Which development model for the Balkans?
Reflections on the twenty years of transition (1989-2009)

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1.Introduction

The paper reflects upon the transition to a market economy in the Balkans over the last twenty years. The narrow definition of the Balkans, often referred to as the Western Balkans or South Eastern Europe (SEE) will be used, which until recently included five countries – Albania, Bosnia-Herzegovina, Croatia, Macedonia and FR Yugoslavia (Montenegro, Serbia, Kosovo). Today, after the split between Montenegro and Serbia in June 2006 and the February 2008 unilateral proclamation of Kosovo independence, the Balkan region includes seven countries. The paper will start by giving a general assessment of the achievements and failures of the twenty years of transition; next, it will discuss the effects of the global economic crisis on the Balkan countries; and finally, it will make a few remarks about the future, particularly regarding the development model.

2. Transition in the Balkans

The transition to a market economy in the Balkan region also started in 1989-90, with the first multiparty elections and radical economic reforms launched by the last Yugoslav government of Ante Markovic, and similar systemic changes a year later in Albania. However, the process was interrupted by the disintegration of Yugoslavia in June 1991, which was accompanied by a very severe political crisis and continuous economic instability. On the political front, the region has experienced five military conflicts from 1991 onwards – in chronological order in Slovenia, Croatia, Bosnia, Kosovo, and Macedonia. Authoritarian regimes and priority of political over economic objectives have clearly delayed transition-related economic reforms. On the economic front, some Balkan countries have had hyperinflations which are among world historical records, and all have gone through a very deep recession in the early 1990s, much more profound than the Central-East European (CEE) countries. Under the exceptionally unfavourable conditions that prevailed in the 1990s, transition-related reforms have proceeded at a slower pace in most countries than in CEE. Political and economic instability has also impeded closer links with the European Union (EU), so the process of Balkan – EU integration had been delayed for a whole decade (see Uvalic, 2010a).

The general political climate began improving for most Balkan countries only after the end of the Kosovo war in mid-1999, when there was a radical change in the international strategy toward the region. The change in the international strategy was greatly facilitated by important political changes in two key countries in 2000, in Croatia after the death of president Tudjman and in Serbia after the fall of the Milosevic regime. The European Union (EU) launched its Stabilization and Association Process specifically for the Western Balkan countries, which provided a major programme of financial assistance (the CARDS programme), liberalization of trade, and the possibility of concluding association agreements with the EU, with prospects of entry into the EU at some point in the future. Parallel with these measures of the EU, the Stability Pact for Southeast Europe (SEE) was also created, with the aim of mobilizing international financial assistance for all countries in the SEE region that were negatively affected by the 1999 Kosovo conflict - thus in addition to the Western Balkans, also Bulgaria and Romania. The Stability Pact for SEE has organized several donors conferences and many usefully regional initiatives. More recently, with the aim of having responsibilities of the Stability Pact's activities return to the region, in this way ensuring "policy ownership", the Pact has been transformed into the Regional Cooperation Council with headquarters based in Sarajevo.

From 2000 onwards, improvements in economic performance have taken place also in countries like FR Yugoslavia (Serbia and Montenegro) or Bosnia-Herzegovina, that were among the worst performers in the 1990s. Transition-related economic reforms have accelerated, while political and economic relations with the European Union have been fully established with all countries, including FR Yugoslavia. Regarding macroeconomic stabilization, during the 2001-08 period the Balkan countries have reduced their inflation rates to around or below 10 per cent, and there has also been some fiscal consolidation characterized by declining fiscal deficits, even occasional surpluses. Since 2001, most Balkan countries have experienced strong growth; the only exceptions are Macedonia that had negative growth in 2001 due to the civil war, and Kosovo that occasionally has had negative growth rates due to its still fragile economic situation. We have also seen increasing Foreign Direct Investment (FDI), which during the 1990s went almost exclusively towards Croatia. After 2001, along with Croatia, Serbia has also attracted substantial FDI, especially after 2003. FDI arrived later to the Balkans than to the CEE region, and has also had somewhat different characteristics. The dominant part of FDI has been in services, including banking, telecommunication, trade and real estate, while relatively little has been invested in manufacturing industry. Moreover, total FDI towards the Western Balkans has been relatively low in recent years, if compared to FDI in Bulgaria and Romania, or the much higher amounts invested in other regions, like CEE or the Community of Independent States (see Figure 1).

Figure 1 around here (FDI)

Regarding transition-related economic and institutional reforms, we can observe major institutional convergence over the last ten years of the Balkan countries, in the direction of functional market economies. Even countries that in the 1990s were lagging behind have accelerated the process of institutional change, judging from the transition indicators of the European Bank for Reconstruction and Development (see Figure 2). The transition indicators measure progress in 9 main areas of reform in EBRD's 29 client countries, through scores that go from 1 (no or little reforms) to 4+ (comparable to a developed market economy). There are four main areas where relatively little progress has been achieved, although Croatia and Macedonia are in a somewhat better position than the others: enterprise governance and restructuring; competition policy; the development of securities markets; and infrastructure (but this is an area where other transition countries have also progressed relatively slowly).

Figure 2 (Transition indicators)

There are also a number of other problems that need to be stressed. The first is extremely widespread unemployment, as the Balkan countries have the highest unemployment rates in Europe. Bosnia has an unemployment rate close to 30%, Macedonia over 35%, Kosovo as high as 45%. The global economic crisis has led to a sharp rise in unemployment even in countries that had relatively low rates, such as Croatia. Although a significant part of the labour force in all Balkan countries has an activity in the informal economy, the dimension of unemployment in the region is still alarming (see Bartlett, 2009).

The second problem concerns the present level of development. The differences within the region are quite remarkable, if we compare the level of GDP per capita in Kosovo with that in Croatia. The process of pre-1989 recovery has been very slow for most countries, after the very severe recession after Yugoslavia's break-up and the return of negative growth rates also in the second half of the 1990s (Uvalic, 2010b). If we compare the Balkan countries real GDP in 2008 with the level in 1989, we see that several countries have still not reached GDP produced almost twenty years back (see Figure 3). Albania is in the best situation, since it started from a very low base and was the first to reach the level of GDP produced in 1989. Croatia and Macedonia have overcome the level of 1989 GDP only recently, while Montenegro, Bosnia-Herzegovina and Serbia are still below the 1989 level of production. In 2010, Serbia was in the worst situation, being at only 70% of its 1989 GDP. [1]

Figure 3 around here (GDP 1989-2008)

Another major problem are huge external imbalances. This is one of the main reasons why the Balkans have been severely hit by the global financial and economic crisis of 2008-09 (see Prica and Uvalic, 2009). In recent years, the Balkan countries have registered increasing current account deficits (see Figure 4), which until the outbreak of the crisis were covered by increasing inflows of FDI, foreign loans, donors assistance, emigrants remittances. These large current account deficits have been primarily caused by the increasing imbalances on the trade account. Despite the increase in trade volumes, the Balkan countries have been having increasing trade deficits in recent years since imports have grown much faster than exports. Limited competiveness of Balkan products on foreign markets is the consequence of both insufficiently restructured industries and policies of strong national currencies.

Figure 4 around here (Current Account deficits)

In the meantime, all Balkan countries have borrowed heavily on external markets, so their external debt today is particularly high, especially in the case of Croatia and Serbia (see Figure 5). If we consider external debt in percentage of exports of goods and services, we see that in 2008, in both Croatia and Serbia, it was close to 200%. There is a also the problem of aid-dependency, particularly in Bosnia-Herzegovina and Kosovo.

Figure 5 around here (Foreign debt)

Another problem is the limited microeconomic and macroeconomic restructuring of the Balkan economies. In the 1990s, restructuring of many enterprises was postponed due to delays in privatization, lack of FDI, and the highly unfavourable general economic conditions in most countries. Whereas in CEE many industries have been modernized thanks to investment by multinationals from Western Europe, in the Balkans this has happened much less frequently. In recent years the Balkan countries have registered very high growth rates primarily in services, but not in the manufacturing industry or agriculture. This also explains the very poor export performance of most Balkan countries.

[1] This may be an exaggeration because the statistics on growth rates from the early 1990s for the Balkan countries may be imprecise, but the reported EBRD data are the only comparable statistics that are available.

3.Effects of the global economic crisis

The global financial and economic crisis of 2008-09 hit the Balkan countries in the last quarter of 2008, when there was a rapid deterioration of most macroeconomic indicators. In 2009, all countries except Albania registered negative GDP growth (see Figure 5). Recovery is on its way in 2010, partly of a consequence of economic recovery in the European Union, though according to recent EBRD forecasts growth is to remain sluggish, not higher than 2%. The Balkan countries were badly affected by the global economic crisis and a few, like Serbia and Bosnia, turned to the IMF for additional finance.

Figure 6 (GDP growth)

The global financial and economic crisis was transmitted to the Balkan countries (like to most CEE countries) through the financial sector, where there was a sharp reduction of all forms of foreign capital inflows (FDI, foreign loans, remittances); and through the real sector, where there was a strong fall in export demand in the EU as their main trading partner (see Nuti, 2009, Prica and Uvalic, 2009).

The sharp reduction of capital inflows to the Balkans can be illustrated by the significant fall in FDI (see Figure 7). FDI has fallen remarkably, by some 40-60% from 2007 onwards in all Balkan countries, even those that have so far attracted the largest part of foreign investment, like Croatia and Serbia. Reduced investment will have longer-term implications, as in the future the Balkan countries will have to rely much more on domestic sources of finance.

Figure 7 (Declining FDI)

Regarding the impact of the global crisis on the real sector, although the Balkan countries have become more integrated with the EU economy, they are still less open than most CEE economies. If we consider a standard measure of a country's economic openness – the exports/GDP ratio – we see that even in the case of Macedonia and Croatia, as the more open countries, export of goods and services still represents a relatively low percentage of their GDP. All the other Balkan countries are still quite closed economies. This factor explains why some of the CEE countries were more affected by the global crisis than most Balkan countries. A recent econometric study on the Western Balkans confirms that those countries that were more integrated into the global economy have also been more severely hit by the global crisis, as it established unidirectional causality between export performance and domestic economic activity (see Jovicic, 2010).

An additional factor of vulnerability, specific to Eastern Europe, regards the banking sector. Similar to what happened in CEE, during the process of privatization the Balkans have also sold their banks to foreign (mainly EU) banks, so today 75-98% of banking assets are owned by western multinational banks (see Figure 8). With the outburst of the global economic crisis, these EU banks have naturally become vulnerable to the worsening credit conditions in their home countries, and have reduced credits to local clients in the Balkans.

Figure 8 (Banking assets)

The process of globalization of financial markets has stimulated cross-border borrowing by firms from the Balkans directly from western banks, which has additionally increased overall private sector debt. Before the global crisis, foreign banks lending policies have typically been based on easy credit to both households and enterprises, which has led to a credit boom in practically all Balkan countries. As illustrated by Figure 9, the credit boom was particularly pronounced in Montenegro, Croatia and Bosnia-Herzegovina, much less in Macedonia, Albania and Serbia.

Figure 9 (Credit expansion)

Bank loans were frequently denominated in foreign currency; in Croatia and Serbia, such loans represented around 60% of the total. In those countries that have flexible exchange rate regimes, the crisis provoked the depreciation of national currencies which brought an increasing number of non-performing loans and credit defaults. For example, the Serbian Dinar has depreciated vis-à-vis the euro by some 18% from September 2008 until August 2010 (see FREN 2010). The exchange rate of the Croatian Kuna, on the contrary, has been maintained stable by continuous interventions of the central bank on the foreign exchange market, which so far have been successful. Adjustments have been more difficult in countries with rigid exchange rate regimes, like Kosovo and Montenegro that both use the Euro, or Bosnia-Herzegovina that has a currency board.

There are several factors which helped attenuate the effects of the global crisis in the Balkans. First, international finance made available to the Balkan countries has been quite important, primarily support of the IMF through a stand-by arrangement concluded with Serbia and Bosnia-Herzegovina. Other international institutions have also helped the Balkans, including the EBRD, the European Investment Bank and the European Commission. The second factor is the initiative sponsored by the IMF and the EBRD, the so-called Vienna initiative, which led to an informal agreement with the western banks operating in the region not to reduce capital exposure, which effectively prevented major capital withdraws. Third, the Balkans have less developed financial markets than the CEE countries; although this is clearly a general disadvantage, it may have been an advantage not to have had the widespread use of sophisticated financial instruments when the global crisis exploded. Finally, there were two additional financial buffers that helped the population in most Balkan countries: remittances fell much less than initially expected (in Serbia they even increased in 2009); and savings “under mattresses” held outside the banking system (in Serbia they amounted to about € 3 billion or about 9% of its GDP).

4. Future challenges

Since Eastern Europe was one of the regions that was most severely affected by the global financial and economic crisis of 2008-10, the crisis has raised many questions regarding the growth model applied during the last twenty years (see Nuti, 2009). Within this debate, the growth model applied in the Balkan countries is also been reconsidered, particularly since they have generally made less progress than the CEE countries.

Despite varieties of transition strategies and differences in the sequencing of reforms, post-communist countries have most frequently applied economic and institutional reforms that were in line with the main prescriptions of the so-called “Washington consensus”. In the majority of cases they have applied fast trade opening, financial liberalization allowing free capital inflows, deregulation, weak social protection, and quick privatization of previously state-owned/public enterprises. The global crisis has pointed to some of the structural weaknesses of the growth model applied in Eastern Europe, including most Balkan economies, due to its emphasis on credit-driven growth and the resulting high dependence on foreign capital inflows. However, the global crisis has also brought to the surface more general flaws of the transition strategy applied in the Balkan countries. Many economic problems were accumulating and were becoming unsustainable: consumption much higher than production, increasing current account deficits, very high and rising unemployment, slow growth of the private sector, excessive expansion of services. It is therefore important to reconsider not only the growth model applied so far, but also the target model, namely the model of an idealized market economy. Does the model need to change, and if so, in which direction?

Drawing a balance on the successes and failures of twenty years of transition, there is no doubt that some important achievements must be preserved. This is the case with price stability. Recalling the dramatic consequences of extremely high inflation rates and record hyperinflations of the early 1990s in the Balkans, macroeconomic stability is an extremely important achievement which must be maintained. Some other policy choices are irreversible, as for example the decision to sell the entire banking sector to foreign Western banks; here measures ought to be taken to establish more prudent supervision of the financial sector, as is being done in the developed market economies. Regarding the model of growth, further integration into the global economy through increasing trade is desirable for the Balkans also in the future in order to further enhance export-led growth, but trade liberalization should also be done prudently and does not require zero tariffs in all sectors – for example in agriculture, as one of the main sectors where most Balkan countries have a comparative advantage (also following the example of the EU that has maintained three-digit tariffs on products such as sugar). Regarding financial liberalization, in the Balkans the process has probably gone too fast, since financial liberalization ought to be in line with the development of financial markets (again following the example of the EU experience, where controls on capital flows were definitely removed only in 1992).

The Balkan countries also need to strengthen the role of the state and improve the quality of governments institutions, in order to facilitate the enforcement of laws, the collection of taxes, the fight against corruption, and the supervision of the financial sector. The key structural deficiency of all Balkan economies is weak export performance, essentially due to the insufficient production of goods at competitive terms for export markets. Many industrial sectors have not been modernized and restructured after the extreme process of deindustrialization of the early 1990s. Due to the recent strong decline in FDI, these countries will have to rely much more on their own resources to finance investment and growth. This is why they need an industrial policy, not to subsidise national champions but to encourage innovation, investment, the protection of quality and technical standards. They need measures that would promote the faster transformation of key industries, enhance enterprise competitiveness, and facilitate deeper industrial restructuring.

Industrial policy also ought to be considered at the regional level, through the creation of concrete networks among the Balkan states. These are small countries that can only gain from trans-national networks in the area of science, R&D, technology, energy, infrastructure, other specific sectors. In line with the long-term objectives in the EU, as specified in the Lisbon and more recently the Europe 2020 strategy, the Balkan countries also need a 2020 strategy that would create new jobs and new employment opportunities, together with increased investment in R&D, human capital, and innovation. The unfortunate events of the 1990s have created an enormous technological gap between the majority of the Balkan countries and the EU, requiring a much faster process of technological catching up.

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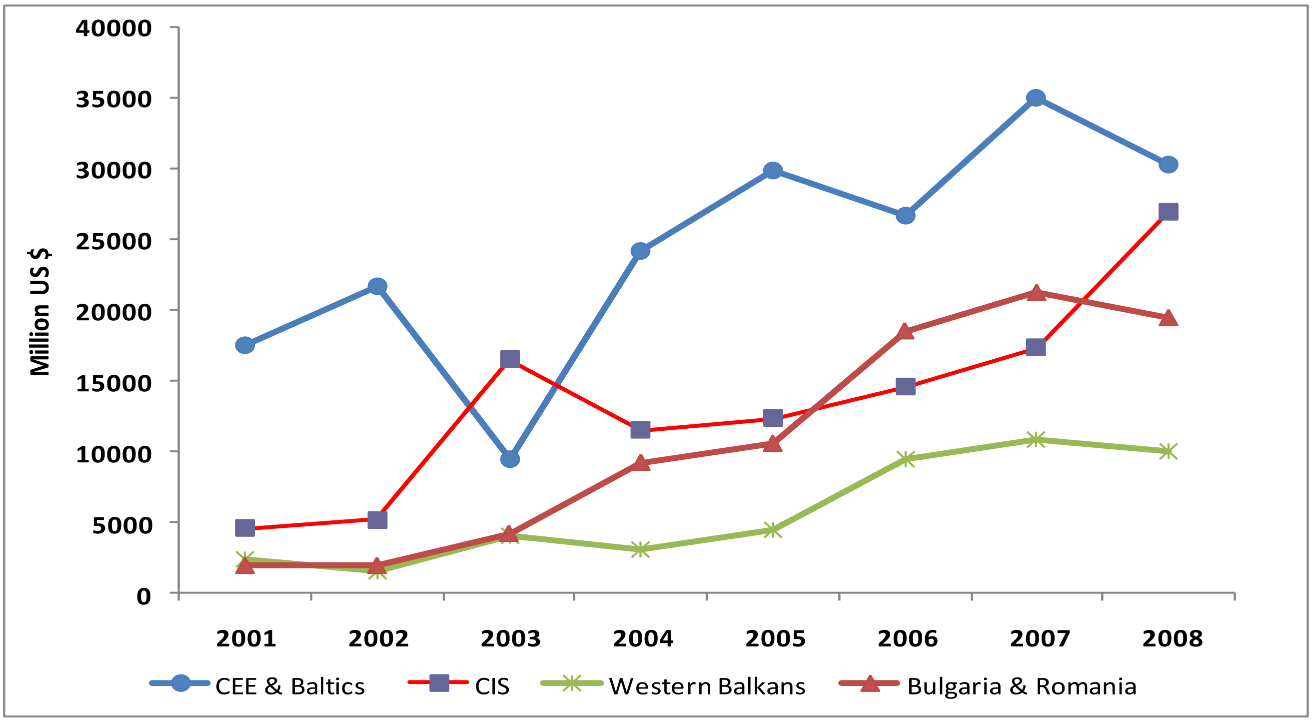
Figure 1. FDI in the transition region, 2001-08 (in million US dollars)



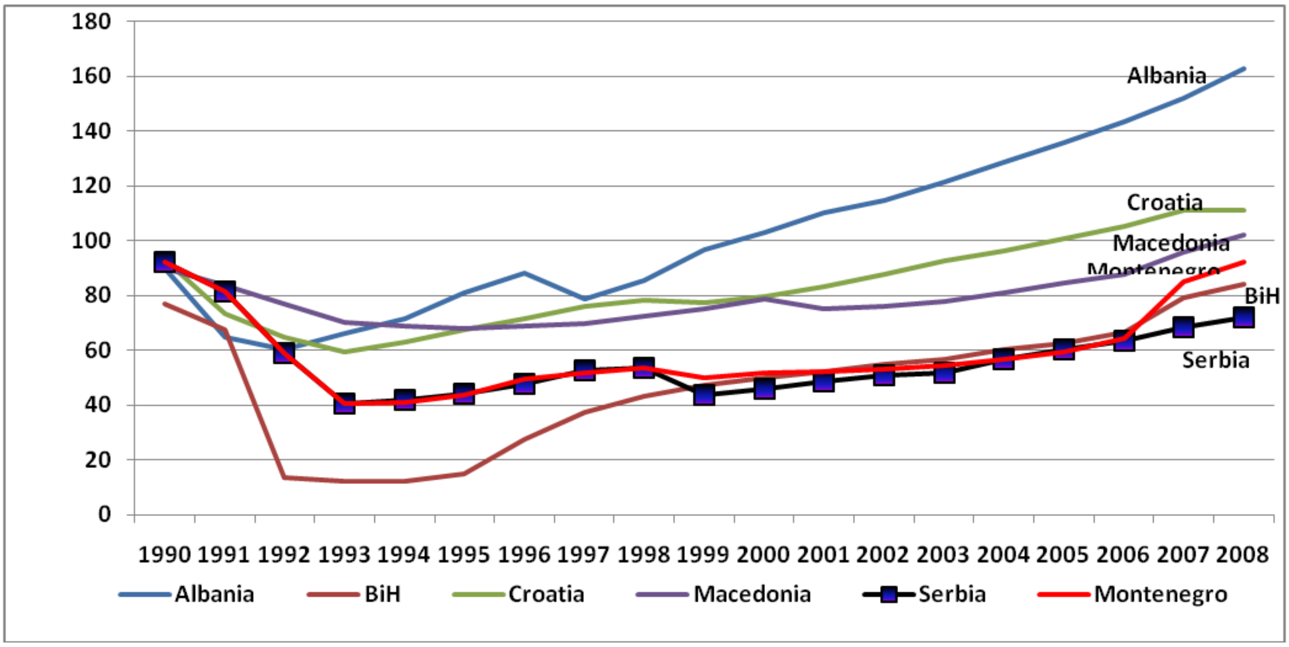
Source: Based on EBRD data.

Figure 2. EBRD transition indicators: scores for the Balkan countries, 2009

		Enterprises			Markets & Trade			Financial institutions		Infrastr-ucture
	Private sector share in GDP	Large-scale privatiz.	Small scale privatiz.	Governance & firm restruct.	Price liberaliz.	Trade & foreign exchange	Compet-ition policy	Banking reforms	Securities markets	Infrastruct. reform
Albania	75	4-	4	2+	4+	4+	2	3	2-	2+
B&H	60	3	3	2	4	4	2	3	2-	2+
Croatia	70	3+	4+	3	4	4+	3	4	3	3
Macedonia	70	3+	4	3-	4+	4+	2+	3	3-	3-
Montenegro	65	3	4-	2	4	4	2	3	2-	2+
Serbia	60	3-	4-	2+	4	4	2	3	2	2+

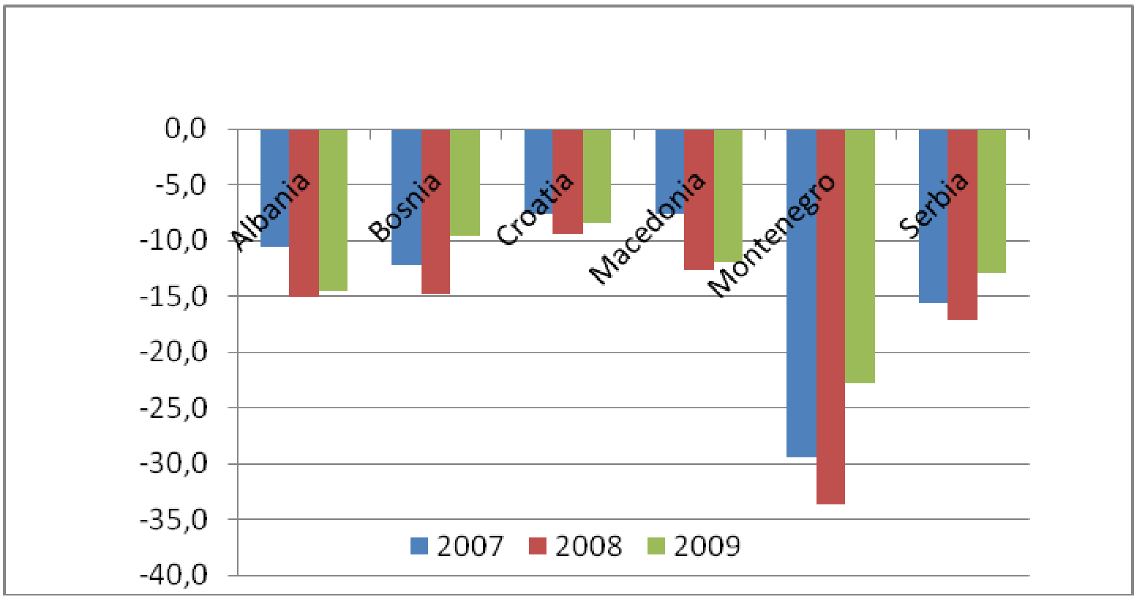
Source: EBRD.

Figure 3. Real GDP growth, 1989 – 2008 (1989= 100)



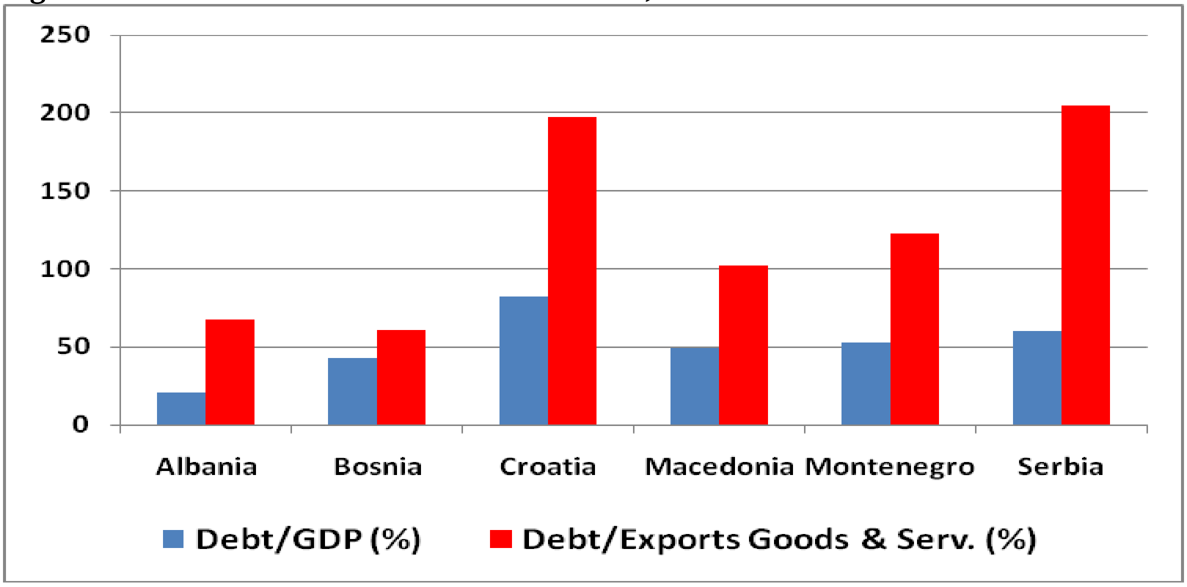
Source: Uvalic (2010b), p. 258, based on EBRD data.

Figure 4.Current account deficits of the Balkan countries (in % of GDP), 2007-09



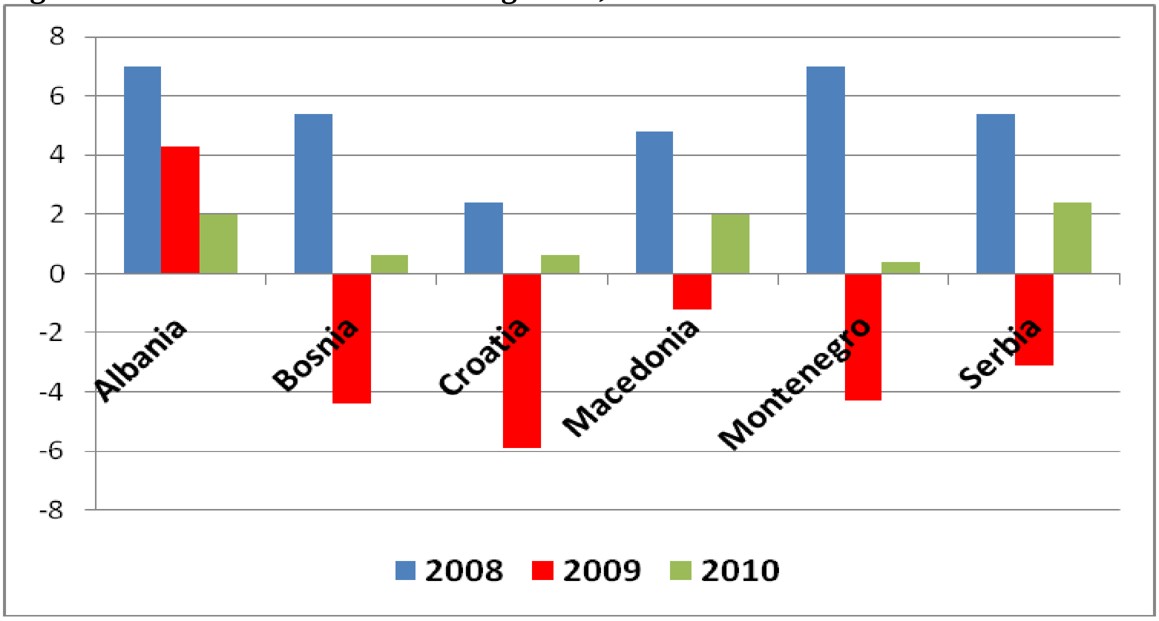
Source: Based on EBRD data.

Figure 5. External debt of the Balkan countries, 2008



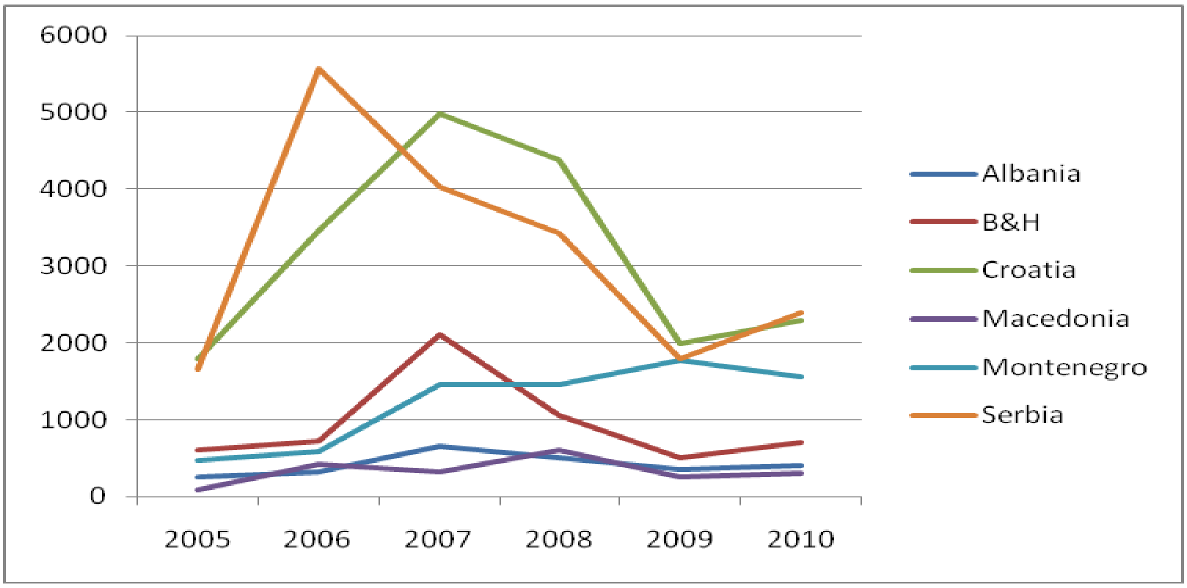
Source: Based on EBRD data.

Figure 6.Balkan countries real GDP growth, 2007-2009



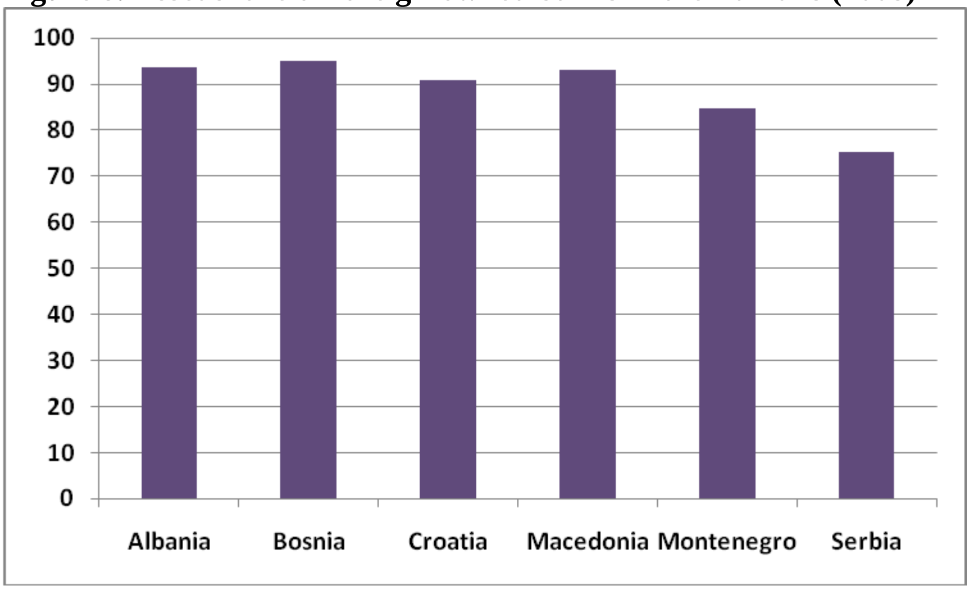
Source: EBRD January 2010 projections.

Figure 7. FDI inflows, 2005-10 (million US$)



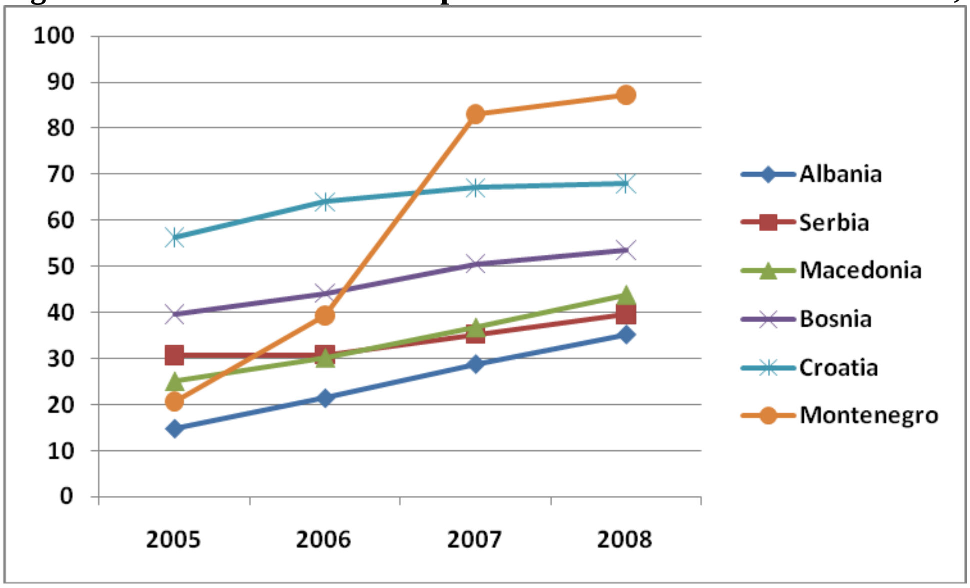
Source: Based on EBRD data.

Figure 8. Asset share of foreign-owned banks in the Balkans (2008)



Source: Based on EBRD data.

Figure 9. Domestic credit to the private sector in the Balkan countries, 2005-08



Source: Based on EBRD data.