yugoslav federation, WB countries' exports have been growing since the year 2001. The average share of exports in the GDP increased from 27.12 in 2000 to 37.26 in 2014, but with disparities across the countries. For example, during the analyzed period the average export as a percent of GDP was 39.41 in Croatia, and 26.45 in Albania (see Chart No.2).

Chart 2. Exports of goods and services (% of GDP)



Source: Authors' calculations based on World Bank Country Database

But in comparison with the New EU Member states the contribution of net exports to GDP growth was lower. This is primarily due to the restrictive monetary policies (which were implemented to combat inflation) which led to strong real appreciation of the national currencies. Furthermore, many WB products are not sufficiently competitive on foreign markets or face non-tariff barriers. On the other side, imports have grown even faster, inducing rising foreign trade deficits.

In the period between 2007-2014 the average current account deficit as a % of GDP was: -4,65 in Macedonia, -11,04 in Serbia; -25,83 in Montenegro, -8,52 in Bosnia and Herzegovina, -3,15 in Croatia, -10,74 in Kosovo and -12,56 in Albania[10].

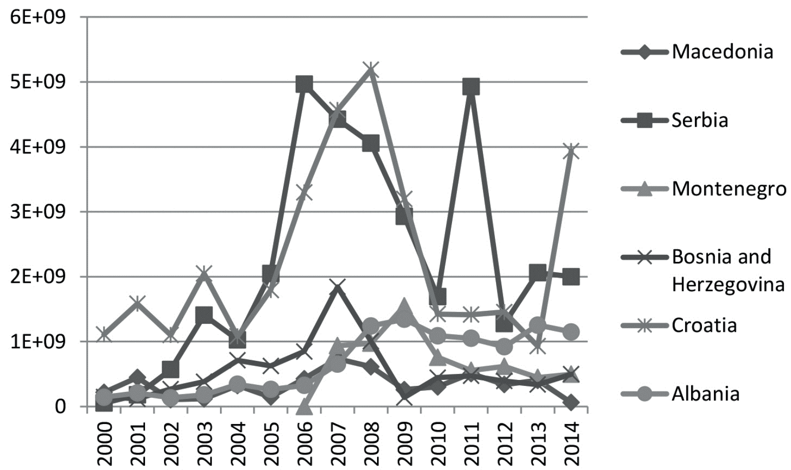
The high current account deficits have been covered by continuous inflows of capital from abroad, such as remittances, foreign loans, and foreign direct investment. In comparison with the 1990s when the high political risk has been the main barrier for more FDI inflows, after the year 2000 the foreign investors have become increasingly interested in the WB region. This is due to many factors such as: stabilisation of the region from late 2000 onwards, improvement of regulatory and structural reforms; the prospect of

[10] World Bank Country Database

EU accession; fall in the interest rates in Western Europe with the introduction of the euro and creation of the conditions for capital inflows to emerging economies, including the Western Balkans[11].

FDI has rapidly increased, in the years 2006, 2007 and 2008 (see chart 3). But, we have to underline that foreign direct investment were biased toward the non-tradable sector and consumption rather than investment, and thus had no significant impact on productivity growth and the creation of a strong export base.

Chart 3. Foreign direct investment, net inflows (BoP, current US$)



Source: Authors' calculations based on World Bank Country Database

In standard economy theory, capital account liberalization would allow more foreign inflows, more investment and rapid growth in the capital stock, ultimately raising living standards. But, as it is well known in practice, sharp increases in capital inflows have often been associated with misdirected credit, absorption as consumption instead of investment, price and asset inflation, and deteriorating competitiveness[12].

Due to their large external financial needs, the SEE countries have been among the most exposed to the global credit crunch. FDI and other forms of foreign investment, in most of the countries in the year 2009 started

[11] European Commission (2009)
[12] Obstfeld and Rogoff (1996)

to dry up and the financial and non-financial private sectors encountered difficulties in servicing their external debts. Some countries started to use part of their official foreign exchange reserves in order to meet external financing requirements.

But, fortunately, capital flows appear to have been more stable in the Western Balkans than in many other Emerging European economies in the postcrisis period. FDI continued to flow in, albeit at a lower level, and portfolio and other inflows remained positive and substantial as well[13].

4. EVALUATION OF TRANSITION PROCESSES THROUGH TRANSITION INDICATORS

Although the transition from socialism to capitalism was less smooth for the Western Balkan countries than for the other parts of Emerging Europe, they made very big progress in the period from the year 2000 onwards. The level of progress achieved in various aspects of transition is quantified by using EBRD transition indicators. The indicators are measured on a scale from 1 to 4, where 1 represents little or no progress in reform and 4 means that a country has made significant progress in a particular aspect of a transition[14].

The process of transition was not uniform across the region, because the starting positions were very different. For example Albania, started the transition process as an isolated and autarkic state with virtually no elements of a market economy.

Despite a difficult decade in the 90s, by the year 2000 the Western Balkans as a group had reached advanced stage of transition, measured on average by a value of 4.1 in the area of price liberalization, 4.2 in the area of trade and foreign exchange, 3.78 in the area small-scale privatization in the year 2014. However, reforms, such as large-scale privatization, competition policy and governance and enterprise restructuring were delayed, and were measured on average 3.28; 2.53 and 2.48 accordingly, in the year 2014.

[13] Zugic, (2011)
[14] EBRD (2015)

Table 3. Transition indicator scores in WB in 2000 and 2014

	Large Scale privatisation		Small scale privatisation		Governance & enterprise restructuring		Price liberalisation		Trade & Forex system		Competition Policy	
	2000	2014	2000	2014	2000	2014	2000	2014	2000	2014	2000	2014
Macedonia	3,0	3,3	4,0	4,0	2,3	2,7	4,0	4,3	4,0	4,3	2,0	2,7
Serbia	1,0	2,7	3,0	3,7	1,0	2,3	2,3	4,0	1,0	4,0	1,0	2,3
Montenegro	1,7	3,3	2,0	3,7	1,0	2,3	3,7	4,0	2,3	4,3	1,0	2,3
Bosnia and Herzegovina	2,0	3,0	2,3	3,0	1,7	2,0	4,0	4,0	3,0	4,0	1,0	2,3
Croatia	3,0	3,7	4,3	4,3	2,7	3,3	4,0	4,0	4,3	4,3	2,3	3,3
Albania	2,7	3,7	4,0	4,0	2,0	2,3	4,3	4,3	4,3	4,3	1,7	2,3

Source: European Bank for Reconstruction and Development, database on Transition Indicators[15]

Table 4. Transition development snapshots in WB

	Current account convertibility	Controls on inward direct investment	Interest rate liberalization	Wage regulation	Tradability of land
Macedonia	full	yes	full	no	limited de jure
Serbia	full	no	full	no	limited de jure
Montenegro	full	no	full	no	limited de jure
Bosnia and Herzegovina	full	yes	full	no	no
Croatia	full	no	full	no	full
Albania	full	no	full	no	limited de facto

Source: European Bank for Reconstruction and Development, database on Transition Indicators[16]

According to the transition indicators presented in the previous tables, we can notice that Croatia is the most advanced country, while all other countries are more or less at the same level of achievement.

If we analyzed these countries as a whole, we can notice that they fulfill criteria regarding convertibility of current account and interest rates liberalization, and they have removed wage regulation. All countries except

15 http://www.ebrd.com/what-we-do/economic-research-and-data/data.html
16 http://www.ebrd.com/what-we-do/economic-research-and-data/data.html

Macedonia[17] and Bosnia and Herzegovina[18] have removed controls on inward direct investment. All WB countries have de facto limited tradability of land, except Bosnia and Herzegovina. In Croatia, the land is tradable, but the right to trade land applies to foreigners only on the basis of reciprocity[19].

The biggest progress is made in the area of price liberalization and foreign trade exchange system. All countries have successfully implemented price liberalization and have opened up their economies through reforms of the foreign trade regime.

The progress in large-scale privatizations was uneven across the region. While many WB countries had already initiated these privatizations in the late 1990s and early 2000s, Bosnia and Herzegovina, Serbia, and Montenegro joined the process at later stages. Albania and Croatia are the most privatized WB economies, measured with the score of 3.7 in 2014, while the private sector has grown the least in Serbia and Bosnia and Herzegovina. In many cases, enterprises were sold at privileged conditions to employed workers and managers, rather than outside owners or foreign investors.

Although, the most SEE countries have reduced subsidies to large non-privatized enterprises and have adopted laws promoting competition, monopolistic structures continue to dominate in a number of sectors. As a result, in the area of competition policy, all countries except Croatia were evaluated in 2014 with a score of 2.3 and Macedonia with a score of 2.7.

Taking all this into account, the Western Balkans still lag far behind the EU and New Member States in the process of economic reforms. Corporate governance and enterprise restructuring of former state-owned enterprises remained a challenge across the region.

Conclusion

The transition from socialism to capitalism in the Western Balkan countries was less smooth than in the other parts of Emerging Europe, which transitioned peacefully into market economies. Unlike them, many WB countries in the 90s coped with wars, civil unrests, international sanctions and blockades. Due to this, WB countries face the risk of permanent

17 There are controls on arms productions, trade in narcotics, historical and cultural heritage
18 There are restriction on the production and sale of arms, ammunition and military
19 EBRD (2015)

marginalisation on the periphery of Europe. The region suffers from low investment, high unemployment rate, weak and fragile growth.

However, in the period from 2000 onwards, these countries made radical political changes and economic reforms: they opened up to global trade, became increasingly export-oriented, expanded the role of the private sector, rapidly adopted modern banking systems and began to build institutions needed to support market system.

In all WB countries except in Serbia, the inflation in the last 15 years has been very low, which is very big achievement taking into account the history of hyperinflation, at the beginning of the transition. Low and stable inflation was achieved by stabilizing or fixing the exchange rate. But, even though exchange rate targeting succeeded in accomplishing price stability in a longer period of time, it has not corresponded to some faster economic growth of these countries.

The WB countries experienced strong growth especially before the global financial crisis. The improved performance in the period from 2001-08 was driven by unsustainable inflows in the years before the crisis, not by real progress in economic reform. However, high GDP growth rates in most countries have been insufficient to alleviate the problem of high unemployment rates, which are the highest in Europe.

As the WB countries transitioned toward market-based systems, economies have become increasingly export-oriented. WB countries' exports have been growing since the year 2001. However, imports have grown faster, inducing rising foreign trade deficits, which were covered by continuous inflows of capital from abroad, especially foreign investment. After the year 2000, foreign investors have become increasingly interested in the WB region, due to many factors, such as: stabilisation of the region from 2000 onwards, improvement of regulatory and structural reforms, the prospect of EU accession, fall in the interest rates in Western Europe with the introduction of the euro etc.

By the year 2000, the Western Balkans countries has reached advanced stage of transition in the area of price liberalization, trade and foreign exchange and small-scale privatization. They also fulfilled the criteria regarding convertibility of current account and interest rates liberalization. However, reforms, such as large-scale privatization, competition policy and governance and enterprise restructuring have still been delayed.

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