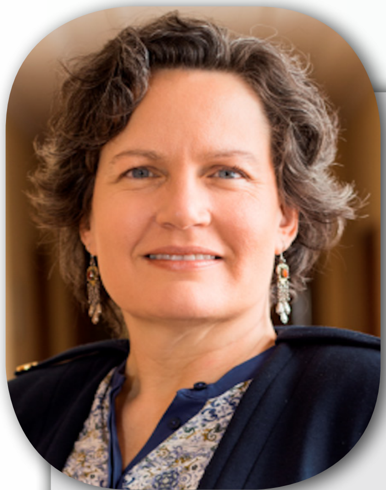
SLOW ECONOMIC CONVERGENCE IN THE WESTERN BALKANS: TIME TO FOCUS ON ECONOMIC STRUCTURE AND POLITICAL ECONOMY



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The slow growth recently exhibited by the western Balkan countries has been attracting attention lately. Should they continue to grow at the rates they have since 2001, it would take them 60 years to converge with the EU. Should they continue to grow at the rates they've managed since the crisis, it would take even longer.[1]

The literature focuses on the need for institutional convergence, which undoubtedly would make a great contribution to the acceleration of growth.[2] The role of economic structure--interpreted broadly, to include available resources, ownership over them, types of economic agents, and sectors of production—tends to get at best an implicit treatment. I take this opportunity to shed light on economic structure because it is of critical importance. First, it sets the limits of possible growth: we do not expect advanced industrial countries to grow very fast despite their generally excellent institutional structures, while some countries with unimpressive institutions still do manage to attain impressive results. Second, it determines the political economy that encourages or blocks institutional reform.

In today's new member states (NMS), the European idea, aided with a credible membership prospect and buoyant capital inflows was able to effect near miracles. However, in their cases, deep change started during the political economic flux of early transition. In the western Balkans, I argue, several factors conspired to slow down structural change following the end of conflict. This entrenched a political economy of status quo that has further generated a vicious cycle, preventing the institutional changes that could have accelerated economic structural transformation and growth. A new economy has been emerging nevertheless, only gradually, on the ashes of the gradually dispersing traditional one. This new economy may hold the key to breaking the deadlock, and it is reaching a significant size. I believe we can and we must invest the necessary thought and effort to ensure this new economy is more directly helped to grow, and thus ensure that further structural change takes the western Balkans towards economic and institutional convergence. This analysis refers to Serbia, but its core applies to other western Balkans countries —particularly the former Yugoslav ones— as well.

Early Hopes and Outcomes

We are now accustomed to thinking of the western Balkan countries as laggards, but this is not what we expected at the turn of the 2000s. During the negotiations of the first stand-by arrangement with the IMF after Milošević's fall in 2001, we deliberated about what economic growth rates to project for the medium-term. We were cautious. On the one hand, post-conflict economies that return to the embrace of international markets tend to recover very quickly. We were, however, concerned that FDI may not flow quickly since our eastern neighbours seemed to be absorbing so much. Nonetheless, the government was extremely ambitious, arguing that the country would catch up not only in growth but also in reforms—we would learn from others' mistakes.

In the event, our expectations were disappointed. Serbia mostly caught up with other western Balkan states, but the gap with countries that today are members of the EU closed very little if at all, and has been opening again since the global financial crisis. We had underestimated the depth of the destruction wrought by the 1990s and its long-term consequences.

Supply Driven, Private Sector Growth

Serbia's economy did not really recover— it has been gradually rebuilt, but with a substantial and permanent loss in productive capacity. Only a small portion of the economy was privatised (comprising some 5% of today's employment).[3] FDI inflows and domestic SMEs gradually picked up resources from the dissipating traditional economy. The strong growth up to the global financial crisis was generated by unsustainable domestic demand fuelled by foreign credit. Nevertheless, supply-side factors also played an increasing role. With the exception of a dip in 2009, export growth has been steady and faster than in the new Member States, although this has had little overall impact on convergence because exports started from an extremely low level. However, the value of total exports has now surpassed 50% of GDP. Should exports continue growing at such rates, they will start taking the broader economy forward.

The new economy grew following the logic of the steady inflow of FDI, and a rather steady trickle of new SMEs and their growth. Domestic companies, overwhelmingly SMEs, today contribute about a third of the total value of exports, and about half of the employment generated by exporting companies. The dynamics of FDI inflows has been surprisingly similar to those in the new Member States, just with several years' delay and without the peak values that these countries enjoyed in the periods around their accession to the EU. The cumulative annual per capita net inflow of FDI in 2017 (5,600 in constant 2015 dollars) corresponds to the level attained by Bulgaria in 2007 or by the CEE countries, on average, in 2006.

This 'new economy' has created a dynamic and comparatively competitive corporate economic core, but the productive capacity of the economy overall has shrunk and this core is relatively small. A quarter of employment is informal, about two-thirds of which on farms. Total employment itself is among the lowest in Europe (59% of the working age population). The unemployment rate has come down to about 13%, which reflects not only growing employment but also that the fact that the large inactive population is becoming less likely to become reemployed. Contrary to common belief, the public administration is not large, but the powerful public utilities comprise a disproportionate 12% of total employment, putting a heavy drag on productivity.

A Political Economy of Status Quo

This slow-changing economic structure spawns a political economy that goes a long way in explaining slow progress in institutional reforms. Despite the aforementioned progress, 45% of the total population older than 18 directly depends on the state for its income (not counting the presumably large portion of their dependents). Pensioners account for over half this figure, with the remainder made up of those who are either directly employment by the state, or who make their living as suppliers to the state. By contrast, those employed in exporting companies—presumably the most independent from political clientelism and directly interested in a healthy business environment— account for only 8% of the adult population. The marginally employed, as well as the unemployed, may equally be interested in reform, or populism.

It is therefore not surprising that Serbia's policies are rarely more than marginal movements around the status quo. This is a population that dreams of Europe but that depends for its daily livelihoods on adjusting to the political leadership of the day. Conversely, politicians depend on this political economy to be elected, a cycle that perpetuates the status quo. This is how, during my second tenure in government while working to reform the public administration and make it more capable of planning and delivering development results, I found little political demand for real 'policy planning', because planning is about change that typically delivers rewards only in the future.

The Lessons

The reconstruction of an economy as deeply destroyed and disoriented would have required a Marshall Plan, with massive funding and close business-to-business cooperation. A series of factors made such support implausible but it did not help that the economic philosophy at the time lay at the other extreme—framed by the Washington Consensus. Significant technical and financial support was given to Djindjic's government to set up a privatization agency that would implement hands-off tenders. Yet, I can think of no support for business-to-business twining, and there was little if any technical assistance to help the government adequately oversee and restructure large bankrupt companies awaiting privatisation. As minister of energy and mining, I readily received assistance for the unbundling of the monolithic electricity system, but not to resolve the fundamental problems the company had accumulated and how it was run. As to the oil company, I could get no assistance at all—the World Bank did not advise on commercial sectors. Of course, one could always hire McKinsey, but we are speaking of a bankrupt, post-conflict government. EU assistance has been generous, but more directed at the establishment of adequate governance systems and less at building management and operational capacity.

Some may point to our central and eastern European and even south east European neighbours to argue that more earnest institutional reform would have generated faster FDI inflows. However, in the more successful cases, early large FDI inflows helped create and maintain the momentum of reform, as well as building strong constituencies for it. Close business-to-business involvement was also not unusual, bringing the process to in fact resemble a Marshal Plan.

What can the EU do?

Looking forward, it is of critical importance to nurture and develop the western Balkan countries' new private sectors. This is vital to institutional reform and economic development. Independent private sectors, preferably export oriented, can be strong constituencies for institutional reform if reasonably competitive and decentralised structures are maintained. They have a vital interest in the development of a conducive business environment that, in turn, would accelerate growth. They can act as an antithesis, an alternative, to dependence on the state and party clientelism.

The EU does much to support private sector development in the western Balkans, but more can be done, more boldly, and better targeted at supporting independent structures. One key step has already been taken by recognising that greater EU involvement in the development of the western Balkans is needed, that the pre-accession process cannot only be about 'strengthening the competitiveness' of already strong economies. Incorporation of the economic reform programs into the Semester process is also welcome. However, competitiveness support is in general delivered through IPA mechanisms that work through government institutions that have limited capacity to deliver.

To provide effective support for private sector development, it is necessary to develop alternative channels of delivery for development assistance. This kind of assistance would meet with and help deliver and multiply the effects of the concessional financing (e.g. from the EDIF and the EBRD). This, however, requires the development of a 'developmental civil society,' which, ironically, has been less developed in the western Balkans than in other transition regions. The capacity to analyse practical economic issues, inside or outside of public institutions, is lower today than it was in the early 2000s. The domestic economy mostly consists of SMEs, yet we know very little about their industrial structure and sectoral challenges. As a result, they typically get a horizontal treatment more appropriate to economies in which the anchors of growth are large companies capable of drawing knowledge from expensive consultancies. Experience shows that SMEs often need technical and financial assistance to foster their growth. Very few programs target individual SMEs to support them to become anchors of growth and those that do, do so very cautiously. In Serbia's burgeoning civil society, few are capable of monitoring economic and business relations. And, finally, there are few civil society organisations capable of implementing development programs, with all the large ones implemented by UN agencies or bilateral partners.

References

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