



CONVERGENCE OF SOUTH EASTERN EUROPE TO EU: BETWEEN THE DREAM AND THE REALITY



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Most people who were unlucky enough to be born in an underdeveloped economy dream of living in a prosperous, well-governed country. And most want to achieve that by staying in their own country rather than emigrating, unless they lose hope of seeing tangible improvement in their native land during their lifetime. Not surprisingly, the most positive views of the European Union tend to be expressed by those living outside the Union rather than citizens of member countries. For the former, the EU is a symbol of the better life they are striving for and hoping to have.

The Dream

While dreaming about a better life is common around the world, those of us from non-EU countries in south eastern Europe (SEE) can see the reality close at hand – close, but also far away. We can travel to our neighbors in the EU and see for ourselves the higher living standards. Visa-free travel, which came into place almost 10 years ago, has created a very powerful demonstration effect. We recall that at the end of the 1990s we had more or less the same level of living standards as Bulgaria and Romania¹; today they are well ahead of us. Some of us remember that in the 1970s our living standards were similar to those in Greece; now, in spite of all its recent problems, Greece is far ahead of us. People in



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SEE have no doubt what made the difference – not background, mentality and culture, which are all like ours, but the prospects, and then the reality, of joining the EU.

The reality

The high popularity of the EU among ordinary people in SEE has ensured that all major political parties in this region have EU membership near the top of the list of priorities in their manifestos. An accession process that is characterised by strong conditionality is driving reforms in many areas. The prospect of EU membership appears to be a very powerful anchor in the convergence process. The experience of the countries that joined EU in the last 15 years is one of a very intensive convergence process in the few years before and after membership. The legal and institutional adjustments driven by the EU *acquis* strengthen the business environment before accession, while the removal of barriers to trade and the introduction of full capital mobility provide a strong boost once membership is achieved.

In the economics literature there are different types of convergence: nominal, real, structural, legal, institutional, financial, of business cycles, of values etc. The list is not exhaustive. The concept of nominal convergence is probably the best known because of the widespread discussion of this issue during the

creation of the European Monetary Union. Nominal convergence refers to the coming together across countries of variables such as inflation, long-term interest rates, exchange rate stability, budget deficits and government debt-to-GDP ratios. By contrast, real convergence is more to do with living standards of poorer countries catching up with richer ones. It is obvious that real convergence cannot be achieved unless countries with lower living standards have sustainable internal and external balances in the economy, rule of law, good governance and institutions, a sound and competitive financial sector, quality infrastructure, good education and health systems and an adequate social security system.

Neoclassical growth theory predicts that the removal of barriers and reduction of risks will bring capital inflows to economies with lower capital-output ratios and higher marginal products of capital, hence boosting investment and economic growth. Similarly, the elimination of obstacles to mobility allows labour to flow from lower- to higher-wage countries, leading to convergence in the marginal product of [labour](#). It follows that countries that make rapid progress in the rule of law, the creation of sound institutions, good governance, educating skilled labor and building decent infrastructure, will benefit most from free trade and capital mobility within the EU. Real convergence of those countries is not solely in the years immediately before



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and after membership but rather extends over a longer time span, thus reinforcing the process². On the other hand, countries with a weaker institutional and business environment typically experience significant labour outflows to higher wage countries³. This in turn slows down real convergence.

The difficulties experienced in several Eurozone economies after the global financial crisis clearly demonstrated that nominal convergence, although important, should be subordinated to real convergence. In fact, the variables used to measure nominal convergence in the EMU are a logical consequence of real convergence⁴. The creation of a Banking Union, Capital Markets Union, macroeconomic imbalance procedure, two-pack, six-pack and other initiatives is actually strengthening the importance of real convergence for the functioning of the EU and EMU. This evolution implies the need for stricter scrutiny of non-EU SEE countries, which are in the early stages of the EU approximation process⁵. It would require stronger reform efforts of the countries' authorities in transforming their societies and economies in accordance with EU standards.

The way ahead

Harmonisation with the EU *acquis communautaire* is driving structural reforms in non-EU SEE countries. Legal and

institutional convergence should create a good environment for faster real convergence. But the region is still years away from EU membership and one cannot be satisfied with the current pace of real convergence vis-à-vis the EU. The process of real convergence is slow and, since 2010, almost stagnant.

A review of cross-country reform indicators, some of which may be a good proxy measure of convergence, reveals the main weaknesses of the region, but at the same time shows where improvements are most needed. A comparison of the region with Bulgaria and Romania, both relative laggards in reforms on the one side, and the Baltic States on the other, is instructive. It is clear that non-EU SEE countries are close to their EU neighbours – Bulgaria and Romania – in most indicators but lag far behind the Baltic states. For example, the EBRD's Assessment of Transition Qualities, which measures progress across six desirable qualities of a sustainable market economy, point to significant gaps in both governance and competitiveness vis-à-vis the Baltics, but only a small gap when compared with Bulgaria and Romania. The picture is even bleaker when looking at the World Bank's Worldwide Governance Indicators, which measure perceptions of governance, regulatory quality, rule of law, control of corruption, accountability and political stability. While the gap with the neighbours ranges from small to non-existent depending on the indicator, it is wide when compared with the Baltics.



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These findings bring us to an interesting point: harmonisation with the EU acquis is not a panacea that will solve all the problems of countries that aspire to join the club. This point is often neglected by political elites. True harmonisation with the acquis is not just about the formal adoption of appropriate legislation and the creation of institutions, but is rather all about fundamentally transforming the country. A focus on substance rather than form would enhance the real convergence process. Above all, an understanding that the purpose of harmonisation is not to satisfy the European Commission but to improve the well-being of the people is of the utmost importance.

At the risk of being accused of bias, I would argue that the banking sector is one of the rare areas where convergence in the non-EU SEE region is well advanced. This sector has proved to be quite resilient to severe shocks in the last 10 years. Two factors have contributed to this resilience. First, central bank laws have provided and protected the institutional, functional, financial and personal independence of national central banks while keeping them accountable for their work. And second, EU banking groups have become dominant in the ownership structure of the region's banking sectors. This combination has created a synergy in the sector so that its development is driven not by the local political agenda but by global developments. Central banks in non-EU SEE countries have been implementing

the Capital Requirement Directive 4 (an EU version of Basel 3) and the Bank Restructuring and Recovery Directive, although they are not obliged to so do. They are aware that they need to follow best global practice and to provide a level playing field to investors in an increasingly competitive world. On the other side, there are counterparties that are capable of implementing these new requirements because the banking sector is effectively already in the EU.

This example shows that independent and professional institutions are very powerful drivers of real convergence. While one can argue that central banks are specific institutions, lessons learned from their experience can and should be replicated. The most obvious candidate institutions for reform are the judiciary and regulatory agencies, for which independence from politics and their professionalisation would unleash valuable potential in the economy. The process could then be extended to the public administration, which is the largest provider of services to citizens and businesses.



Endnotes

1 - In 2000, GDP per capita at PPP of BG was 24.3% of EU 15, ROM was 22.4%, MK was 23.4% and SRB was 21.8%. In 2016, the situation was very different. GDP per capita at PPP of BG was 44.8% of EU 15, ROM was 54.8%, MK was 34.2% and SRB was 35.8%.

2 - Baltic countries are a good example of this. They are quite advanced in the real convergence while also frontrunners in transition of their economies and societies measured by several composite indicators like EBRD transition indicators, WB governance indicators, TI perception of corruption index.

3 - Bulgaria and Romania are countries with the largest emigration to other EU countries as a proportion of their population while featuring significantly lower on the above mentioned indicators.

4 - Though, as we said above, nominal convergence is also one of the prerequisites for a sustainable real convergence.

5 - Montenegro opened accession negotiations in 2012, Serbia in 2014, while Albania and North Macedonia are expected to open negotiations this year.