

Gabrisch, Hubert et al.

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Improving Competitiveness in the Balkan Region – Opportunities and Limits

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Research Report 411

Improving Competitiveness in the Balkan Region – Opportunities and Limits

Hubert Gabrisch (IWH), Doris Hanzl-Weiss, Mario Holzner,
Michael Landesmann, Johannes Pöschl and
Hermine Vidovic



The Vienna Institute for International Economic Studies
Wiener Institut für Internationale Wirtschaftsvergleiche

Improving Competitiveness in the Balkan Region – Opportunities and Limits

HUBERT GABRISCH (IWH)

DORIS HANZL-WEISS

MARIO HOLZNER

MICHAEL LANDESMANN

JOHANNES PÖSCHL

HERMINE VIDOVIC

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Hubert Gabrisch was the former Head of the Research Group Institutional Convergence and National Development Paths in Central and Eastern Europe at the Halle Institute for Economic Research (IWH); his current email-address is: gab@antec-kabel.de, his website: www.hubert-gabrisch.com. Michael Landesmann is Scientific Director of the Vienna Institute for International Economic Studies (wiiw) and Professor of Economics at Johannes Kepler University Linz, Austria. Mario Holzner is Deputy Director of wiiw. Doris Hanzl-Weiss, Johannes Pöschl and Hermine Vidovic are wiiw Research Economists.

This paper is an abridged version of the Report on 'Improving Competitiveness in the Balkan Region – Opportunities and Limits' (in German language) finalised in January 2015 by the Vienna Institute for International Economic Studies (wiiw) and the Halle Institute for Economic Research (IWH) and commissioned by the German Federal Ministry of Finance (Research Project fe 2/13). Thanks are due to the Ministry of Finance for translating the shortened version of the more extensive German text. The full German version was published as wiiw Forschungsbericht No. 3, December 2015.

Executive summary

Most Western Balkan countries have a high and, generally, persistent current account deficit of around 10% of GDP. Any reductions in the current account deficit over recent years occurred mainly due to crisis-related reductions in import demand.

In the average Western Balkan country (as defined by the unweighted average of seven countries, namely Albania, Bosnia and Herzegovina, Croatia, Kosovo, Montenegro, Serbia and the former Yugoslav Republic of Macedonia (hereafter referred to as Macedonia), exports account for no more than 20% of GDP. In the five new EU Member States of Central and Eastern Europe (NMS-5), i.e. Poland, Slovakia, Slovenia, the Czech Republic and Hungary, this ratio is more than three times as high. However, nearly all Western Balkan economies have managed to increase their goods exports as a percentage of GDP, compared with the pre-crisis period.

While the technology-driven sector of machinery and vehicle manufacturing is the backbone of German industry and that of the NMS-5, it is still very small in the Western Balkans. The chemical industry is rather poorly developed, too. Nevertheless, both high-tech sectors have seen an increase in exports recently.

The increase in unit labour costs in relation to the German level, combined with a growing share of exports in the EU market, reflects the higher quality of goods now being exported from most Western Balkan states. Croatia, Serbia, Bosnia and Herzegovina and Macedonia, in particular, are comparatively well integrated into international production networks, whereas Albania, Kosovo and Montenegro continue to be poorly integrated. Around 60% of exports from Western Balkan countries come from low-tech industries. Similar to other Southern European countries in the past, the countries of the Western Balkans have slowly lost their comparative advantages in many of these industries over the past decade. A gradual transition towards a medium-tech industry is both foreseeable and necessary.

The service sector (including construction) is the most important economic sector in all Western Balkan countries. It accounts for 66% of total value added in Serbia and Kosovo and up to 79% in Montenegro, accounting for 60% to 82% of employment. In Croatia, Montenegro and Serbia, some structural imbalances existed before the crisis, with a bias towards construction and non-tradable services.

While the trade balance of Western Balkan countries shows a high deficit, the balance of services is positive. Exports of services are of particular importance in Albania, Croatia and Montenegro thanks to tourism. Free trade in services is promoted under GATS and CEFTA and by closer links with the EU.

For most countries in the region, administrative and technical trade barriers remain an obstacle. The situation in this area is improving as integration into the European Union moves forward. More generally, this also applies to the quality of public institutions in the legislative, judicial and executive branches of government.

While still largely underdeveloped at present, public transport infrastructure has been upgraded notably over recent years, at least with respect to roads. The supply of electricity remains a problem in very limited instances only.

The quality of human capital is generally lower than that of the reference group in the NMS-5. However, a number of statistical trends are pointing towards an improvement. In fact, technical and vocational higher secondary education seems to be more widespread than in the reference group. Yet this does not lead to higher employment of technicians and engineers.

The labour market in the Western Balkan countries is characterised by low participation and employment rates, combined with high and persistent unemployment. Women and young people face particular disadvantages in the labour market. Vocational training is outdated and fails to keep pace with the requirements of today's labour market. Traditionally, migration has helped to mitigate labour market problems in the region, with remittances from migrant workers providing an important source of income. Vocational schools must be upgraded, the training of teachers must be improved, and curricula must be updated in coordination with employers and trade unions. The introduction of a dual system of education and training, for instance, would require political support as well as the willingness of suitable companies to provide such training. Active labour market policies should be intensified and implemented with a clear focus on each target group.

Overall, the labour market is in bad shape, even if the unemployment rate, on average, has remained stable (albeit high) at 23% in the seven Western Balkan countries despite the crisis. This, however, is largely due to stagnant population growth and an ageing population. Apart from widespread migration, insufficient labour market efficiency is also reflected in the high share of employment in subsistence farming and the large numbers of self-employed people. The oversupply of available or precarious labour also explains why employers in the Western Balkans can be relatively flexible in hiring and firing workers. Wage-setting in the Western Balkan countries largely takes place at company level, and relations between employees and employers tend to be confrontational. A higher degree of cooperation between social partners and more centralised wage-setting could lead to a more efficient wage policy and help to improve competitiveness.

While the supply of labour in the Western Balkans is abundant, the supply of financing still appears to be very limited as a result of the crisis. Lending interest rates in real terms are very high, the share of non-performing loans is growing steadily, while growth in bank loans has ground to a halt, thus creating a vicious circle as economic growth remains low.

Regulatory and supervisory authorities in the financial sector have been rather indulgent towards the banks, thus raising their bailout expectations. More resolute action to eliminate options for passive behaviour by banks is urgently needed, including the introduction of higher capital ratios. In addition, it is important to significantly enhance the quality of new loans and to encourage banks to provide financing for innovative projects likely to generate high profits. This includes measures under the so-called Asset Quality Reviews (AQRs) geared towards enhancing the transparency of credit portfolios and involving an assessment of bank assets by supervisors. In this context, it is recommended that countries adopt the standards currently emerging within the EU. For some countries – i.e. Bosnia and Herzegovina, Montenegro and Croatia – the establishment of a bad bank to deal with non-performing loans should be considered, following an effective AQR and independent stress tests.

Net capital inflows have contributed to a real currency appreciation in Western Balkan countries, thus helping to explain the existing current account deficits to a large extent. A floating exchange rate, however, is not the right instrument to avert undesired capital inflows; it is even an obstacle when it comes to expanding exports in the short and medium term. Consequently, Albania and Serbia should consider adopting an intermediate exchange rate system allowing broader fluctuation bands. Broadening the existing bands in Croatia and Macedonia would also help to reduce speculative pressure on the market. The adoption of a national currency would not be recommendable for Kosovo and Montenegro as they are too small to have their own monetary and exchange rate policy and would probably have to pay a high price for protecting their currency against speculative attacks. What we recommend here – just like for the other countries – is to control capital inflows by adopting measures such as using a minimum reserve system and imposing diversified taxes on capital inflows.

As most countries have chosen a fixed peg to the euro or even adopted the euro unilaterally, the short-term option of a substantial nominal depreciation to improve competitiveness is not available in any country of the region. In addition, the high degree of euroisation of loans to private companies and households, together with an increasing external debt in all Western Balkan countries, make stronger depreciations to improve competitiveness even more unlikely. As a substitute for currency depreciation, all Western Balkan states – more or less deliberately – engaged in fiscal depreciation over recent years. Most countries in the region increased VAT rates while reducing income tax rates and social security contributions. Overall, the tax modifications of recent years may have helped to promote import substitution and exports. At the same time, however, they have also increased the burden on low-income groups while providing relief to top earners.

The region has seen an increased use of regional and sectoral structural policies in recent years, including investment promotion, subsidies and tax benefits. It is very difficult, however, to assess the success of such investment policies, at least over the short term. The same is probably true for regulatory policy.

In the long term, however, the prospect of joining the EU should play a major role in helping to improve regulatory frameworks in the Western Balkans on a permanent basis. Strong support from the European Union to the Western Balkan countries in their efforts to strengthen their competitiveness could be mutually beneficial in the long term. However, EU accession alone will not remove all the shortcomings in terms of competitiveness, as the Croatian experience shows.

Keywords: competitiveness, economic policy, non-performing loans, capital inflow, real exchange rate, production networks, trade in goods, trade in services, foreign direct investment, labour market, migration, infrastructure, dual education, fiscal devaluation, Western Balkans

JEL classification: E24, E60, F10, F21, F22, F31, F32, H52, H54, I25, L14, O18, O24

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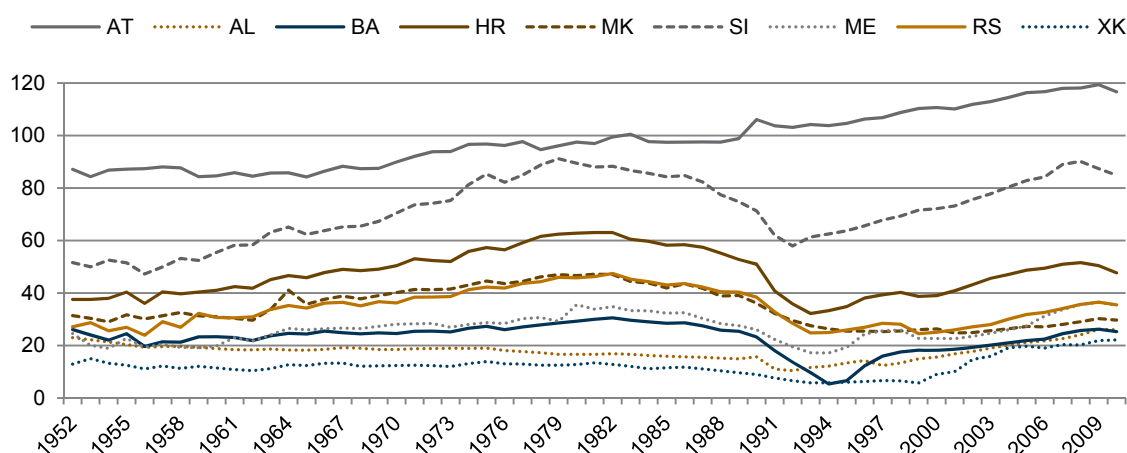
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1. Indicators of competitiveness by regional comparison

One objective of enhancing the competitiveness of an economy should be to increase social wealth to the greatest possible extent. Historically, it appears to be beneficial for an economy to have steady economic growth, together with a current account close to balance, in order to minimise exposure to the extreme volatility of international financial markets. During their eventful past, Western Balkan countries experienced several periods of rapid economic growth, fuelled by debt and followed by equally rapid economic decline once the foreign capital flows dried up. In addition, the economic system of these countries underwent several fundamental transformations. Finally, economic instability contributed to social tension and armed conflict, which, in turn, had far-reaching repercussions on economic development.

Figure 1.1 / GDP per capita at PPPs, in % of the German level (1952-2010)



Source: Maddison Project Database, wiiw Database, own interpolations and extrapolations.

Figure 1.1 shows the long-term development of GDP per capita at purchasing power parities as a percentage of the German level; this serves as a wealth indicator. This comparison is based on the assumption that Germany plays a leading role for the small and open economies of Central, East and Southeast Europe in terms of productivity and technology and is also an important market for these countries, thus providing the setting for their potential economic development. What is remarkable is that over a period of sixty years the average of the seven Western Balkan countries in question, i.e. Albania (AL), Bosnia and Herzegovina (BA), Kosovo (XK), Croatia (HR), Macedonia (MK), Montenegro (ME) and Serbia (RS), improved their wealth, compared to the German level, by only six percentage points, i.e. from slightly more than one quarter to just below one third. In contrast, their neighbouring countries in the North, i.e. Slovenia (SI) and Austria (AT), starting from different positions and taking different paths, made good progress towards Germany in the last 60 years, catching up around 30 percentage points.

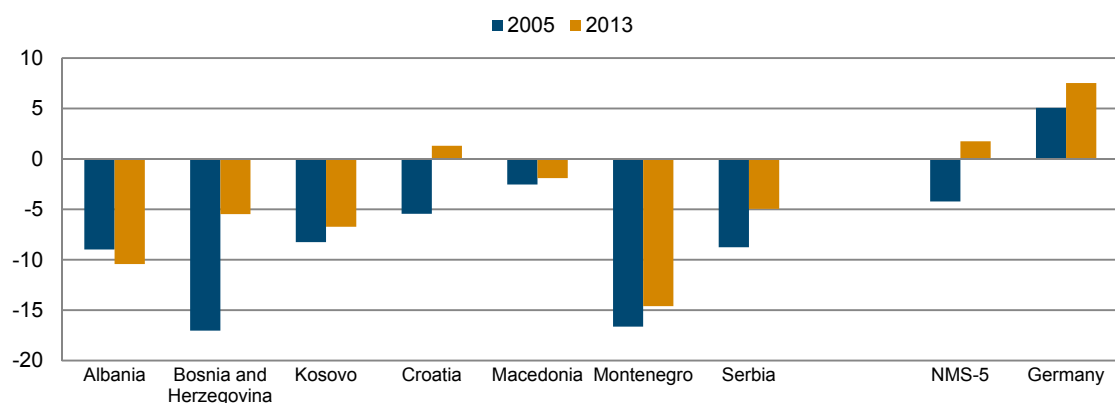
While most Western Balkan countries had a mixed record during the fifties, they saw periods of strong economic growth in the sixties and seventies, albeit increasingly financed by foreign loans. The dramatic increase in interest rates worldwide in the wake of the second oil crisis of 1979 led to a massive rise in external debt and a forced decline in domestic demand to offset the current account balance. The eighties were characterised by constant economic decline in the Western Balkans, resulting in a deep crisis and transformation of the economic system, followed by various armed conflicts and economic collapse in the early nineties. The first decade of the 21st century saw the heyday of financial market liberalisation, flooding the Western Balkans with foreign capital, mostly FDI and cheap credit. The collapse of international financial markets towards the end of the last decade resulted once again in another radical reversal for the Western Balkans.

In this context, it is noteworthy that, generally, the quality of statistics in the Western Balkans has improved significantly over recent years. Enormous efforts have been undertaken to reach Eurostat standards and thus to achieve data comparability. More specifically, major shortcomings persist in some areas of the national accounts system. In most cases, there is no instrument available to measure the income distribution of GDP or to provide input-output-accounts, which would make it possible to calculate gross exports as well as value-added exports, among other things. Moreover, the smaller countries of the region, in particular, are frequently not covered by all the existing rankings and surveys.

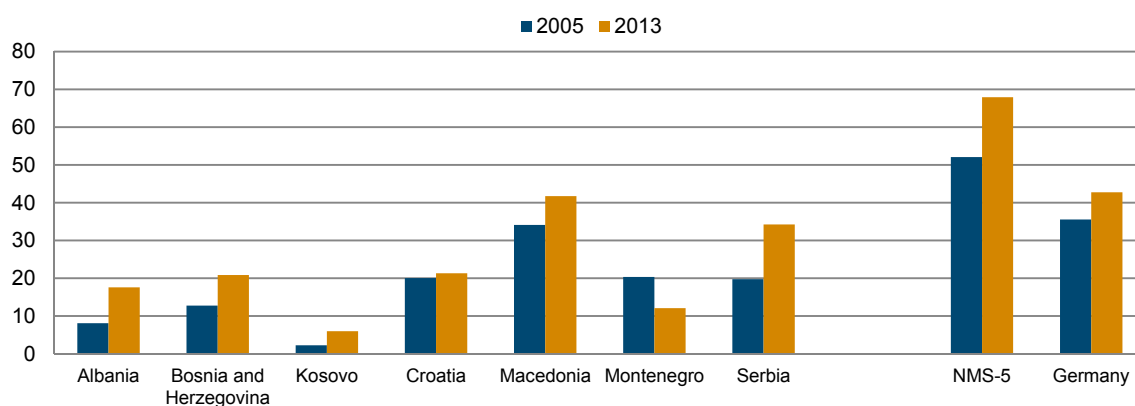
1.1. COMPETITIVENESS IN INTERNATIONAL MARKETS

One of the major indicators to describe the competitiveness of an economy in international markets is the balance of the current account as a share of GDP. A persistent current account deficit tends to go hand in hand with unsustainable external debt, whereas a structural current account surplus usually leads to irrecoverable claims against other countries in the long term. Most countries of the Western Balkans have a high and persistent current account deficit of around 10% of GDP (see Figure 1.2). The only countries that have a slightly lower current account deficit – which was the case even before the global economic crisis – are Macedonia and Croatia. In fact, Croatia even posted a minor current account surplus during the long recession, largely caused by weak import demand.

Figure 1.2 / Current account balance, in % of GDP

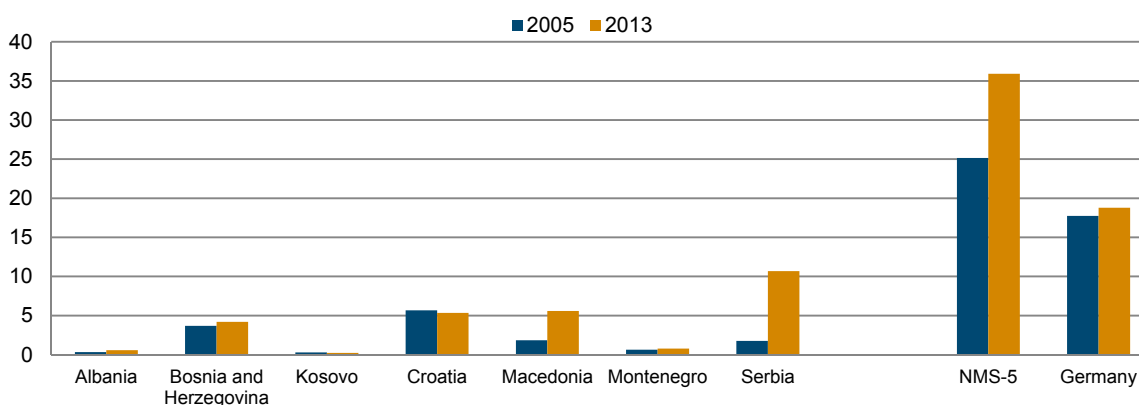


Source: wiiw Database, Eurostat.

Figure 1.3 / Exports of goods, in % of GDP

Source: wiiw Database, Eurostat.

With respect to goods exports, the NMS-5 gained 15 percentage points of GDP in 2013, compared with 2005. With the exception of Montenegro, which experienced a strong decline in the production of its largest export product, i.e. aluminium, as a result of the aluminium price collapse and global overcapacity, all the other Western Balkan countries were able to increase their goods exports in 2013 as a share of GDP compared to 2005, albeit to a much lower extent and at a much lower level than the NMS-5.

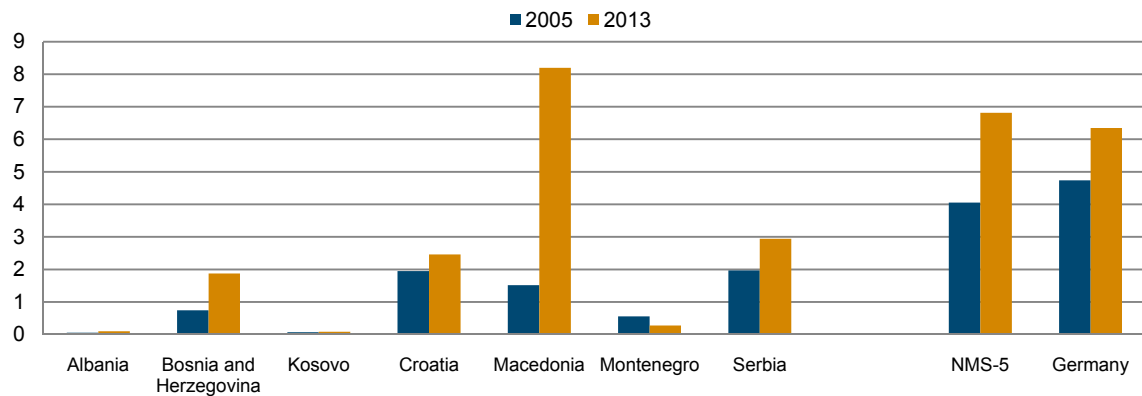
Figure 1.4 / Exports of machinery and vehicles, in % of GDP (SITC 7)

Source: wiiw Database, Eurostat.

While the technology-driven sector of machinery and vehicle manufacturing is the backbone of German industry and that of the NMS-5, it is almost non-existent in the Western Balkans. The only country where the export share of machinery and vehicles as a percentage of GDP has been traditionally higher than 5% is Croatia because of its (technically obsolete) shipyards. Macedonia has reached the same percentage recently as several auto parts manufacturers have set up business there. More recently, it has been joined by Serbia where Fiat started to manufacture Fiat Punto Classic and Fiat 500L cars a few years ago, mainly for the export market.

Another largely technology-driven sector is the production of chemical products, including pharmaceuticals. Again, exports from Western Balkan countries are very small when compared to the NMS-5 or Germany (Figure 1.5). Macedonia was the only country where exports of chemical products, mainly catalytic converters, accounted for more than 8% of GDP.

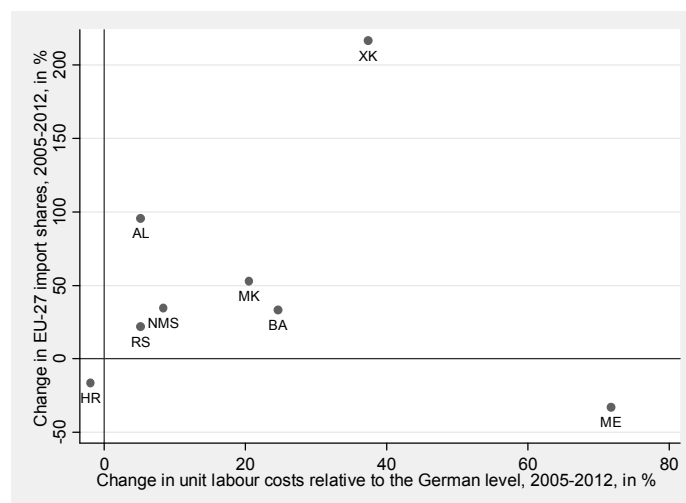
Figure 1.5 / Exports of chemical products, in % of GDP (SITC 5)



Source: wiiw Database, Eurostat.

Overall, exports from Western Balkan countries are small and low-tech, still largely consisting of raw materials, energy, textiles and shoes as well as agricultural goods. Nevertheless, in most countries, there are trends indicating an increase in both the quantity and quality of exports. Most Western Balkan countries show a positive trend with regard to their competitiveness in international markets, including the highly competitive EU market. Montenegro and Croatia are the exception: while the former lost shares in the EU-27 market between 2005 and 2012 because of a strong increase in unit labour costs, the latter equally lost EU market shares, even though unit labour costs (ULC) fell.

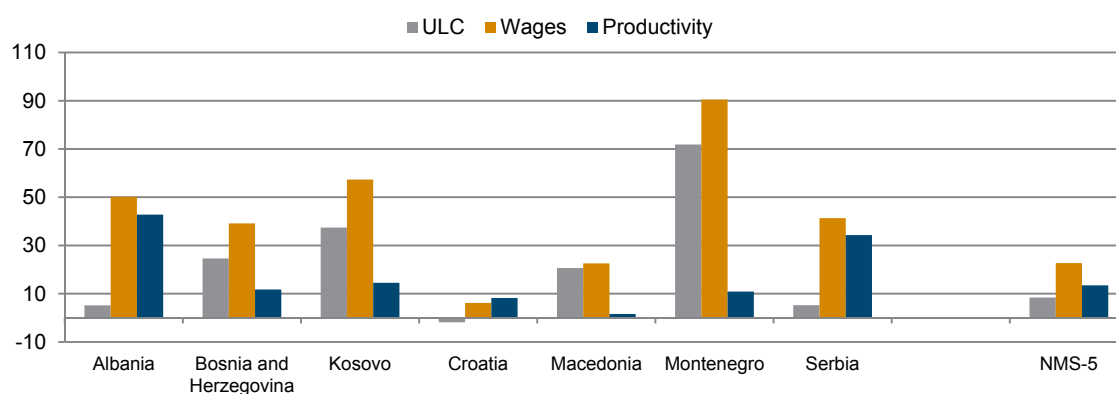
Figure 1.6 / Qualitative upgrading of exports to the EU-27



Source: wiiw Database, Eurostat.

A breakdown of the change in ULC into wage and productivity components reveals that the strong ULC increase in Montenegro was based on the enormous increase in euro-denominated gross wages per employee between 2005 and 2012, while productivity grew at a moderate rate, similar to the NMS-5. The ULC increase in Kosovo, Bosnia-Herzegovina and Macedonia was also above average. Croatia is the only country where ULC went down. This was due to low wage growth resulting from the depression and the fact that productivity growth was equally low but still slightly higher, largely as a consequence of the strong increase in unemployment. Albania and Serbia managed to keep the ULC increase at a moderate pace by increasing productivity significantly, despite rather generous wage increases.

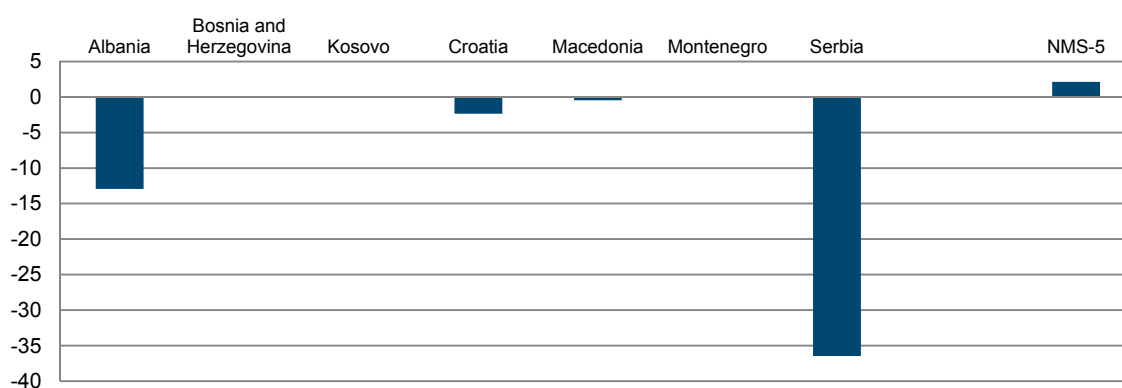
Figure 1.7 / Change in unit labour costs and components relative to Germany, 2005-2012, in %



Source: wiiw Database.

The floating exchange rate system may be one reason why Albania and Serbia, in particular, saw a relative harmonious development of wages and productivity. While both countries were in a position to let their currency depreciate significantly against the euro during the crisis (see Figure 1.8), this option was not available to the other Western Balkan countries, as Kosovo and Montenegro use the euro, while Bosnia-Herzegovina is pegged to the euro through a currency board, and Macedonia and Croatia are keeping the exchange rate de facto fixed to the euro.

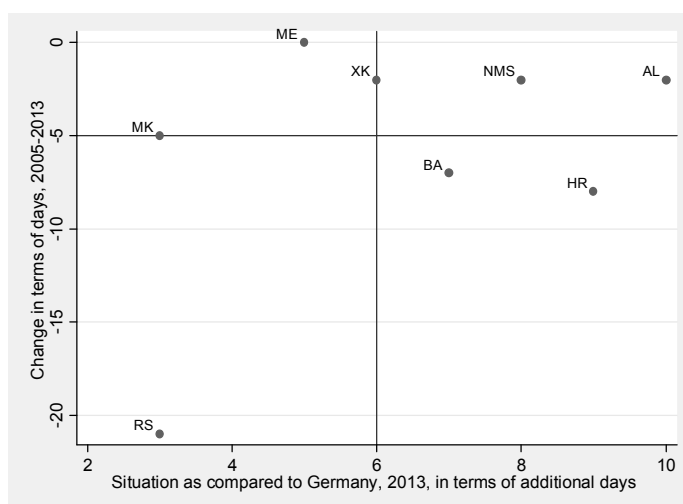
Figure 1.8 / Change in the nominal exchange rate vis-à-vis the euro, 2005-2013, in %, + = appreciation



Source: wiiw Database.

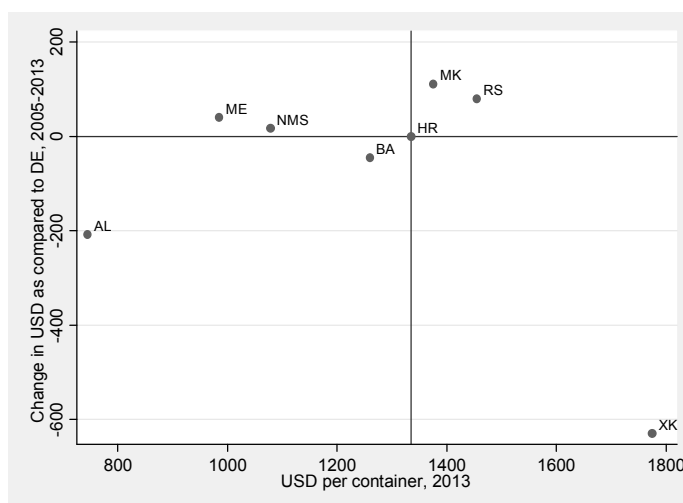
One alternative to a floating exchange rate policy would be an active wage policy. In most cases, this is unlikely to happen as trade unions and employers' associations are poorly organised and the level of cooperation between social partners is generally low.

Figure 1.9 / Time to export



Source: The Doing Business project.

Figure 1.10 / Costs per container for export

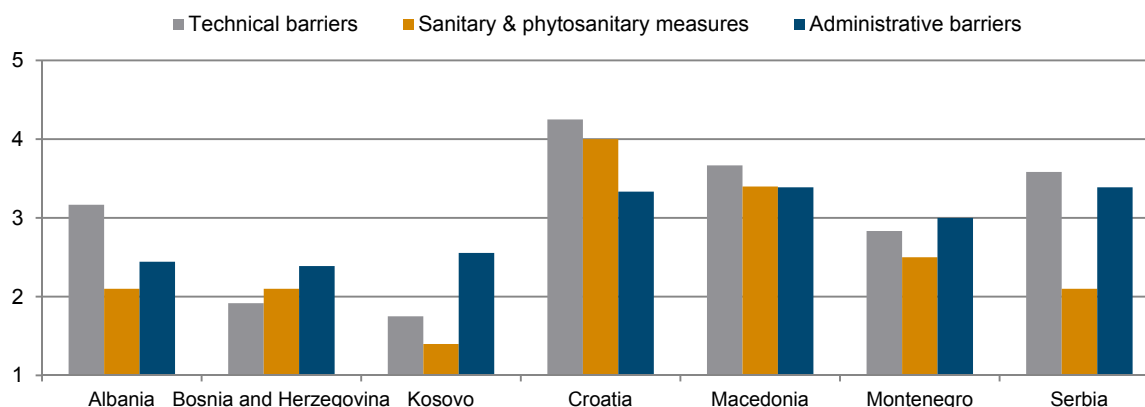


Source: The Doing Business project.

With the exception of Montenegro, all Western Balkan countries were able to reduce the lead time for exports. However, the only countries in the region to come close to Germany in terms of lead time are Serbia and Macedonia (as of 2013). Reducing the administrative and technical barriers to exports would be desirable and could be achieved both swiftly and in a cost-efficient way. Yet it is hard to predict the positive impact this would have on export performance.

Non-tariff barriers to trade (NTBs) include technical barriers (TTB) and administrative barriers (ATB) to trade but also sanitary and phytosanitary measures (SPS). With regard to ATBs, it is particularly important for Western Balkan countries to improve the formal requirements in the field of documentation and automation as well as customs procedures and processes. A closer analysis of specific NTBs leads directly to the issue of the overall quality of public institutions in the region.

Figure 1.11 / Non-tariff barriers to trade, 2011, 5 = international best practice

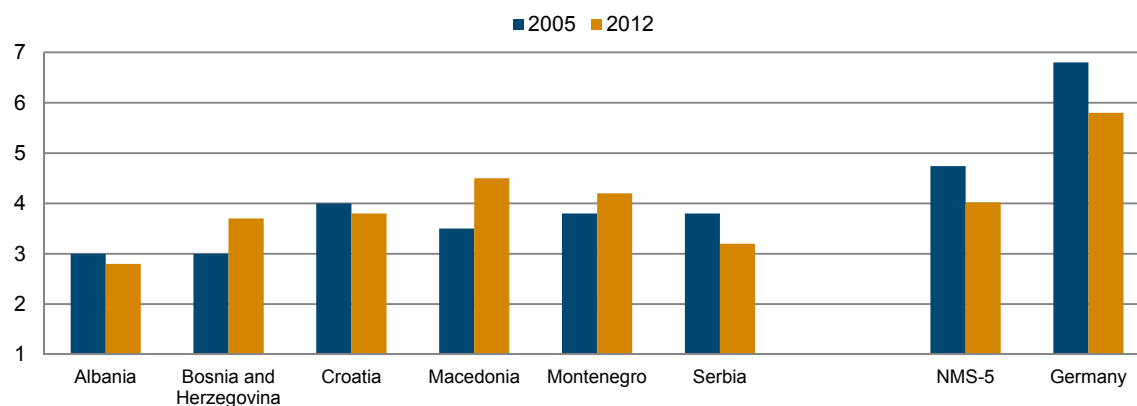


Source: OECD (2012), CEFTA Issues Paper 4.

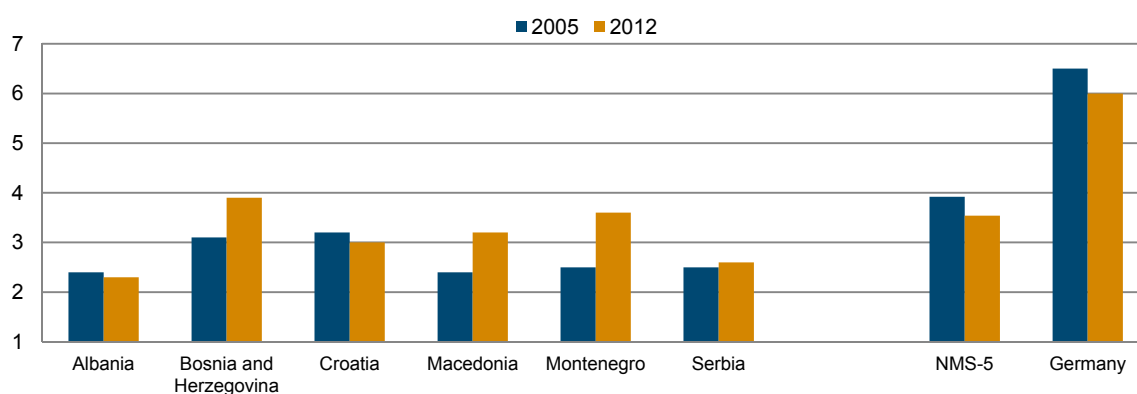
1.2. QUALITY OF PUBLIC INSTITUTIONS

In many studies, the quality of public institutions is seen as a key to sustainable development. However, it is important to note that there is no definitive answer to the question of institutional exogeneity in relation to economic development. Moreover, such causality may work in different ways. One essential requirement for any business activity in a market economy is the protection of property rights. The protection of property in the Western Balkans is considered to be lower than in the NMS-5. Another important indicator is the independence of the judiciary. In this area, conditions in the reference group (NMS-5 and Germany) appear to have deteriorated in recent years, while most Western Balkan countries have made significant progress in improving judicial independence.

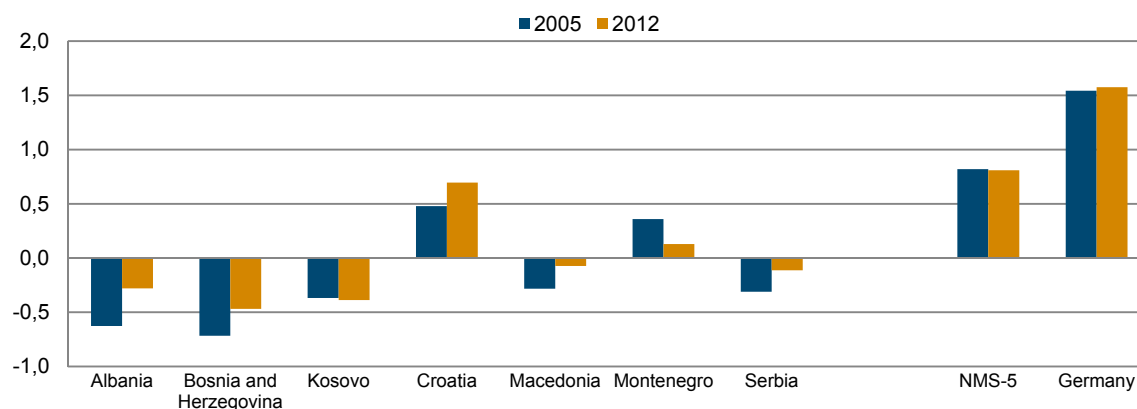
The issue of public management comprises the quality of public services, the quality of the administration, including the extent to which it is free from political pressure, the quality of policy formulation and implementation as well as the credibility of government. In this respect, Croatia is the only country in the Western Balkans to have reached the level of the NMS-5. The other countries are still lagging far behind although they have achieved significant improvements in public governance and management over recent years.

Figure 1.12 / Property rights, 7 = clearly defined and well protected by law

Source: World Economic Forum, Executive Opinion Survey.

Figure 1.13 / Judiciary independence, 7 = entirely independent

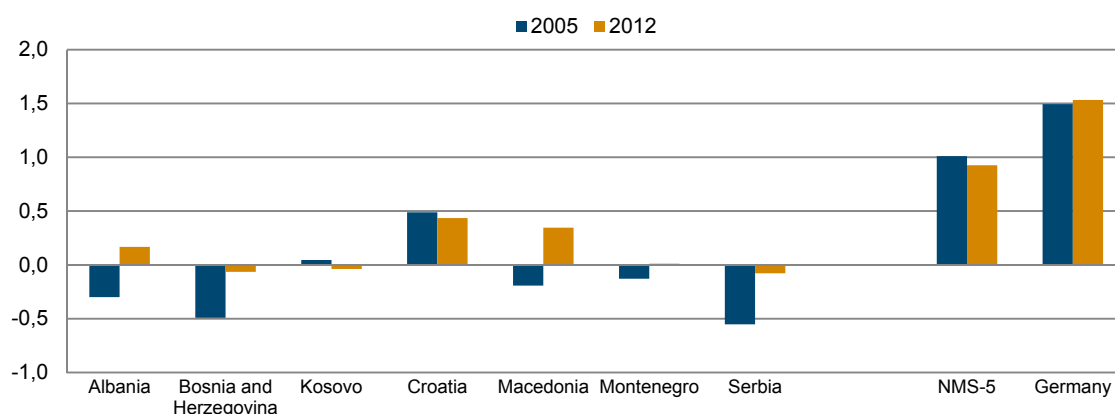
Source: World Economic Forum, Executive Opinion Survey.

Figure 1.14 / Government effectiveness, -2.5 = weak, 2.5 = strong

Source: The Worldwide Governance Indicators project.

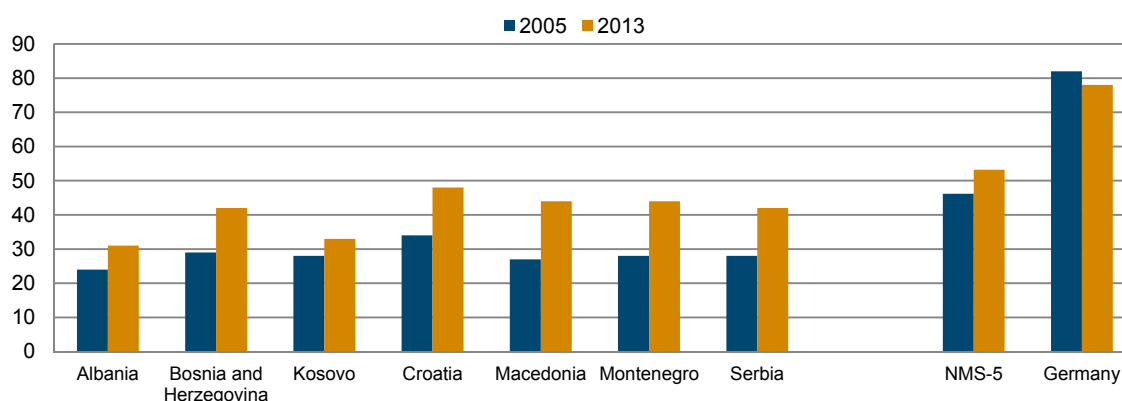
The indicator of regulatory quality reflects the perception of government as being able to formulate and implement good policies and to create a framework that enables and promotes private sector development. Here the Western Balkan countries seem to vary less from one another, and their overall level seems to be closer to that of the NMS-5. With regard to this indicator, only Croatia is still much further below the NMS-5 level than under the previous indicator. For the average Western Balkan country, however, it is safe to say that the quality of the regulatory framework is better than the quality of managing that framework, while both are steadily improving.

Figure 1.15 / Regulatory quality, -2.5 = weak, 2.5 = strong



Source: The Worldwide Governance Indicators project.

Figure 1.16 / Corruption perception index, 0 = highly corrupt, 100 = very clean



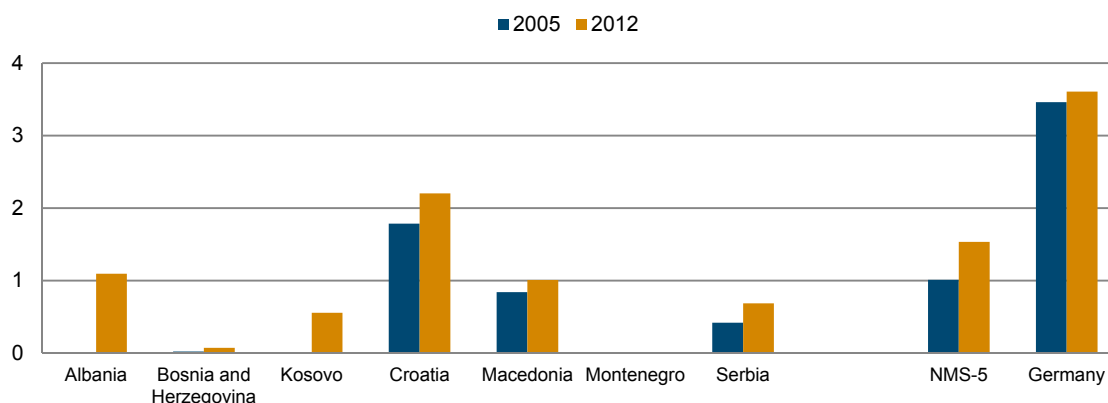
Source: Transparency International.

The relatively poor quality of public administration goes hand in hand with high levels of perceived corruption. In the well-known Corruption Perceptions Index published by Transparency International, all the Western Balkan states rank behind the NMS-5, which are perceived as less corrupt (see Figure 1.16). Most Western Balkan countries, however, have improved their ranking under this indicator in recent years.

1.3. QUALITY OF PUBLIC INFRASTRUCTURE

Improvements in physical infrastructure, especially in transport and energy supply, help to reduce domestic production costs and encourage industrialisation in many sectors. In addition, better connections to international infrastructure networks facilitate access to markets abroad.

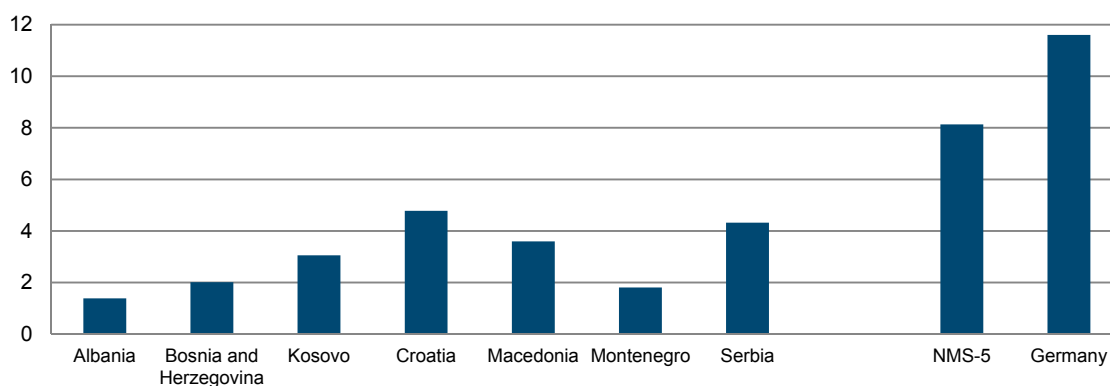
Figure 1.17 / Motorways in km per 100 km² land area



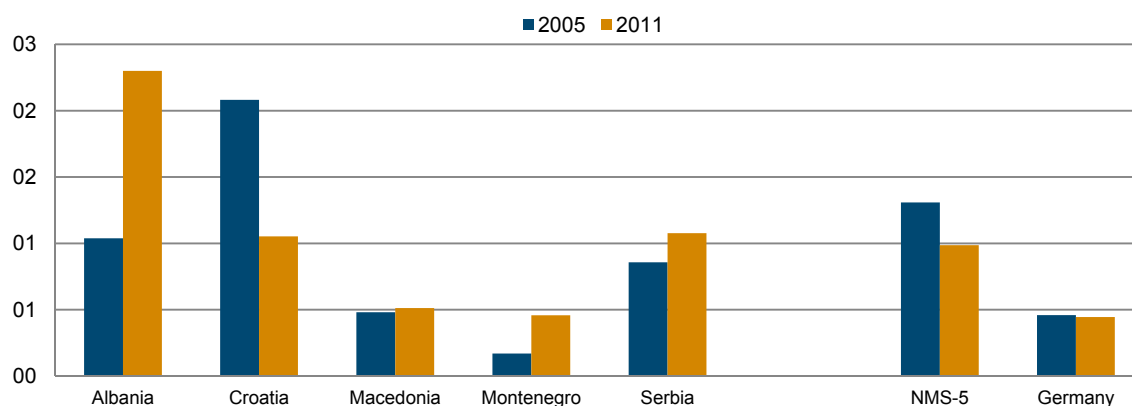
Source: Eurostat, own extrapolations and estimates.

The density of motorways in the Western Balkans is still far from the high density found in Germany. Croatia, however, has already reached a higher motorway density (km of motorway per 100 km² of land area) than the average NMS-5 country, and most other countries in the region have also expanded their motorway networks quite significantly. Only Bosnia-Herzegovina and Montenegro still have hardly any modern roads, whereas Kosovo has built a relatively large motorway network within a few years. As to the density of railway lines (see Figure 1.18), none of the Western Balkan countries comes close to the high level existing in Germany and the NMS-5.

Figure 1.18 / Railway tracks in km per 100 km² land area, 2012 (or latest year available)

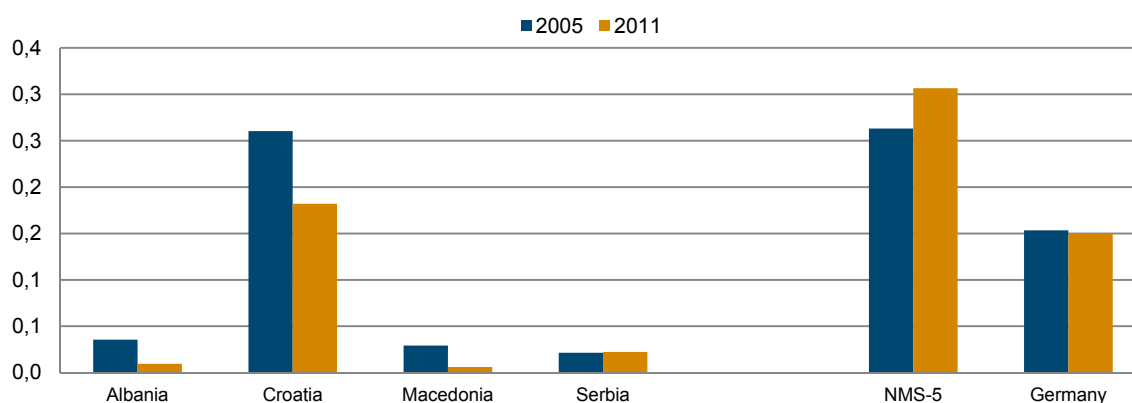


Source: Eurostat, own extrapolations and estimates.

Figure 1.19 / Investment in road construction, in % of GDP

Source: OECD.

The expansion of the motorway network is reflected in higher public spending on road construction as a percentage of GDP. Despite the crisis, all Western Balkan countries have recently made higher investment expenditures than Germany (in relative terms). The only country in the region to reduce public spending on road construction was Croatia, cutting it in half under its austerity policy. Nevertheless, it is still spending more on roads than the average NMS-5 country. The leading country for such investment spending is Albania, which has made enormous efforts in recent years to improve its roads. With the exception of Croatia, investment in railway construction is hardly existent. Most Western Balkan countries spend very little on expanding the railway system. In Croatia, the relevant expenditure, as a share of GDP, is slightly above the German level but clearly below that of the NMS-5. There is definitely need for action in this area, even more so as many goods exported from the Western Balkans, such as raw materials and processed metals, would be extremely well-suited for transportation by rail.

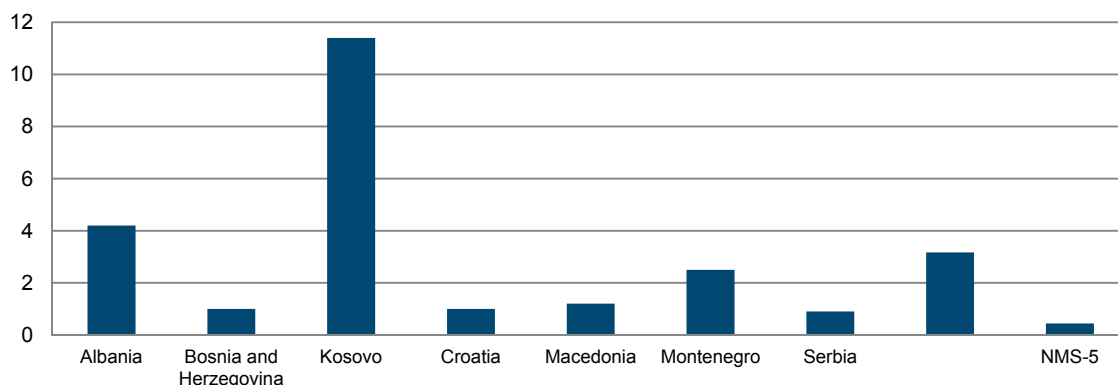
Figure 1.20 / Investment in rail construction, in % of GDP

Source: OECD.

In most countries of the Western Balkans, the supply of electricity is secured, even if there are occasional power cuts. This does not apply to Albania and Kosovo, however, where power cuts are still common. The situation there may have slightly improved recently but both countries still need to invest

heavily in diversified power generation and a modern distribution network as well as reliable connections to the grids of their neighbours.

Figure 1.21 / Power outages per firm per month, 2013 (or latest year available)

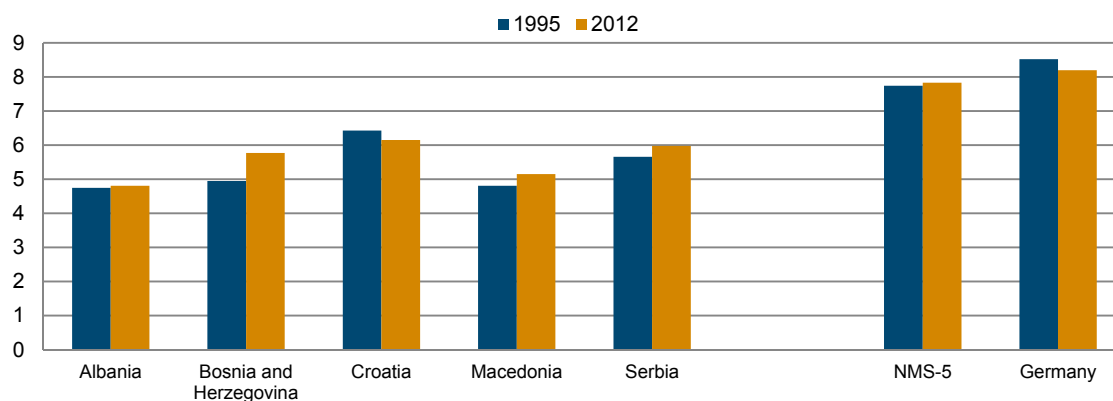


Source: World Development Indicators.

1.4. EDUCATION, TRAINING AND RESEARCH

It is a commonplace that investment in education, training and research is crucial for economic development in the long term. In reality, however, it is very difficult to provide evidence for such a causal relationship, one reason being the high degree of inaccuracy when it comes to measuring the quality of economically relevant education, training and research.

Figure 1.22 / Education and training index

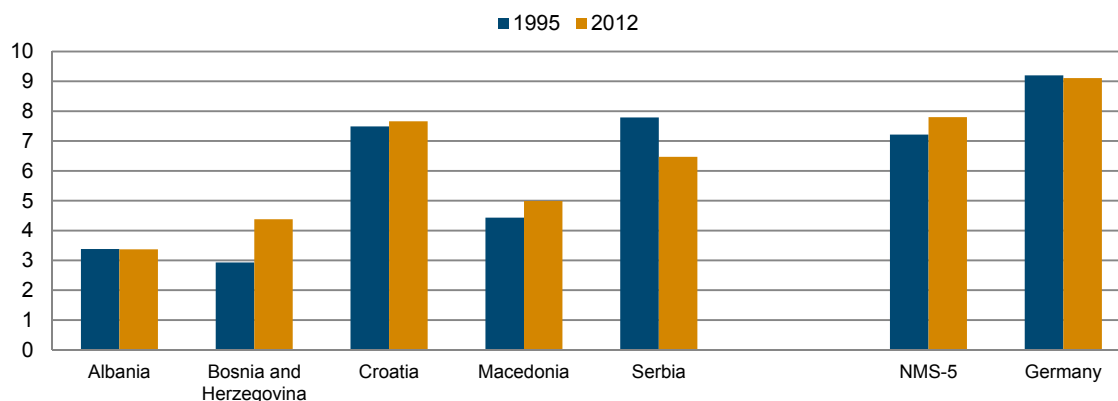


Source: Knowledge Assessment Methodology 2012.

Most countries in the region were able to improve their performance in the field of education and training as well as innovation over the long term (1995-2012). However, none of the Western Balkan countries comes even close to the level of the NMS-5, except Croatia and, to a certain extent, Serbia. Other indicators for measuring the quality of education and training used by the OECD in its international PISA

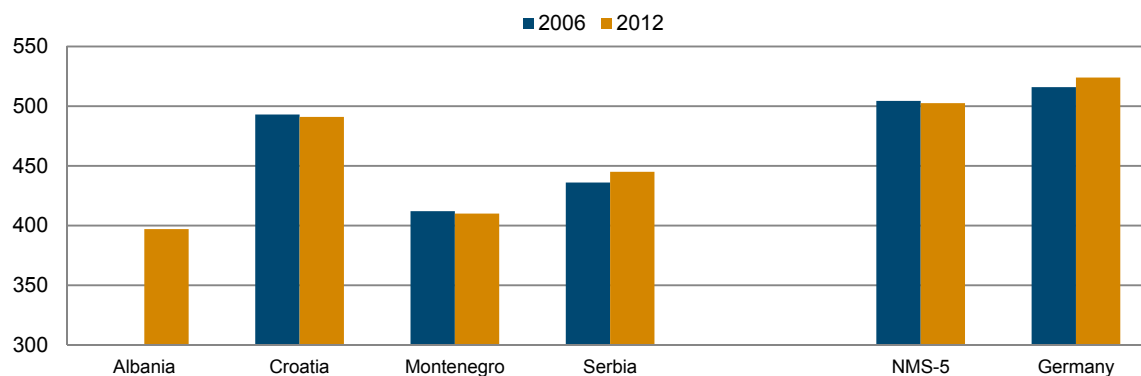
study on student performance as well as UNESCO data on the number of researchers as a share of the population produce similar results, at least with regard to the relative differences in performance.

Figure 1.23 / Innovation index



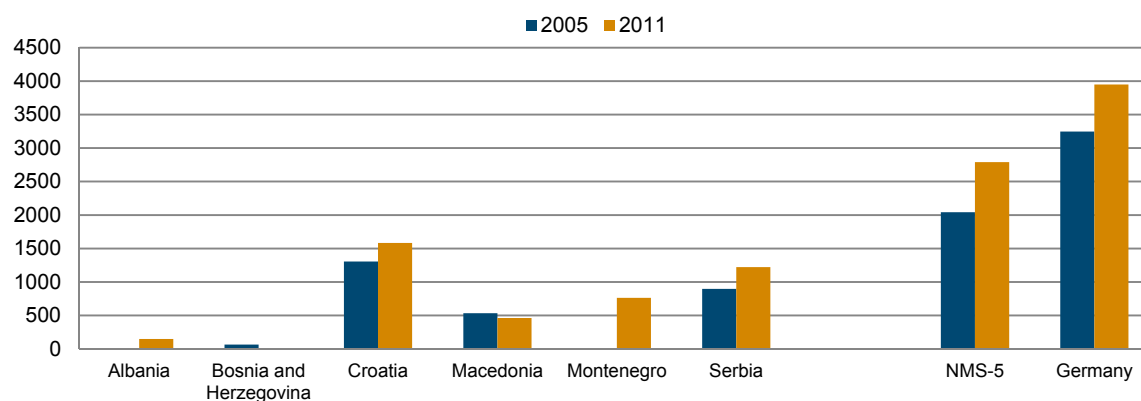
Source: Knowledge Assessment Methodology 2012.

Figure 1.24 / PISA test results, natural sciences



Source: OECD PISA Database.

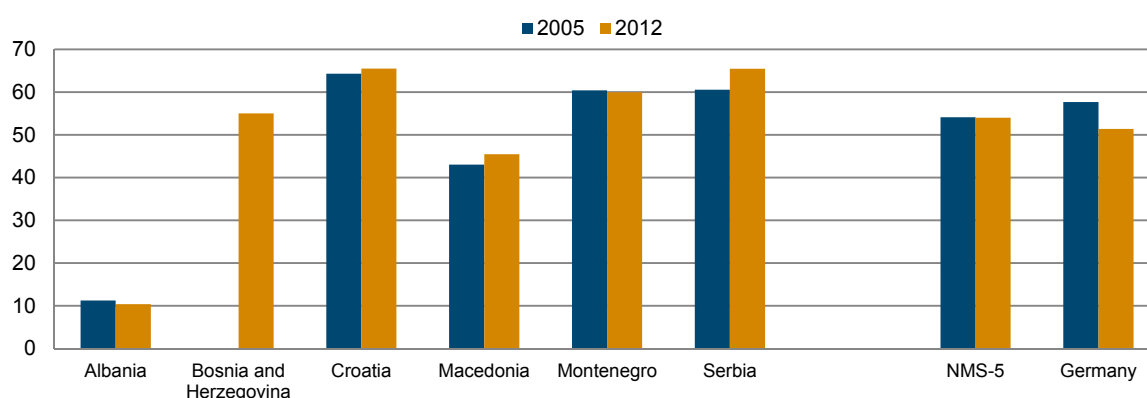
Figure 1.25 / Researchers per 1 million inhabitants, in full-time equivalents



Source: UNESCO Institute for Statistics.

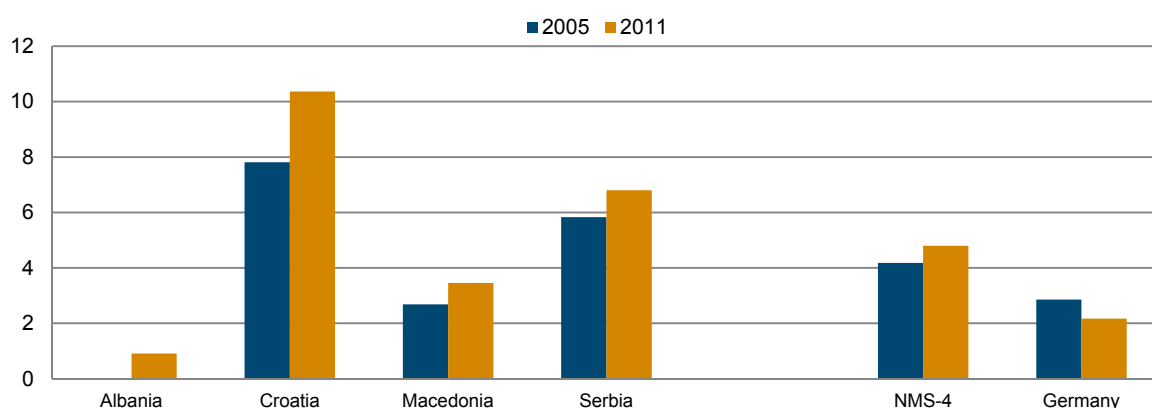
The findings from the PISA results for natural sciences mentioned in the report are very similar to the results for maths and reading literacy. Equally, the figures for GDP spending on research and development correspond to the statistical data on the number of researchers mentioned herein. Many experts, however, argue that theoretical knowledge and 'ivory tower research' have little to do with the kind of human capital formation needed to build a globally competitive industry. For them, the key to success is the provision of a broad range of technical and vocational higher secondary education, as it exists in Germany and Austria.

Figure 1.26 / Enrolment rate in upper secondary technical and vocational education, in % of respective population



Source: UNESCO Institute for Statistics, own extrapolations.

Figure 1.27 / Teachers in upper secondary technical and vocational education, per 100 persons of respective population

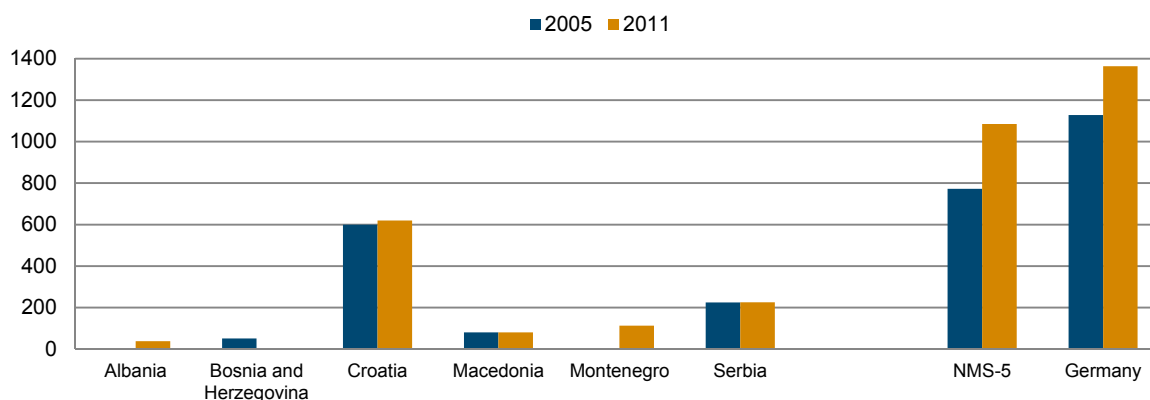


Source: UNESCO Institute for Statistics, own extrapolations.

Interestingly, the number of students enrolled at technical and vocational higher secondary schools expressed as a percentage of the relevant cohort is surprisingly high in comparison with the NMS-5 and Germany. More surprisingly, the number of teachers at technical and vocational higher secondary schools per 100 persons of the relevant cohort in most Western Balkan countries, for which data is available, is significantly higher than in Germany and still growing by comparison. However, when looking at the number of technicians and engineers as a share of the total population, one can see the

familiar picture illustrated by previous figures (e.g. on the number of researchers). While Croatia is beginning to keep pace with the NMS-5, the other Western Balkan countries are still lagging far behind. Technicians and engineers are defined as persons whose job requires technical know-how and expertise in one or more fields of engineering, science or biology.

Figure 1.28 / Technicians per 1 million population, in full-time equivalents



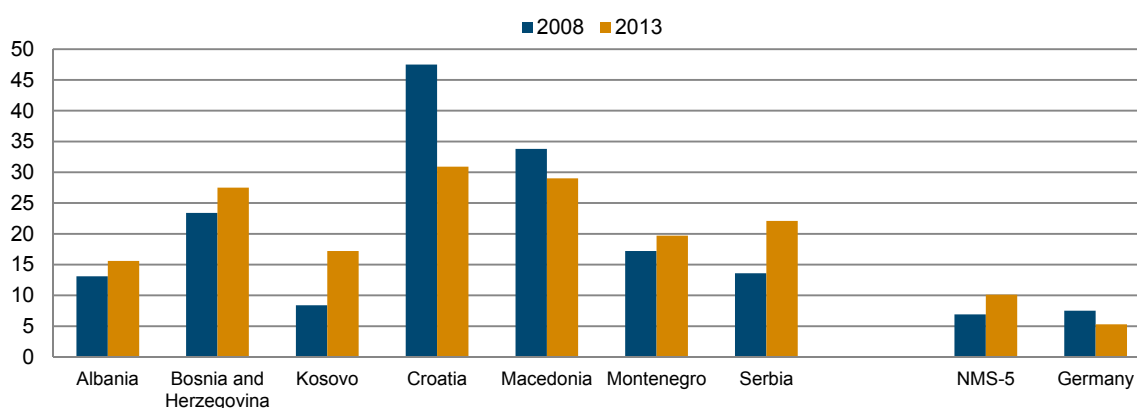
Source: UNESCO Institute for Statistics, own extrapolations.

Generally, one can say that despite some strong efforts in the field of education, training and innovation, the Western Balkan countries have made only modest progress in producing economically useful human capital, such as engineers, technicians and researchers.

1.5. LABOUR MARKET EFFICIENCY

In addition to the quality of human capital, the supply of labour can also have an important impact on the economy. Moreover, an inefficiently organised labour market may result in underutilisation of labour potential and reduce competitiveness, insofar as there are price distortions.

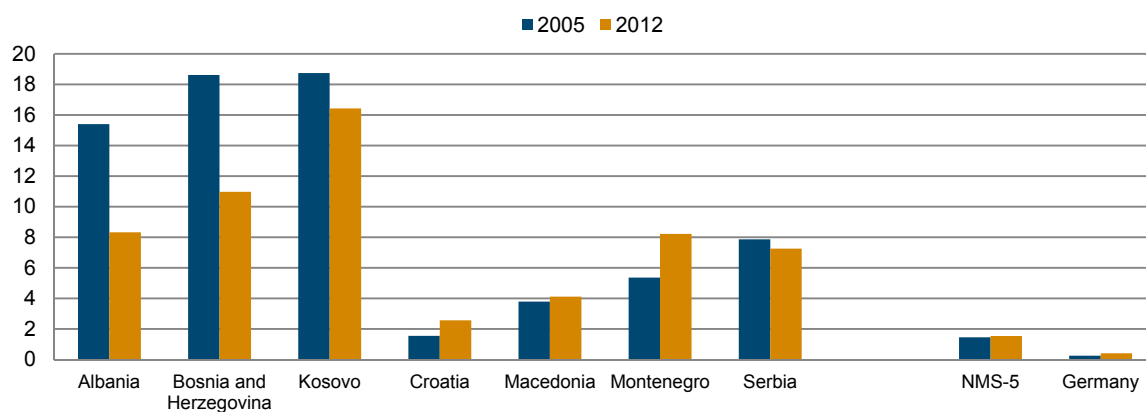
Figure 1.29 / Rate of unemployment in %, LFS



Source: wiiw Database, Eurostat and national statistics.

Traditionally, the army of unemployed persons in the Western Balkans has been huge. For many decades, Western Balkan economies have failed to provide employment to a large part of their labour force. Thus, for many people from the Western Balkans, the labour market has always included the whole of Central Europe and beyond, even before the Federal Republic of Germany signed an agreement with Yugoslavia in 1968 to attract labour from the region. It is interesting to note that, in most countries of the region, unemployment has recently increased only slightly, compared to pre-crisis levels, while in some countries it even fell. This is not true for Croatia and Serbia, however, where the unemployment rate continued to increase. Between 2008 and 2013, the average unemployment rate for all seven countries remained constant at a high level of 23%, which is quite unacceptable from a Central European perspective.

Figure 1.30 / Remittances of migrant workers, in % of GDP

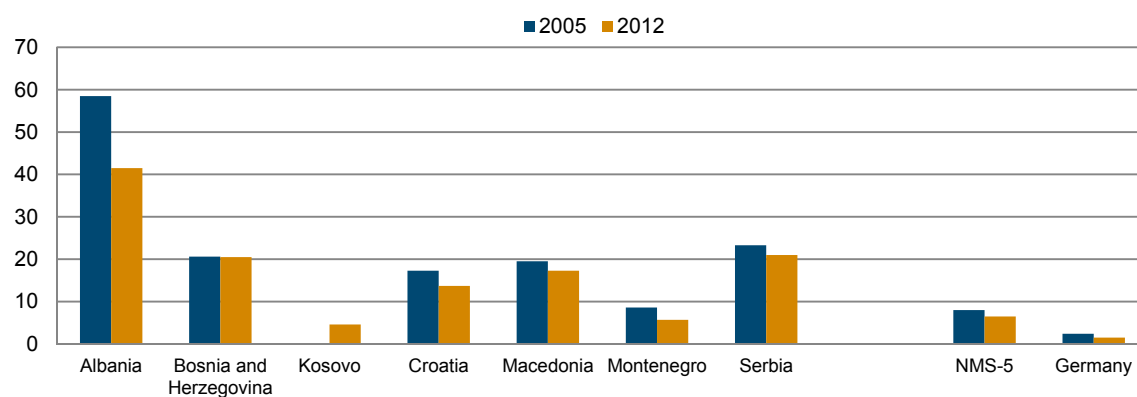


Source: World Bank.

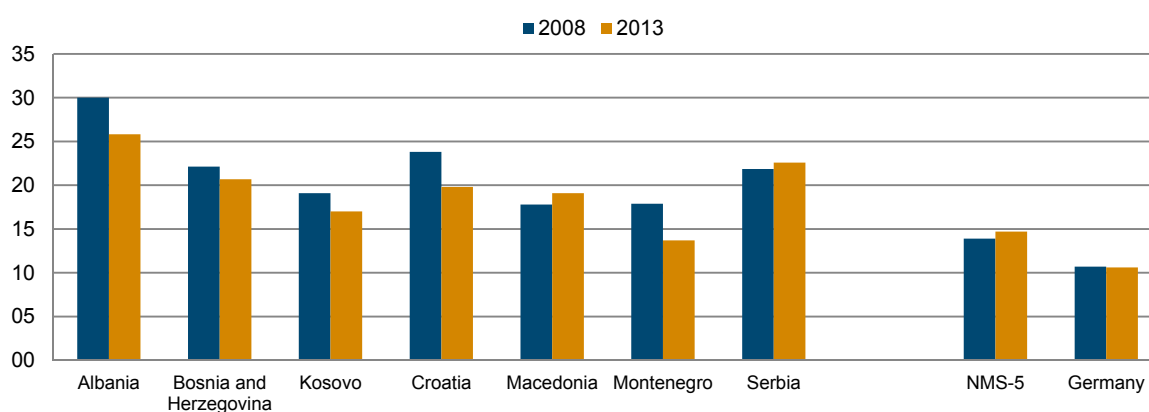
One reason why unemployment rates remained stable despite the crisis is the fact that population growth in the region was stagnant, too, if not declining. Together with an ageing population, this has taken some pressure off the labour market. Migration continues to play an important role in helping to ease the pressure on the local labour markets, albeit to a much lesser extent than in the nineties.

In the entire region, the volume of remittances as a share of GDP is extremely high, reaching double-digit rates in Bosnia and Herzegovina and Kosovo, although there is a strong downward trend. In many places, remittances provide a substitute for the insufficient provision of social benefits by government and are frequently a key driver for the local construction industry.

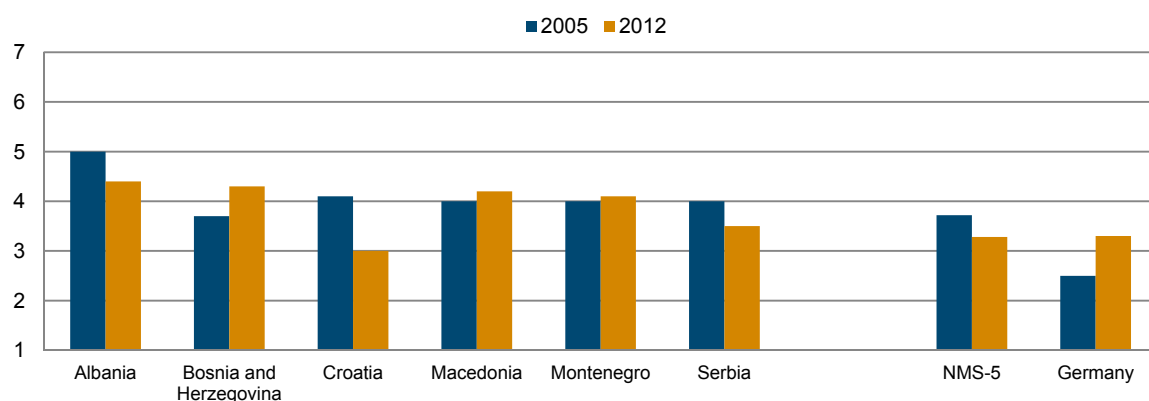
In addition to migration, there is wide-spread subsistence farming, which also helps to ease the precarious labour market and can be largely classified as hidden unemployment. Data on employment in agriculture show that, while subsistence farming has been on the decline across the Western Balkans (with the exception of Kosovo and Montenegro), it continues to play an important role, accounting for more than one third of workers in the extreme example of Albania. In the case of Montenegro, there are hardly any agricultural areas, while Kosovo Polje, the central plains of Kosovo, has been taken over by suburban sprawl. In both countries, however, the share of workers in the services sector is above average, with the hotel, restaurant and retail trade providing a function similar to that of subsistence farming.

Figure 1.31 / Persons employed in agriculture, in % of total employed

Source: World Development Indicators, own extrapolations.

Figure 1.32 / Self-employed persons, in % of total employed

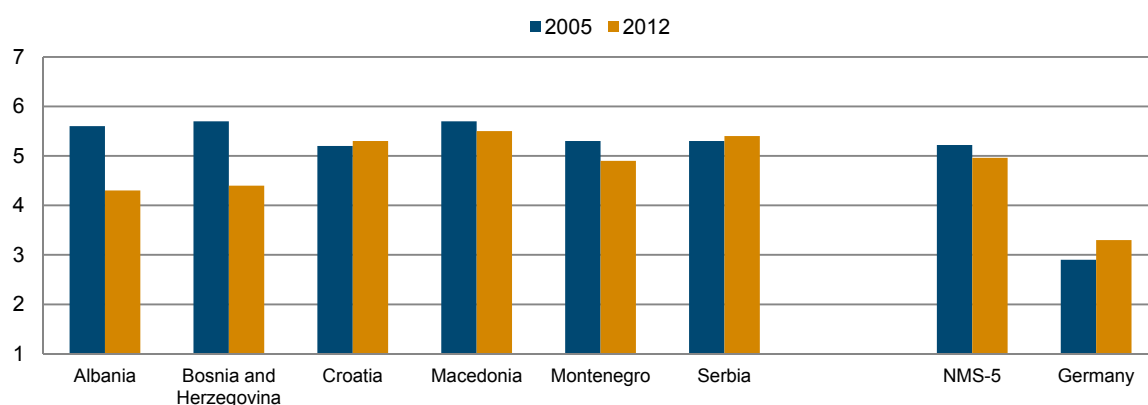
Source: Eurostat and national statistics. Kosovo refers to 2012 (instead of 2013).

Figure 1.33 / Hiring and firing (1 = heavily impeded by regulations, 7 = extremely flexible)

Source: World Economic Forum, Executive Opinion Survey.

Another indicator illustrating the oversupply of labour, which cannot be absorbed by the official economy as it is too small, is the number of self-employed persons as a share of the total population. This indicator is frequently used to measure the size of the shadow economy. On average, around 20% of workers in the Western Balkans are self-employed, with Albania reaching more than 25%. In most cases, we are thus dealing with economies that are in large part stuck in production conditions characterised by constant returns to scale and a low potential for productivity gains. The oversupply of available or precarious labour also explains why employers in the Western Balkans can be relatively flexible in hiring and firing workers.

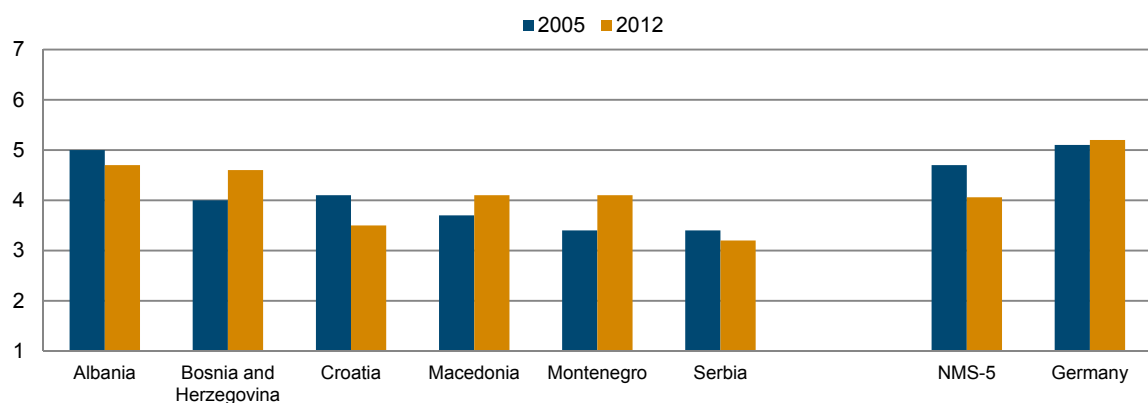
Figure 1.34 / Wage setting (1 = centralised, 7 = by each individual company)



Source: World Economic Forum, Executive Opinion Survey.

Similar to the NMS-5, wage-setting in the Western Balkans takes place at company level and not in a comparatively centralised way at industry level, which is the case in Germany. Finally, the labour market in the Western Balkans is characterised by relations between employees and employers that tend towards confrontation, quite unlike the social partnership model in Germany, for instance, which is based on cooperation.

Figure 1.35 / Labour-employer relations (1 = generally confrontational, 7 = generally cooperative)



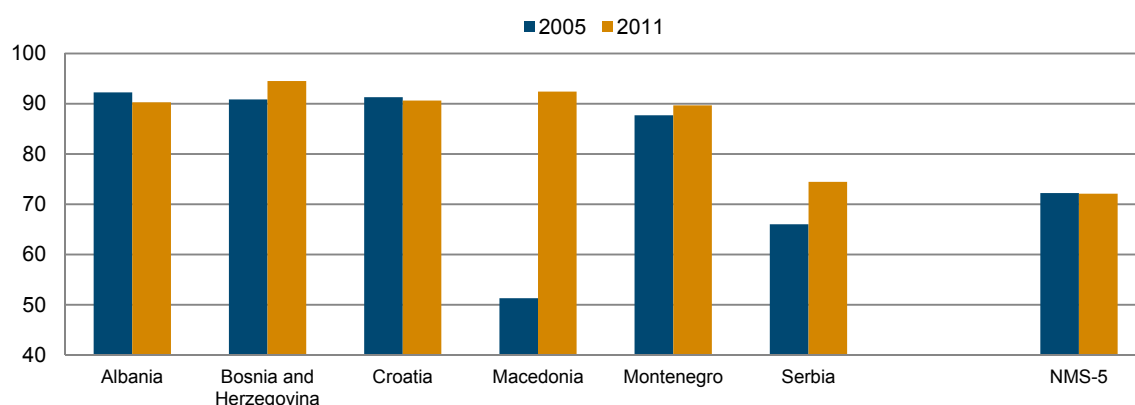
Source: World Economic Forum, Executive Opinion Survey.

A higher degree of cooperation between social partners and more centralised wage-setting could result in a more efficient income policy, which might help the heavily euroised Western Balkan countries to compete with international goods markets in terms of prices and quality, while creating more jobs in the official economy. Countries that have better social partnership instruments usually benefit from joint efforts by social partners to provide education and training and tend to have more efficient employment services. Furthermore, in such countries wage policy is more likely to be integrated into the overall context of macroeconomic policies.

1.6. FINANCIAL MARKET DEVELOPMENT

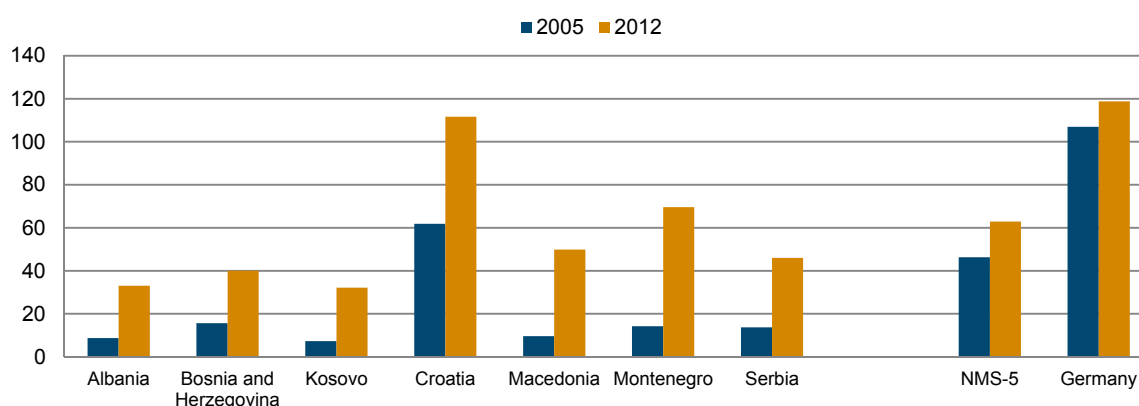
Financial market development in the region has been largely driven by banking groups from the EU countries, including Austria, Italy and Greece. Financial markets in the region are dominated by foreign control, accounting for more than 90% in most countries. Serbia is the only country where 'only' 75% of assets are under foreign control.

Figure 1.36 / Share of foreign banks in assets, in % of total assets

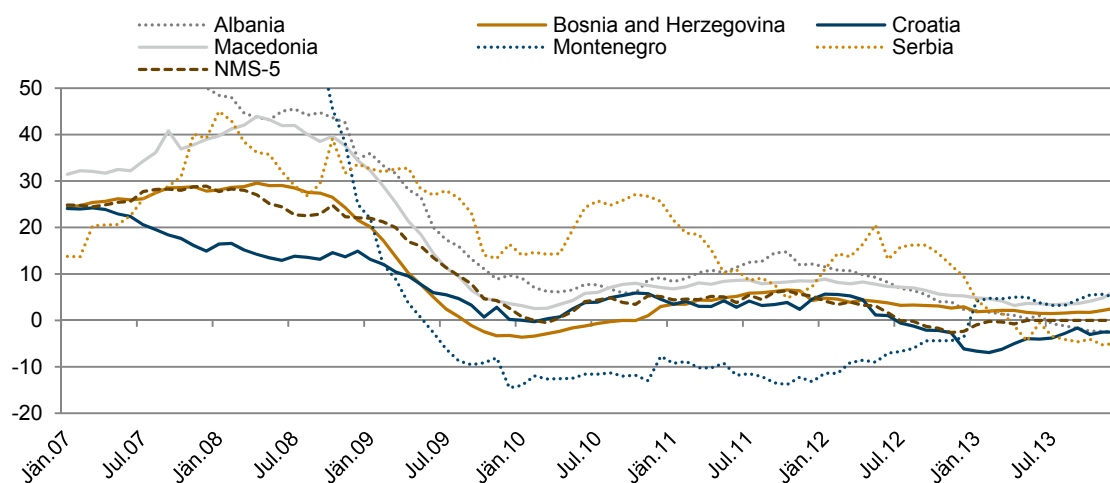


Source: EBRD Banking Survey, own extrapolations.

Figure 1.37 / Automated teller machines per 100,000 adults

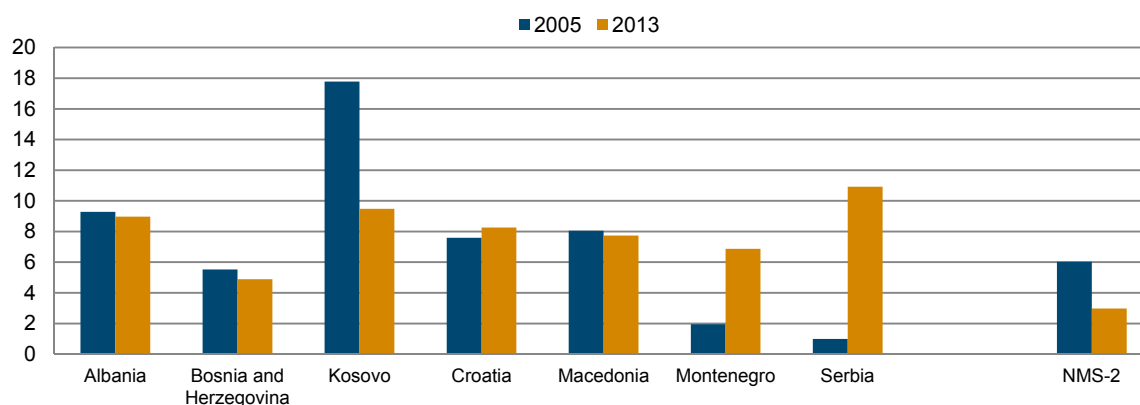


Source: World Development Indicators, own extrapolations.

Figure 1.38 / Bank loans, annualised rate of growth in %

Source: wiiw Database.

One problem is the fact that the creation of money through bank lending has ground to a halt in recent years. As a result of deleveraging across Europe, new tier 1 capital requirements and enhanced risk-awareness, assets in peripheral countries are being reduced, with capital flowing from the periphery to the large financial centres. Growth in bank lending in the region is either negative or so low that existing loans will not be refinanced, given the current level of interest rates. On average, real interest rates for loans either remained high or reached a high level, compared to the period before the global economic crisis. In Kosovo, for instance, real interest rates almost halved in 2013, when compared to 2005, but are still close to double digits. Given the currently low economic growth rates, such interest rates look to be completely untenable. Against this backdrop, it is hardly surprising to see a steady increase in non-performing loans (NPL).

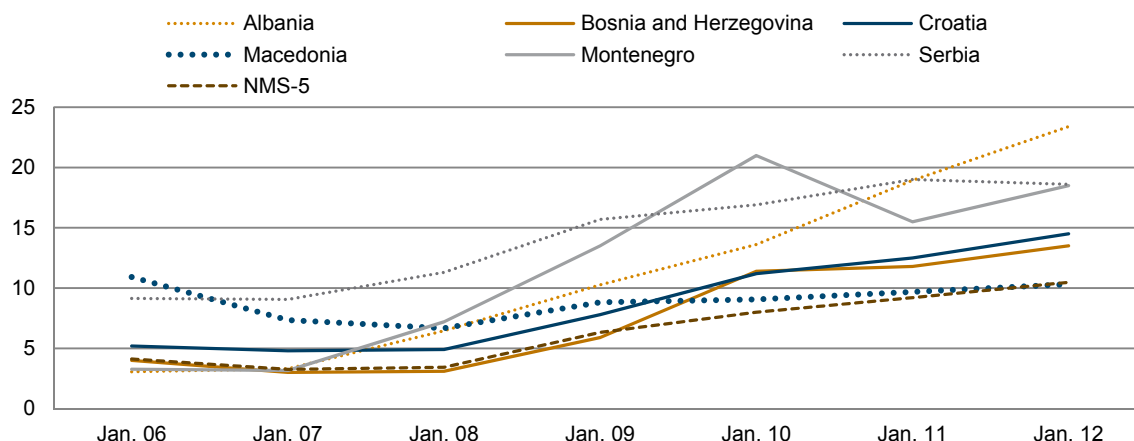
Figure 1.39 / Real interest rate

Source: World Development Indicators, own extrapolations; NMS-2 = Hungary and Czech Republic.

In Albania, one quarter of all loans have become non-performing. A loan is non-performing when payments of interest or principal have been in default for 90 days or more. For the other Western Balkan countries, the rate of NPLs is between 10% and 20% and expected to increase further in most cases.

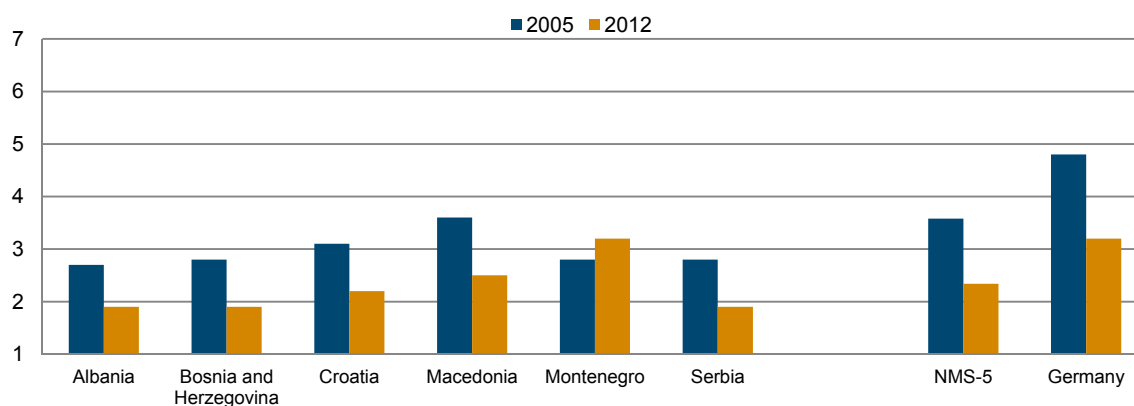
The increase in NPLs leads to reduced lending and a further increase in interest rates, which in turn triggers an increase in NPLs ('vicious circle').

Figure 1.40 / Non-performing loans, in % of total loans



Source: wiiw Database.

Figure 1.41 / Venture capital availability (1 = very difficult, 7 = very easy)



Source: World Economic Forum, Executive Opinion Survey.

At the same time, there are ever fewer funds available to be used as venture capital for innovative business start-ups, although the availability of venture capital had been relatively low even before the crisis. This trend, however, can be found in other parts of Europe, too.

It is obvious that the poor financial market performance in the Western Balkans is a major obstacle to improving competitiveness. It is extremely difficult to imagine a significant increase in private investment to expand export capacities, merely funded by the cash flow, as long as bank lending remains insufficient. Economic policy must break the current vicious circle of weak economic growth, the growing volume of bad loans, higher interest rates and lower lending by addressing one or more of these problems. It is certainly no consolation that other peripheral economies in Europe are stuck in the same vicious circle.

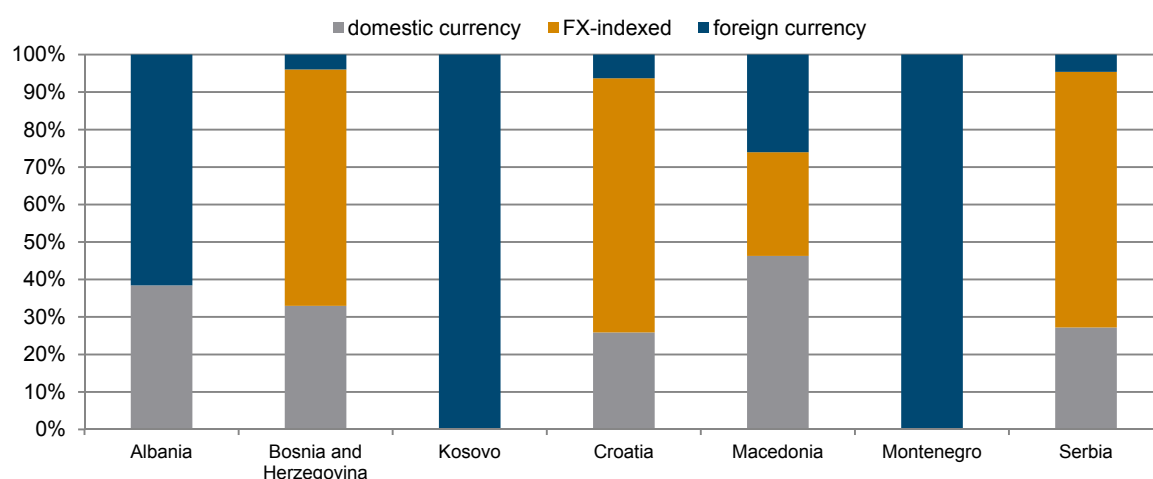
2. Assessment of policies to date by regional comparison

This section outlines major economic policy instruments of the seven national economies of the Western Balkans and assesses their impact on competitiveness.

2.1. MONETARY AND EXCHANGE RATE POLICY

Though monetary and exchange rate policy is de jure committed to the objective of assuring price stability, it still seems as if an exchange rate target against the euro is de facto (and in some cases in the form of an official interim target) more or less resolutely pursued. While Montenegro and Kosovo unilaterally adopted the euro, Bosnia and Herzegovina has opted for a fixed currency board against the euro, and Croatia and Macedonia are keeping to almost fixed (within a narrow band) exchange rates against the euro. Albania and Serbia are the only countries to use more flexible regimes vis-à-vis the euro. In the wake of marked exchange rate fluctuations, however, both have repeatedly tried to adopt a narrower band to the euro. Consequently, only these two countries were able to mitigate the impact of the external shock somewhat by devaluing against the euro during the crisis period. In the last months, however, both the Albanian lek and the Serbian dinar experienced only minor fluctuations against the euro.

Figure 2.1 / Credit to the non-financial private sector, by currency clause, in %, November 2013



Source: National central banks.

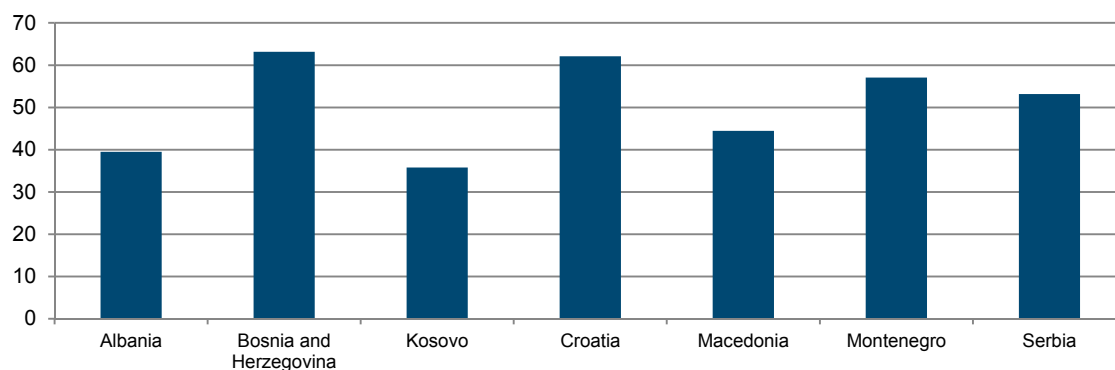
The instrument of devaluation would, however, be especially suited for small open economies who wish to achieve missing price competitiveness and thus bring their current account close to balance in a simple way. Such beggar-my-neighbour-policy reaches its limits when it causes a devaluation spiral that

is fuelled by inflation or affects the capacity to service debt denominated in foreign currency. Both risks exist with regard to the strongly 'euroised' Western Balkan countries and serve to explain why most central banks stick to rigid pegs to the euro.

No statistics exist with regard to the most important issue, namely the percentage of income indexed in euro. It may be assumed, however, that most countries in the region do not index wages and pensions to the euro. Therefore, currency devaluations would not necessarily be immediately offset by higher inflation. The large share of foreign currency loans, which will become more expensive for debtors if the currency is devaluated, is expected to be a major problem.

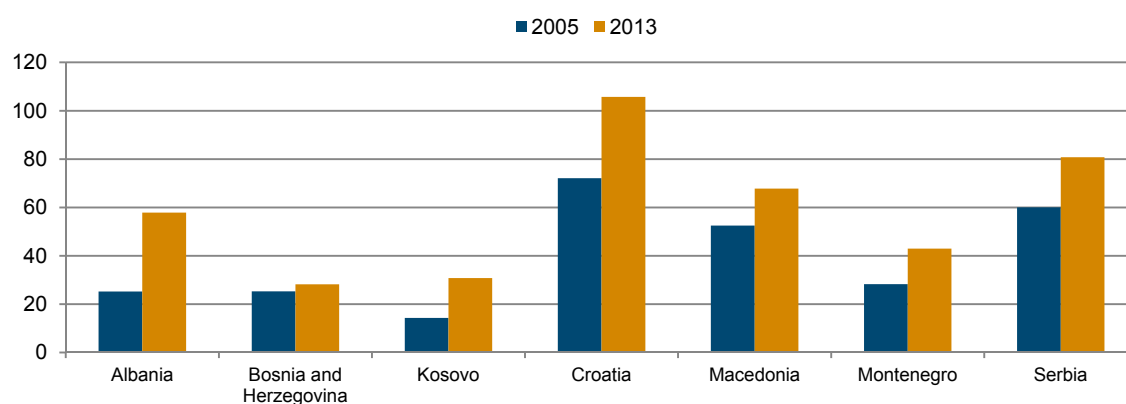
Aside from the fact that businesses and households in Montenegro and Kosovo must in the absence of a national currency invariably borrow in foreign currency, the share of loans denominated in local currency is very low at around 33% in the other countries. In Croatia, only 25% of loans are denominated in national currency, and most loans are denominated in euro or Swiss francs. Devaluing would be much less of a problem for local bank balances than for borrowers, especially as currency mismatch is small and private bank deposits are mainly denominated in foreign currency. Nevertheless, it is probably no coincidence that the very two countries that were able to use nominal devaluation during the crisis (Albania and Serbia) reported the highest percentage of non-performing loans in relation to total loans.

Figure 2.2 / Credit to the non-financial private sector, in % of GDP, November 2013

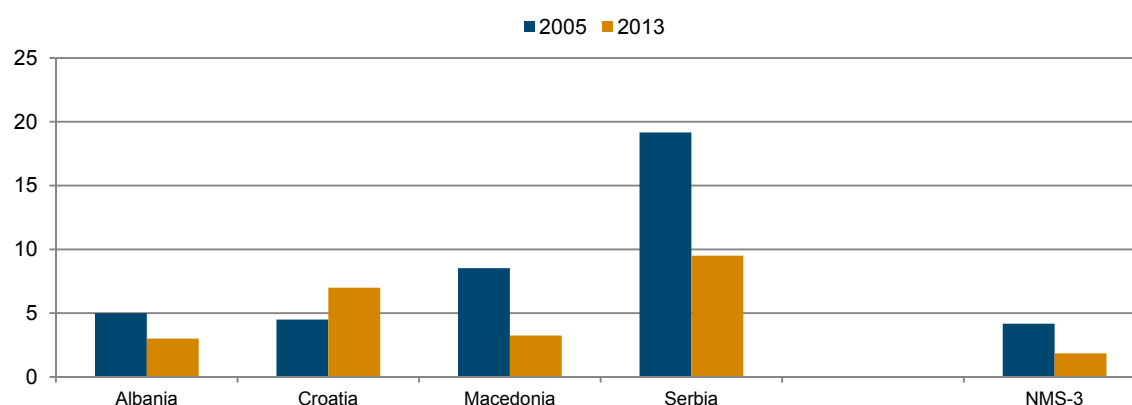


Source: National central banks.

Alongside currency composition, volume of total credit is another parameter for assessing the risks associated with currency devaluation. While the volume of total credit is still below 40% of GDP in Albania and Kosovo, loans to the non-financial private sector are above 60% of GDP in Bosnia and Herzegovina and in Croatia. In this context, gross external debt across sectors as a share of GDP is a relevant indicator as well. Starting from a relatively low level, it has registered a sharp increase throughout the region in recent years and reflects once again the lack of competitiveness of the Western Balkan countries and the resulting trend towards unsustainable debt positions. Moreover, external debt at above 100% of GDP, e.g. in Croatia, has reached a level which causes decision-makers in the country's National Bank to hold on to the peg to the euro even more decidedly.

Figure 2.3 / Gross foreign debt as a share of GDP, in %

Source: wiiw Database. Bosnia and Herzegovina, Montenegro: gross foreign debt of the government.

Figure 2.4 / Benchmark interest rates of the national banks, in %

Source: wiiw Database.

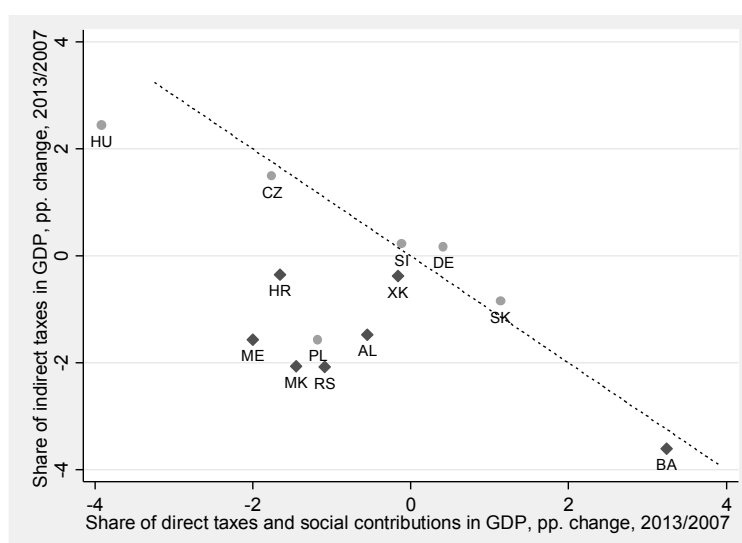
Interest rates in real terms are well above current economic growth rates and above those to be expected in the next few years. Even the prime lending rates of national banks with their own national currency, which banks do not pass on to borrowers without charging significant risk premiums, appear overly high in view of sluggish growth and generally low inflation rates. In the case of Croatia, the prime rate was even significantly raised compared to pre-crisis levels to maintain the exchange rate against the euro.

All in all, a rather restricted monetary policy, and not controlled devaluation, can be expected to continue in the region in the near future. Therefore, support to exporters and domestic enterprises in the single market that is aimed at strengthening their competitiveness must in fact be provided via economic policy substitutes rather than through the use of nominal depreciation of national currencies. Such a substitute (of a fiscal nature) is described in the following section.

2.2. FISCAL AND LABOUR MARKET POLICY

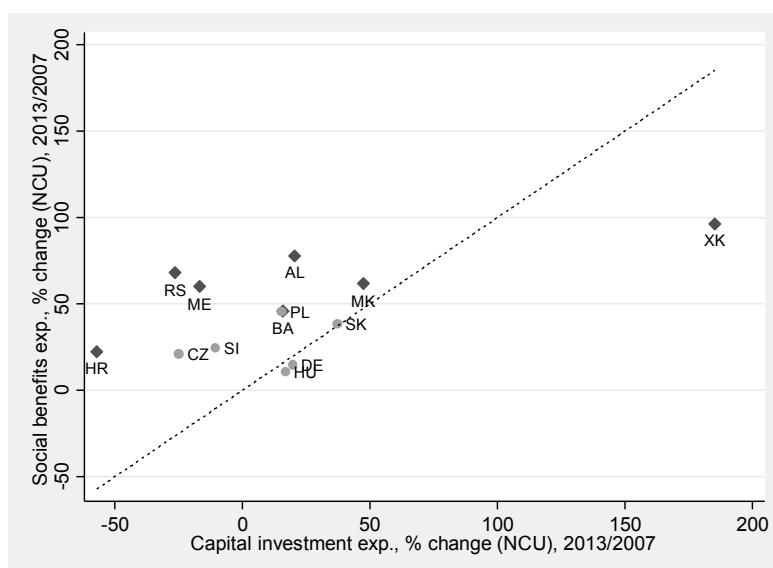
A comparison of fiscal policies of Western Balkan countries in the years 2007 and 2013 suggests that most of the Western Balkan countries recently pursued passive to expansionary policies, which in any case were not characterised by strong fiscal austerity. A trend towards a restrictive fiscal policy, especially as regards expenditures, may be observed in Croatia, if at all. Macedonia, for example, has pursued an expansionary policy on both the revenue and expenditure sides. All in all, public deficit financing in the Western Balkans is likely to have led to a stabilisation of aggregated demand and, hence, prevented greater damage to competitiveness.

Figure 2.5 / Fiscal behaviour, government revenues



Source: wiiw Database, own calculations.

Figure 2.6 / Fiscal behaviour, government expenditures

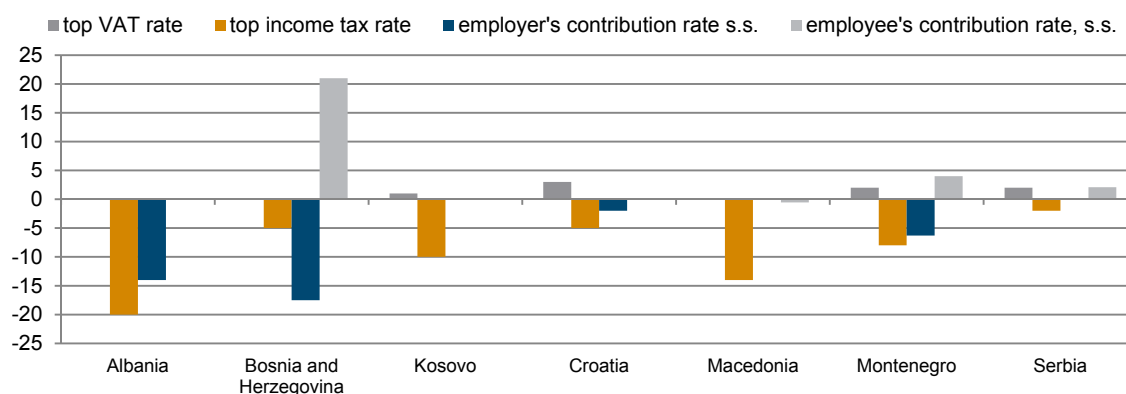


Source: wiiw Database, own calculations.

Actually, all countries recently raised their social expenditures in the course of the economic crisis, mostly through the operation of automatic stabilisers such as unemployment benefits. This increase was surprisingly low in Croatia despite a five-year recession and a simultaneous doubling of the unemployment rate. Almost all Western Balkan countries reported less of an increase in public fixed investment than in social expenditures. In Montenegro, Serbia and, above all, Croatia, public fixed investment in fact decreased heavily with corresponding negative consequences for competitiveness. Croatia reduced public investment by almost 60% compared to 2007. This contrasts with Kosovo, one of the few European countries that have been able to avoid recession since the onset of the global economic crisis. Starting from a low level, social expenditure in Kosovo has nearly doubled and fixed investment has increased by 185% with an average inflation rate below 4%.

In recent years, all Western Balkan countries used the structural changes on the government's revenue side (more or less consciously) to bring about fiscal devaluation — as an alternative to currency depreciation. Fiscal devaluation is especially aimed at limiting imports of consumer goods by raising value added tax (VAT) and excise duties. At the same time, reductions in income tax rates and in particular in social security contribution rates were to reduce costs of domestic enterprises, and thus to promote import substitution and exports. Simulations suggest that a budget neutral shift from social security burdens to value added tax burdens in the amount of one percentage point of gross value added, respectively, would result in a trade deficit reduction of on average 0.9% of gross value added, at least in the short run.

Figure 2.7 / Changes in tax and contribution rates between 2005 and 2013, in percentage points



Source: EK, UNMIK, FIPA, SIEPA, KPMG, PWC.

In the years 2005-2013, the VAT top rate, which in all Western Balkan states also serves as VAT standard rate, was increased in Serbia, Montenegro, Croatia and Kosovo. It was left unchanged in the other countries. With respect to income tax, marginal rates of taxation were reduced, without exception, in all Western Balkan countries. Employer's social security contribution rates either remained unchanged or were likewise reduced. In Bosnia and Herzegovina and in Montenegro, these obligations were for the most part passed on to the employees. Overall, the taxation modifications introduced in recent years are likely to have served their purpose of improving competitiveness. At the same time, however, they have also increased the burden on low-income groups, while providing relief to top earners. A widening of

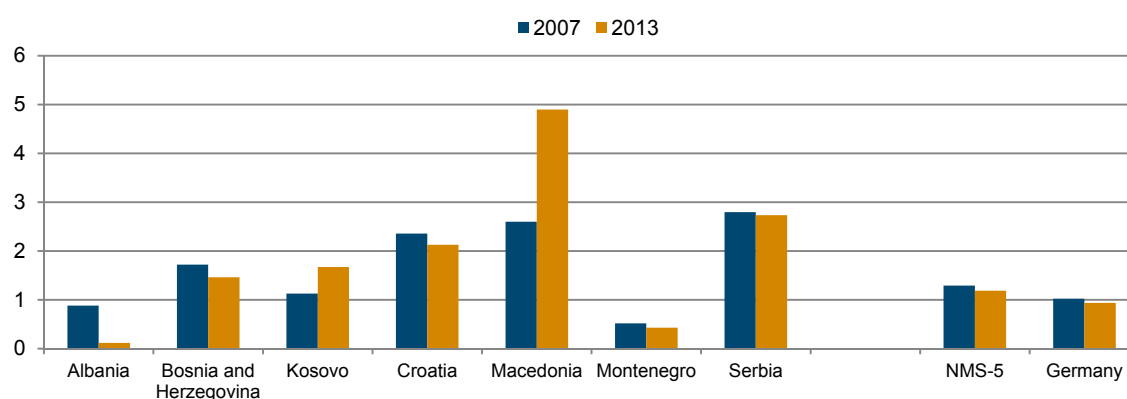
economic disparities has the potential to damage the political acceptance of further measures to enhance competitiveness.

Of much more serious import, however, are the effects of the Western Balkans' extremely high unemployment levels on income distribution. Although activation policies and the application of active labour market policies (ALMP) have become a trend all over the world, evaluations show that the direct impact of ALMPs is merely moderate and cannot overcome high unemployment in the Western Balkans either. Moreover, it cannot be claimed that the current level of unemployment benefits in Western Balkan countries was a serious 'disincentive'. Net replacement rates (0-50%) are rather low. In addition, coverage of unemployment benefits is mostly low. The number of unemployed enrolled in ALMP measures is low as well. Another reason undoubtedly is that expenditures on active measures are generally quite low in these countries. Public labour administration in the Western Balkans is generally understaffed and overburdened. As already mentioned, there is also a lack of cooperative institutions of social partnership which could contribute to enhancing competitiveness and increasing employment through, for example, macroeconomic wage policy coordination.

2.3. REGULATORY AND STRUCTURAL POLICY

In recent years, regional and sectoral structural policies in the form of investment promotion, subsidies and tax expenditures were merely applied in specific cases in the Western Balkan region. A network of local and national Agencies for the Promotion of Investment and Competitiveness was established that is primarily geared towards attracting foreign investors. Croatia and Serbia in particular have developed quite a comprehensive program in this regard.

Figure 2.8 / Public expenditure on subsidies, state, consolidated, in % of GDP



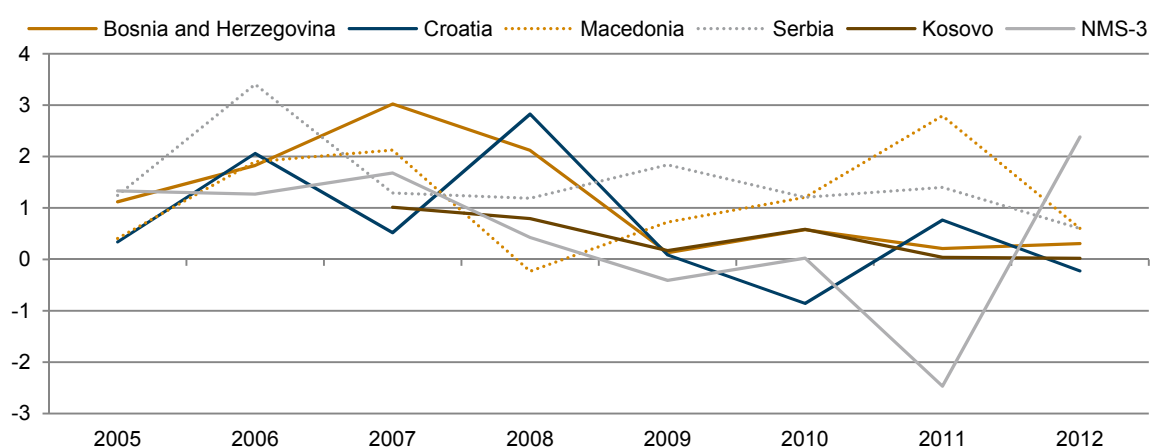
Note: Macedonia 2010 and 2013.

Source: IMF, national statistical offices, National Banks, finance ministries, wiiw Database, own calculations.

In the past, foreign direct investment was mainly attracted by large privatisations. By now, the portfolios of the competent privatisation agencies in the Western Balkans still comprise a number of smaller state assets. These regularly include enterprises that are difficult to sell and must be restructured before sale, which as a rule is politically sensitive. As in the case of the regulatory authorities in the monopoly-prone energy and communications markets, clear objectives must be laid down for privatisation agencies, and political interference in day-to-day business must be eliminated. At present, this is not the case for the

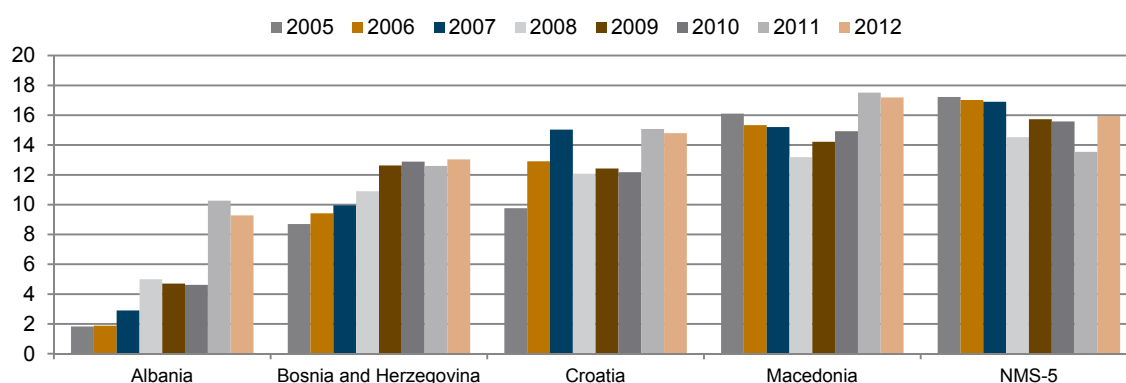
institutions in the Western Balkan region. In Serbia and Kosovo, both latecomers on the road to privatisation, larger publicly-owned corporate portfolios still exist. Ownership issues still play a significant role, especially since the distinction made between state-owned enterprises and enterprises under worker self-management which dates back to the times of former Yugoslavia must in the course of the separation of Kosovo and Serbia be further clarified. The scope for fiscal measures is increasingly diminishing in most Western Balkan countries and is expected to expedite privatisation of the last remaining state assets. Attracting investment to the Western Balkans, therefore, must increasingly focus on the establishment of new businesses.

Figure 2.9 / Foreign direct investment in the manufacturing sector, in % of GDP, net, flow statistics



Source: wiiw Database, BQK; breaks in NACE nomenclature 2008-2010; gross figures for Serbia; NMS-3 = CZ, HU & PL.

Figure 2.10 / Foreign direct investment in the manufacturing sector, in % of GDP, stock statistics



Source: wiiw Database; breaks in NACE nomenclature 2008-2010.

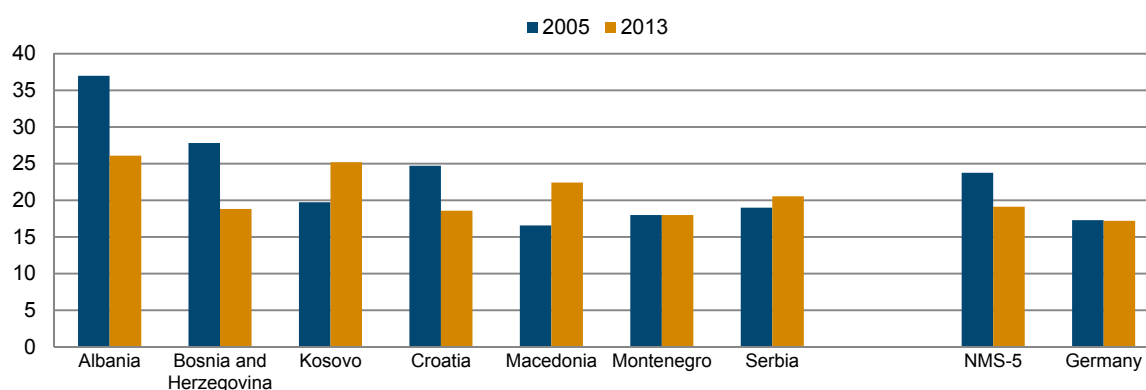
Almost all Western Balkan countries have made efforts to implement the European Small Business Act for small and medium-sized enterprises. Overall, subsidies in the region as a percentage of GDP are likely to have been marginally lower when compared with pre-crisis levels, but should in any case have amounted to about 2% in recent years, a figure twice as high as in the NMS or in Germany, for example.

Subsidies are especially low in Albania and Montenegro. They are particularly high in Serbia and Macedonia and recently accounted for almost 5% of GDP. In Macedonia and Kosovo subsidies have increased over the last few years as well. It is very difficult, however, to assess the degree of success of the investment support measures implemented in the Western Balkans. Flow statistics of foreign direct investment in the manufacturing sector that draw on balance of payments data reveal a negative trend of net cash flows as a percentage of GDP in Bosnia and Herzegovina, Croatia and Kosovo and a positive trend in Serbia and Macedonia over the last years. However, it needs to be mentioned that only gross values are available for Serbia. Comparability, therefore, is limited.

Inventory statistics, which is based on data from corporate balance sheets, seem to indicate a positive trend for foreign direct investment in the manufacturing sector for the Western Balkan countries in general. Recently, this positive trend was especially pronounced in Croatia and Macedonia. Both countries have caught up with the NMS-5 in terms of level.

Overall, however, the investment rate in the Western Balkan countries remained mostly unchanged (Montenegro, Serbia) or even fell sharply (Albania, Bosnia and Herzegovina, Croatia) between 2005 and 2013. Only in Kosovo and Macedonia, the share of gross fixed capital formation to GDP showed a noteworthy increase. They were the only two countries in the region to record an increase of subsidies to GDP, but met with varied success in acquiring foreign direct investment. The effectiveness of the structural policies implemented in the Western Balkan states thus remains unclear. Investment incentives are probably only of limited suitability for improving a country's investment ratios and its competitiveness.

Figure 2.11 / Gross fixed capital formation, in % of GDP



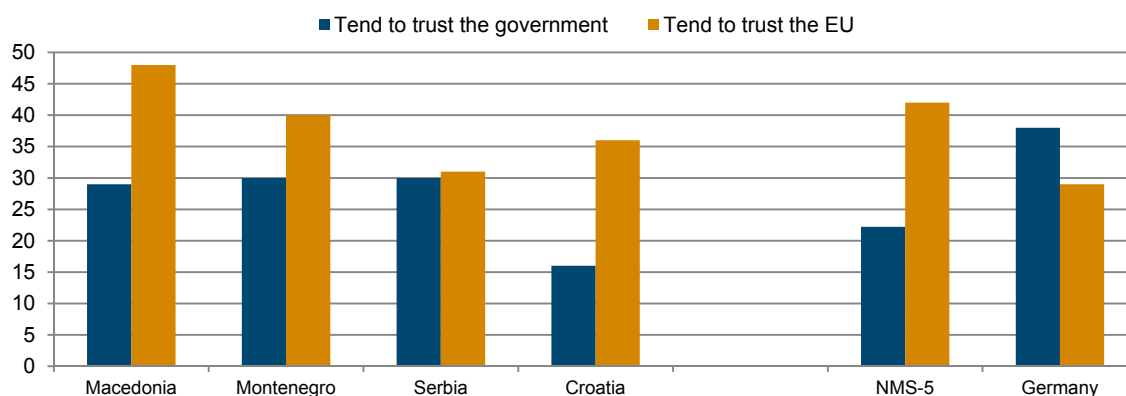
Source: wiiw Database, Eurostat.

The same presumably applies to regulatory policy. Trends are encouraging, even if the level can still be improved compared with the NMS. In this regard, the prospect of joining the EU is a decisive factor and will lead to sustainable improvement of the regulatory framework that shapes the economy.

Eurobarometer-surveys show just how important the European Union as an anchor of institutional stability is for the peoples of the Western Balkans. In all countries in the region as well as in the NMS, confidence of the population in national governments is low when compared to confidence in the European Union. It is significant that in the core countries of the EU, e.g. in Germany, the exact

opposite is the case. This also reflects periphery-centre interdependencies we need to overcome. A state of equilibrium more favourable to all participants could be induced through a cooperative approach. Strong support by the European Union to the Western Balkan countries in their efforts to strengthen their competitiveness could be mutually beneficial in the long-term. Yet, EU accession alone will not remove all the shortcomings in terms of competitiveness, as the Croatian experience shows.

Figure 2.12 / Trust in institutions, in % of those questioned, autumn 2013



Source: Eurobarometer.

In its progress reports, the European Commission has accordingly always directed its attention to the Western Balkan countries' reform efforts in the area of public administration. Consequently, Croatia as member country of the EU has implemented comprehensive public administration reforms. A separate Ministry in charge of public administration and a State School for Public Administration in charge of training schemes for civil servants were established. In Kosovo as well there is a separate Ministry for Public Administration and the Kosovo Institute for Public Administration is in charge of training schemes for public sector employees. Few personnel and limited financial resources, however, are a major challenge to the implementation of the policy papers and action plans. This, of course, is true for most of the other countries in the region as well.

The European Commission also evaluates progress achieved in the area of judicial reform. Some Western Balkan countries, e.g. Macedonia, have already implemented many measures that are in line with European standards. Nevertheless, major challenges remain with regard to the practical functionality of courts. In early 2013, Kosovo introduced a new judiciary. Moreover, a new Criminal Code and new Code of Criminal Procedure have entered into force and must now be implemented. The challenges regarding judicial independence are daunting as well as there is frequent talk of political interference. The situation in Albania and Bosnia and Herzegovina is quite similar in this respect. Political interference in the judiciary especially as regards staff decisions is a major problem in Serbia and Montenegro as well. Parliaments in these countries have recently adopted reforms to ensure greater independence of the judiciary. In the field of judiciary reform, Croatia meets the fundamental requirements arising from the accession negotiations. According to the European Commission, the reform of the Judicial Council and the Prosecutorial Council has laid the foundations for transparent and impartial appointments of high-level officials in the judiciary.

Recently, the European Commission was satisfied that most Western Balkan countries have made progress in combating corruption but at the same time established that there still are substantial shortcomings.

2.4. POLICY AREAS WITH POTENTIAL FOR REGIONAL COOPERATION

A large number of regional organisations have made it their task to coordinate policies in the Western Balkans and/or on the entire Balkan Peninsula and beyond and to facilitate cooperation. The cooperation partners mostly seek to advance Euro-Atlantic integration. In this regard, the Regional Cooperation Council (RCC) of the South-East European Cooperation Process (SEECP) based in Sarajevo is taking a preeminent role. In the field of trade, the Western Balkan states and Moldova renewed the Central European Free Trade Agreement (CEFTA) in 2006. In the other competitively significant policy areas, regional cooperation so far was strongest in the transport and energy sectors. In 2004, the South East Europe Transport Observatory (SEETO) was established whose purpose is to promote cooperation on the development of a multimodal transport infrastructure in the Western Balkans and to connect the regional transport network to the EU transport network in the framework of the Trans-European transport networks (TEN-T). The agreed-upon SEETO network encompasses 6,554 km of roads, 4,807 km of railway lines, 4 rivers, 10 sea ports, 17 airports and 8 inland harbours.

A great deal has already been achieved with regard to the improvement of major intra-regional roads while progress was limited regarding the improvement of the railway network.

Cooperation in the field of energy policy is taking place mostly within the framework of the Energy Community. Members include the European Community, the Western Balkans, Moldavia and Ukraine. The declared objective of the Energy Community Treaty is to export the European Community's energy policy to non-EU countries. This Treaty seeks to promote investment in energy production and energy networks, to establish an integrated energy market, to achieve security of supply, to protect the environment and to improve competition on the regional level. It is also envisaged to adopt the relevant parts of the *acquis communautaire*, to establish regulatory structures and to liberalise local energy markets. Moreover, 35 'Projects of Energy Community Interest' (PECI) were defined.

Modern transport and energy infrastructures that are connected to international networks are central to a country's economic development and competitiveness. This can be observed in countries, e.g. Kosovo, that have significant deficiencies in both areas. Since the Western Balkan is heavily fragmented on the national level, it is precisely with regard to these two network infrastructures that international cooperation and coordination are of the essence and should be increasingly promoted.

3. Need to reform lending activity and the banking sector

3.1. OBJECTIVE AND STATUS OF THE CHAPTER

Since the start of the global financial crisis, the Western Balkan countries have experienced a continuous reduction in the assets reported in bank balance sheets accompanied by a simultaneous sharp increase in non-performing loans in their portfolios. It is reasonable to assume that a revival in enterprise borrowing and an improvement in asset quality are the key preconditions for investments in innovation and technology. The third section examines the size of the problem posed by non-performing loans. The last section focuses on economic policy options, and within this, on an approach that is largely designed to enable the banks to deal with the problem of non-performing loans themselves rather than to wait for comprehensive government support.

3.2. THE IMPORTANCE OF LOAN FINANCE FOR INNOVATION ACTIVITY IN THE WESTERN BALKAN REGION

In the new Member States (NMS) of the EU and the Western Balkan countries, capital market finance – measured in terms of equity market capitalisation – currently plays less of a role than in the eurozone; Croatia and Montenegro are exceptions to this rule (no information is available for Kosovo). Consequently, enterprises depend on debt (i.e. loan) finance.

Table 3.1 / External financing vs. market-based financing (unweighted averages of the period 2007-2011)

	Stock market capitalisation	Assets of financial sector	Commercial banks	of which: Investment funds	Insurance companies	Pension funds
	in % of GDP		in % of assets of the financial sector			
Albania	k. A.	64.7	89.5	0.0 ^a	2.2 ^b	0.0 ^c
Bosnia and Herzegovina	k. A.	60.8	86.7	6.9	6.3	k. A.
Croatia	54.8	105.6	77.7	5.1	8.0	9.0
Macedonia	19.5	49.6	85.9	1.8	6.0 ^b	3.6 ^c
Montenegro	81.9	73.1	100.0	0.0	0.0	0.0
Serbia	32.1	50.4	91.5	k. A.	7.1	0.6
Poland	33.3	62.8	53.2	9.1	16.6	21.2
Slovakia	5.9	80.3	76.1	5.9	10.3	7.7
Slovenia	29.9	116.2	81.2	4.9	12.0	1.5
Czech Republic	27.0	57.8	66.1	5.0	18.9	9.7
Hungary	23.0	80.6	59.6	15.0	11.0	13.2
EMU ^d	54.0	189.0	71.2	8.5	16.9	3.0

a) 2009-2010; b) 2009; c) 2007-2010; d) 18 countries.

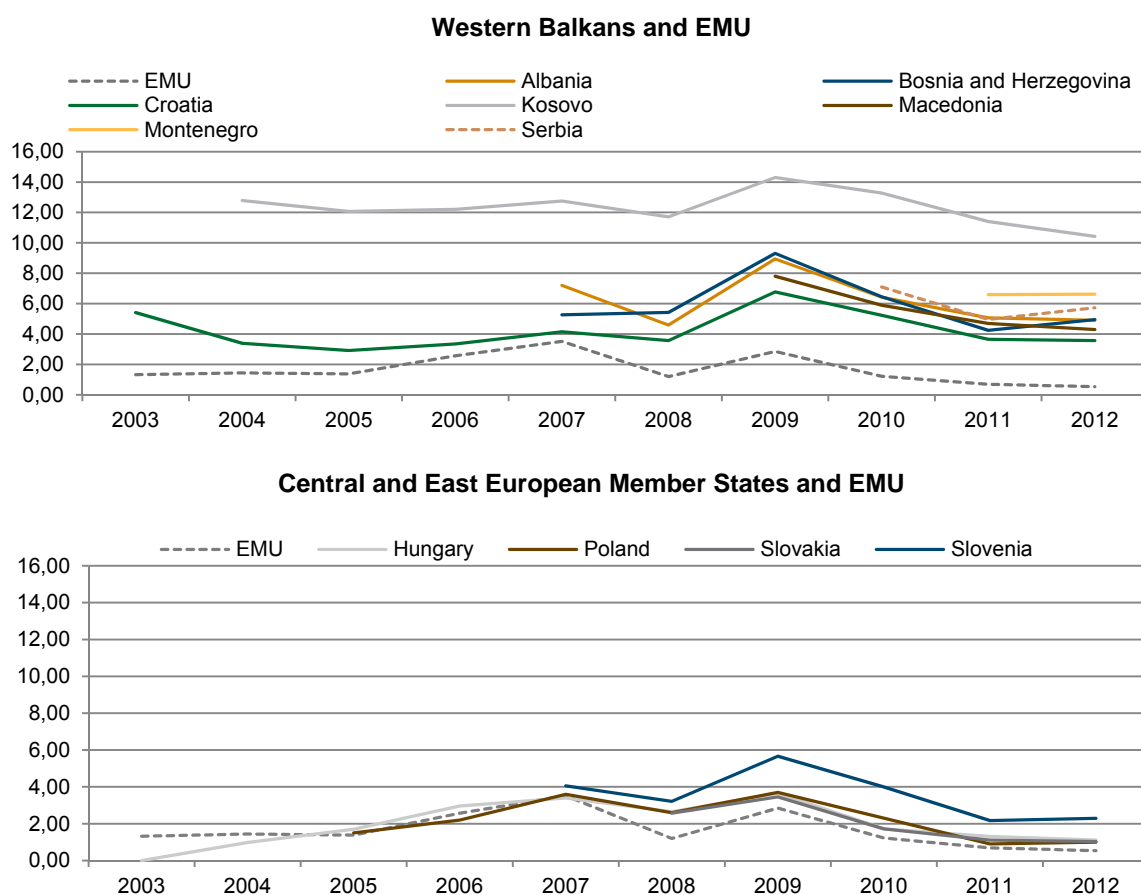
Source: Federal Reserve Bank of St. Louis data base online; accessed 14 October 2013 and 24 June 2014; own calculations.

The dominant form of debt finance in transformation economies typically comprises bank loans. This dominance is more pronounced in the Western Balkan region than in the eurozone and the NMS, where bond finance already plays a considerably more important role. The higher proportion seen in certain NMS reflects the greater progress made by them in the transformation process, as well as their membership of the EU. No secondary bond market exists for practical purposes in the Balkan countries – with the exception of Croatia. Neither financial institutions nor enterprises issue significant volumes of bonds; only the governments do this.

Most lending and deposits in the Western Balkan countries involve foreign currencies, and in particular the euro. Foreign currencies consistently accounted for more than 50% of outstanding loans and deposits in the period between 2011 and 2013. The main institutional reasons for this were the far-reaching liberalisation of capital flows to and from abroad, the adoption of the euro as legal tender in Montenegro and Kosovo, and loan interest rates that were and are lower than rates for loans in the domestic currency.

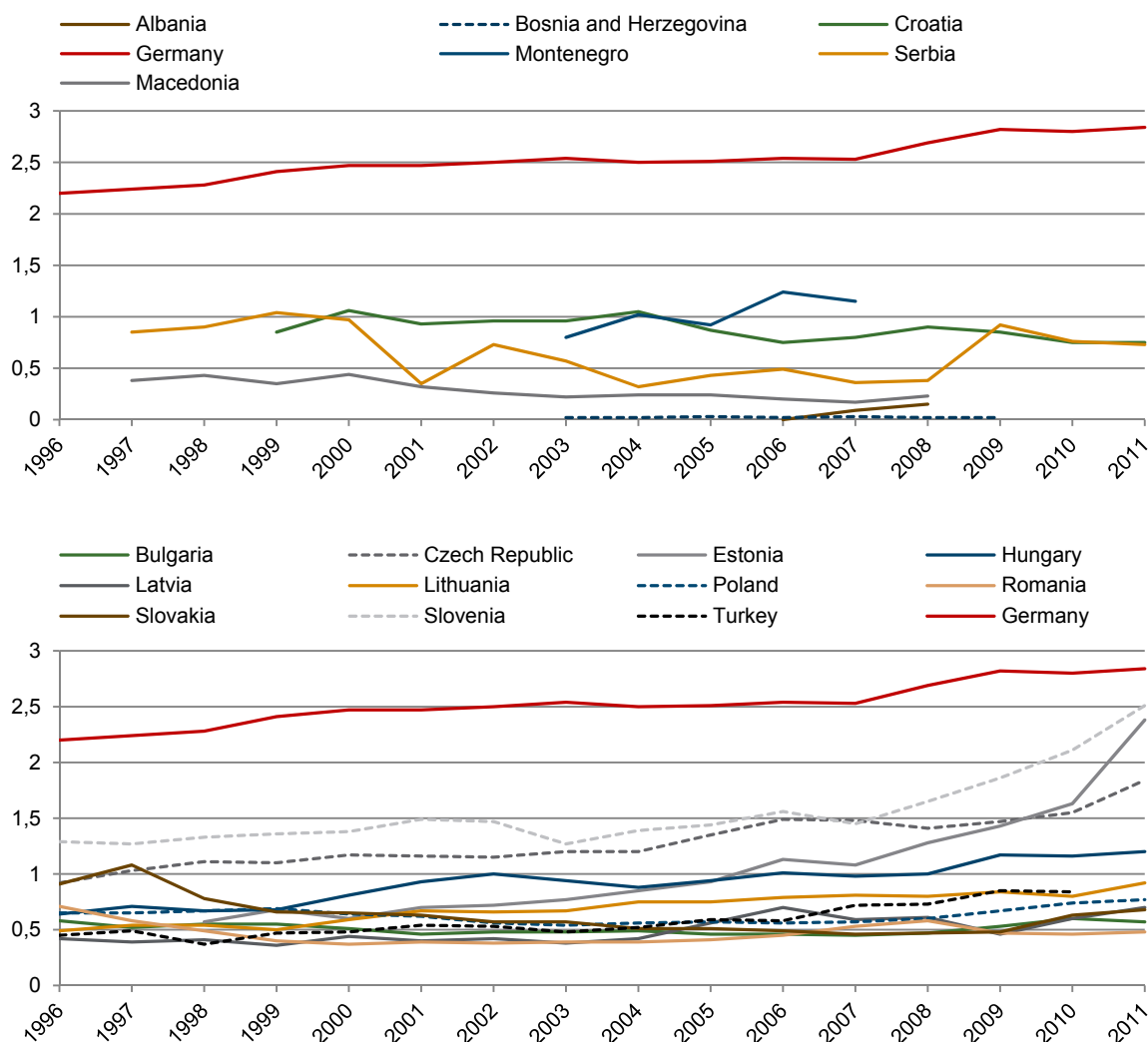
The pace of innovation in the countries belonging to the Western Balkan region is slower than in the NMS where, among other advantages, real borrowing costs are also lower. It is even trending downwards in the current crisis, whereas it is clearly rising in some NMS and not declining in the others.

Figure 3.1 / Real interest rate on long-term foreign currency loans (euro-based)^a



a) Nominal interest rate deflated with euro inflation rate.

Source: Eurostat and National Banks; own calculations.

Figure 3.2 / Gross domestic expenditure on research and development (GERD), in % of GDP

Source: UNESCO Institute for Statistics, 2014; own calculations.

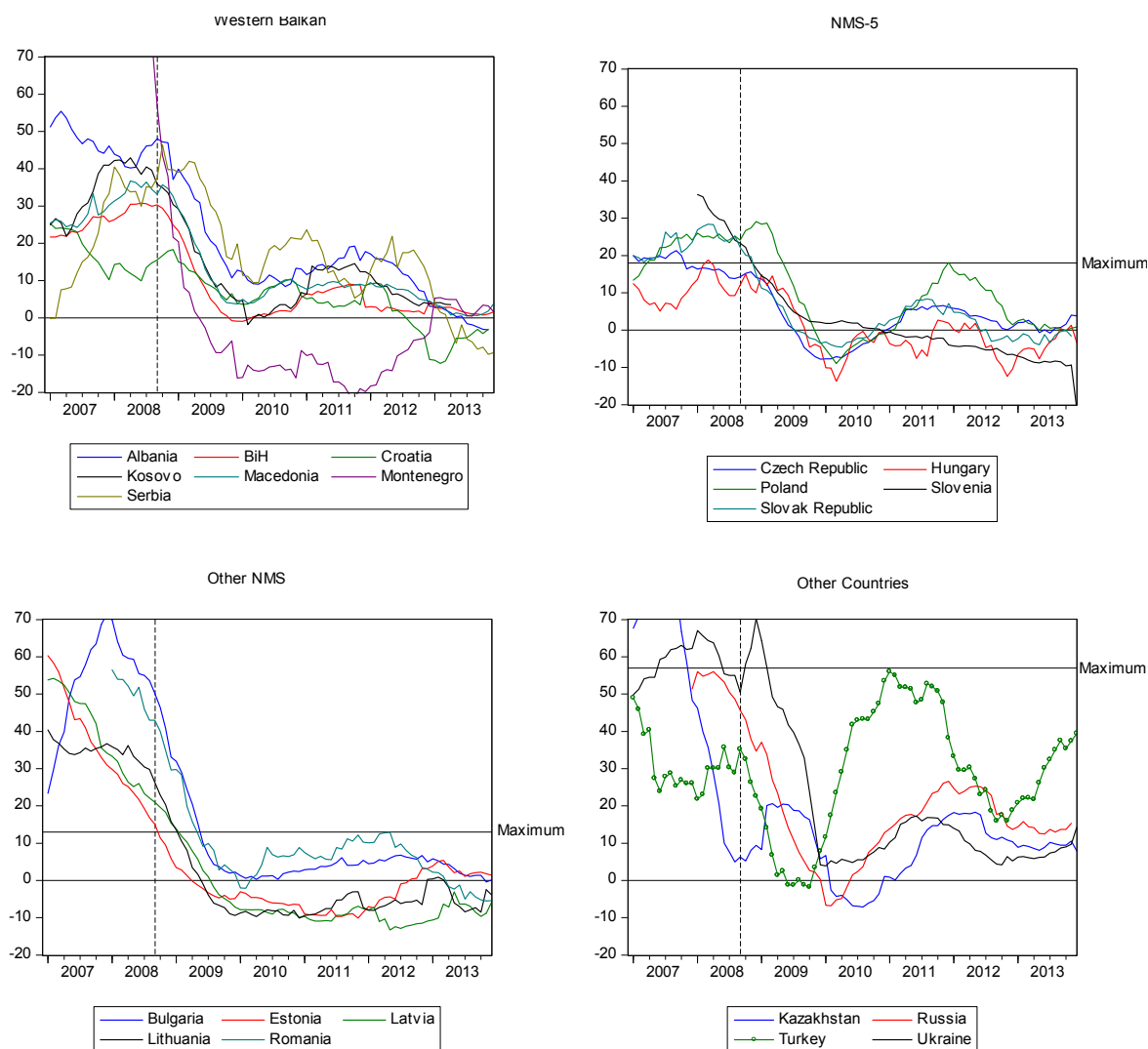
3.3. MACROECONOMIC TRENDS IN LOAN FINANCE IN AND THE RELATED DRIVERS

Until the outbreak of the global financial crisis in September 2008, the NMS of the EU and Southeast Europe (the Western Balkans including Turkey) experienced a lending boom with what were for a time extremely high growth rates in certain countries. From 2009 onwards, EU banking groups started to reduce their exposure to the Western Balkan countries and the NMS. The squeeze on external funding induced local banks to raise interest rates and to apply more restrictive credit standards (terms, volumes, currencies and collateral). The original credit boom was stronger in the Western Balkan countries¹ than in the NMS-5, but the slump after the crisis was less pronounced than in the other NMS, and in particular the Baltic states. In contrast, developments in the non-EU countries were less extreme and a recovery took hold in the current periphery (this applies in particular to Turkey as a regional

¹ Growth rates of temporarily more than 100% per year in Montenegro, however, appear exaggerated.

competitor of the Western Balkan countries); in contrast, a slight upturn was seen at the end of 2013 at best in Bosnia and Herzegovina, the Czech Republic and Latvia.

Figure 3.3 / Outstanding loans of commercial banks to non-financial corporations (monthly, annualised rates of change in %)



Source: wiiw.

The regular surveys by the European Investment Bank of Albania, Bosnia and Herzegovina, Croatia and Serbia reveal that demand for loans outstripped supply until the end of 2013 and that, equally, no trend reversal is expected in the coming months (European Investment Bank, 2014). Lending conditions in these four countries deteriorated in the period up to the end of 2013 or remained at a low level, whereas demand for credit was set to improve further. Local banks saw the high level of non-performing loans in their portfolios and its further increase as one reason for tightening their lending policies. A further factor mentioned by the local banks surveyed was uncertainty regarding developments in the regulatory environment. These include in particular the Basel II core principles and the pending implementation of Basel III, with its new capital ratios and countercyclical liquidity buffers.

Table 3.2 / Conditions of supply of and demand for loans, according to surveys 2nd half of 2013

	Loans to the corporate sector ^a	Demand for loans	Supply of loans	Non-performing loans	Lending standards	Refinancing
Albania	-2.5 (3 rd quarter)	+	-	-	0	+
Bosnia and Herzegovina	1.6 (4 th quarter)	-	0	+	-	0
Croatia	-3.1 (3 rd quarter)	-	0	-	-	+
Serbia	-9.3 (4 th quarter)	-	-	-	-	+
Western Balkans ^b	-0.6 (2 nd half-year)	-	0	-	-	+
WB(4)+NMS ^c	-0.2 (2 nd half-year)	+	+	0	-	+

a) Annual rate of change. b) Authors' estimate. c) Bulgaria, Czech Republic, Hungary, Poland, Romania, Slovakia.

Source: European Investment Bank (2014); own computation.

At the same time, no clear picture emerges of whether lending is being driven primarily by supply or demand factors. In order to obtain a more systematic insight into the workings of the credit cycle, regressions were estimated using panel data for a maximum of 20 new market economies in Europe for two periods, whereby the second period is purely a crisis period with predominately negative or flat rates of credit growth.²

In general, these estimates revealed a change in the drivers for lending for all of the new market economies observed up to the end of 2009/beginning of 2010. In the first period, which featured a credit boom in 2007 and 2008, general demand effects set the tone for lending by the banking sector; in the subsequent 'pure' crisis phase supply factors – in this case the increase in non-performing loans – predominated. Any interpretation of the results of estimates for the Western Balkan countries is subject to the caveat that the number of observations is substantially reduced; although the quality of the estimated results is lower, they reveal a similar change in drivers; however, non-performing loans to private households play a greater role than in the group of countries as a whole. Consequently, the remainder of this assessment focuses on an analysis of the volume of non-performing loans and the solution to this problem.

3.4. THE SIZE OF THE NON-PERFORMING LOAN PROBLEM

Non-performing loans are generally defined as loans that are more than 90 days past due.³ Their share of the entire loan portfolio in the banking sector has been rising since 2007, and has increased particularly rapidly and dangerously since 2009 in all Western Balkan countries and certain NMS. The exceptions among the NMS are Poland, the Czech Republic and Slovakia. The levels reached in 2012/2013 are similar to those seen in eastern Asian countries following the crisis in 1997/98 and in Turkey in 2001.⁴ Among the NMS of the EU, Romania and Hungary experienced a comparable rise to the Western Balkan countries. The additional credit restrictions expected to be imposed by the banks in

² Detailed information about the quantitative assessments can be found in Appendix B to the German version of the study or in Gabrisch, H.: 'Financial constraints on growth: comparing the Balkans to other transition economies', *Eastern European Economics*. Vol. 53, Issue 4, 2015, pp. 309-327.

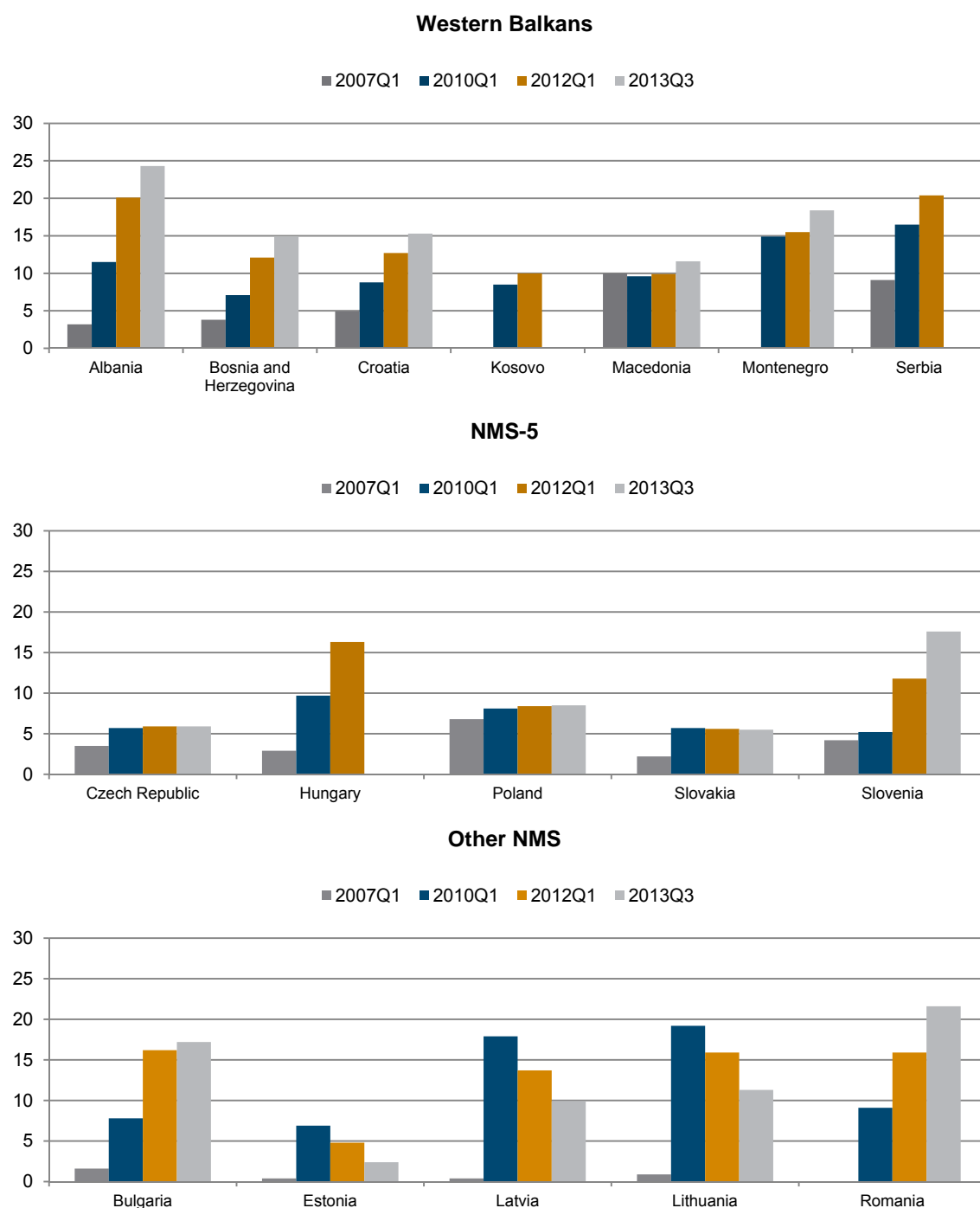
³ The terminology used is often different from one country to another, making the comparability of statistics difficult.

⁴ At about the 30%; Norway had a similar problem, the proportion of bad loans in 1991 reached almost 17% (European Banking Coordination „Vienna Initiative“, 2012).

the Western Balkan region are apparently also being driven by expectations of a further increase in non-performing loans.

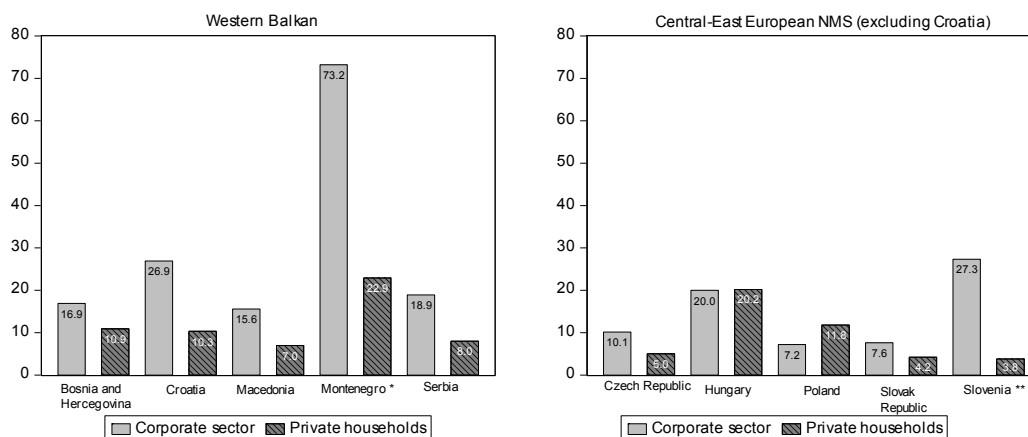
The regression analyses performed for the Western Balkans suggest that a solution to the problem for private households would lead to substantial positive effects on a revival in enterprise borrowing.

Figure 3.4 / Non-performing loans in % of all loans of the banking sector, by region



Source: wiiw Database. Kosovo (2010 and 2012): World Bank, 2013.

Figure 3.5 / Non-performing loans in % of all loans of the banking sector to the corporate sector and to private households, second quarter of 2013



* 4th quarter 2012. ** Data for private households refer to the second quarter 2012.

Source: wiiw Database; Montenegro: National Bank e-mail communication.

- › *Risk management:* Loan portfolio vulnerability also depends on the risk assessment performed before loans are granted. Banks' risk management in the boom period up to 2009 was inadequate. The application of international risk assessment standards to borrowers was impacted by the fact that the banks' credit committees were more interested in building market share. In the absence of loan registers, this led to loans being granted to new clients for whom no credit history was available. The situation has improved in general terms insofar as public or private loan registers now exist in all countries. In Serbia, an expansionary lending policy was facilitated by the low level of bank concentration, with the result that loan interest rates did not always reflect the risk associated with the projects being financed. The figure of 33 banks still seems too high for a relatively small economy such as Serbia.
- › *Currency hedging:* The lack of currency hedging by banks and borrowers is an important local cause of non-performing forex loans in Albania, Croatia and Serbia, and results in inefficient lending – for example in the case of mortgage loans to private households. The Albanian National Bank reports that almost 49% of all bank loans at the end of 2012 were not currency hedged, while the Croatian National Bank reported an even more pronounced figure of 93% for the first quarter of 2013. In Serbia, only a small number of banks entered into fair value hedges (2011: 6 out of 33), and the volume of such transactions has seen a downward trend in recent years. Currency hedging depends on markets for forward contracts, which ultimately entail the division of risk costs between the counterparties. These markets are underdeveloped in the Western Balkan countries. There seem to be two reasons for this (Djenic et al., 2012): Firstly, unclear derivatives market rules mean that the derivatives on offer are limited to forward contracts, which also stunts market development opportunities. A second reason has to do with the fact that forward transactions are by nature loans. Their volume has declined since 2008 in line with the generally more restrictive approach to lending conditions.

- › *Bail-out expectations:* The failure of the banks to restructure exposures in default on their own initiative, and hence to remove current and future problems from their balance sheets, played a key role in the increase in non-performing loans. This behaviour is due in part to difficulties in enforcing claims. Exposures that are completely uncollectible and that require the liquidation of the borrower represent only part of the non-performing loans. A larger proportion could be returned to the portfolio of 'good' loans by renegotiating the loan terms on a temporary basis. To date, governments and bank supervisors have been relatively patient with the banks. This has given the latter a new option: the expectation that the government will subsidise enterprises in the course of restructuring programmes – as has already happened in Serbia. In turn, the supervisory authorities in certain countries have contributed to this option, which amounts to expectations of a bail-out, by relaxing asset classifications and the rules for dealing with non-performing loans. It is possible that the experience of a number of EU Member States, whose governments rescued their banking sectors at a high cost to taxpayers instead of pressurising banks to draw up recovery plans themselves, have contributed to this wait-and-see attitude. However, what are needed are measures to induce the banks to look for solutions to the problem of non-performing loans on their own.
- › *Payment arrears:* In Albania, payment arrears on the part of the government to enterprises (including VAT refunds) halved the fiscal deficit as a percentage of GDP between 2009 and 2012, but also led to an increase in non-performing loans. Part of the arrears were settled in the first quarter of 2013, which promptly led to a renewed rise in the public-sector deficit (Bank of Albania, 2013).

High rates of non-performing loans have an effect on the real economy first and foremost by restricting the potential loan supply.

3.5. ECONOMIC POLICY DISCUSSION

3.5.1. Existing policies

The failure in the past by the commercial banks to solve the problem of non-performing loans is due to disincentives put in place by politicians:

- › In almost all countries, the rules governing allocations to LLRs were eased by the regulators on multiple occasions since 2008, with the amount required to be allocated – staggered by the period of time that a loan is past due – being reduced. Because the reserves are non-interest-bearing, relaxing the allocation ratio also represents an incentive for the banks to adopt a wait-and-see attitude to removing non-performing loans from their loan portfolio. The contrary is therefore what is required: tougher rules governing allocation and the threat of a decline in the banks' return on equity.
- › The governments of these countries seem to have a preference for starting by restructuring the corporate sector (with correspondingly subsidised programmes such as in Serbia), incorrectly assuming that the problem was triggered largely by a reduction in macroeconomic and export demand, and therefore the corporate and export sector has to be restructured. Inevitably, these programmes did not have any significant positive effects because the causes lie in the countries' banking systems (risk management and bail-out expectations), and are compounded by weaknesses in the institutional environment. To have any success, this is where a programme would have to start.

A further increase in non-performing loans can be expected if the loan portfolios are not restructured. Greater risks to the stability of the banking system would arise if the review of the major EU banks (in the course of implementing the banking union) were to reveal an increased need to restructure and recapitalise those banking groups that dominate lending activities in the Western Balkan countries. In this respect, the window of opportunity for solving the problems of non-performing loans in the Western Balkan countries is limited to two to three years. Without a solution, the chances of achieving productivity-driven economic growth will be damaged in the long run.

The primary objective of national economic policy should therefore be to reduce the stock of non-performing loans within this time frame at least to pre-crisis levels. The experience in Turkey shows that this is possible. On the other hand, the EU examples of Ireland and Slovenia show how difficult and protracted it can be.

A firm strategy for the banks themselves to reduce non-performing loans is of central importance. No Western Balkan country currently has such a strategy. Supplementary measures that might weigh on the government budget in the short term and prospectively can only be considered once such a strategy has been developed.

3.5.2. Elements of a programme for reducing non-performing loans

Irrespective of the stress tests, the regulators should institute two measures and consider taking other ones:

- › Firstly, incentives for the commercial banks not to deal with their non-performing loans immediately and on their own should be eliminated. Tightening the rules for allocations to the LLR appears to be necessary. A resulting decline in profitability could force the banks to restructure their portfolio or prompt their international owners to work towards this sort of restructuring.
- › Secondly, the regulators should impose quantitative and (quarterly) deadline requirements on the commercial banks to restructure their non-performing loans. If individual banks fail to meet the targets, they could be sanctioned by the regulator, for example by way of increased LLR allocations. This was the approach chosen in Ireland, but its success is only emerging very slowly. This reflects the continued undercapitalisation of the Irish banking system. To reduce the options open to banks about how to deal with their non-performing loans, stricter requirements could also be considered for their CARs and their leverage ratios (or the introduction of caps on their leverage ratio). This would be an alternative to increasing their LLRs from income. Increasing the CAR would have the greatest effect, because the banks could then only stabilise their RoE by removing non-performing loans from their loan portfolio. The leverage ratio could be increased by reducing assets evenly across all risk groups.

3.5.3. Measures with fiscal effects

In the Western Balkan countries, nationalising the banks has not been one of the preferred political options to date. One reason is that the banks are mostly owned by EU banking groups. In general, the fiscal costs of bank restructuring were kept comparatively low (exception: Slovenia) and were incurred at most via subsidies paid to insolvent enterprises. However, one option with potentially high fiscal costs would be the establishment of a bad bank to stabilise individual insolvent or illiquid banks. The bank(s) in question would also have to play a systemically important role.

The institutional advantage of a bad bank is that it is not actually a 'bank' in the conventional sense, but a special purpose vehicle (SPV) that can therefore operate without a banking licence. The SPV could buy the majority of a bank's uncollectible receivables at a discount by issuing bonds, significantly improving the bank's risk-weighted assets and thus also its CAR. This restores the bank's ability to lend, as does the eligibility of the bonds for central bank borrowings.

However, establishing a bad bank must be preceded by an extensive AQR – as in Slovenia – so as not to encourage moral hazard. Another problem is that a bad bank always means socialising private risks. This could be justified as a short-term solution if it were to encourage investment and economic growth. In the long term, on the other hand, injecting new private capital into the banking system appears to be the better solution.

3.5.4. Summary

All Western Balkan countries need to take urgent action to solve the problem of non-performing loans. This applies to all of the countries. For some of them – in this case Bosnia and Herzegovina, Montenegro and Croatia – establishing a bad bank to handle non-performing mortgage loans of private households would be a feasible solution. However, this option should only be considered after a detailed assessment of the uncollectible receivables so as not to create incentives for banks to dump as many mortgage-backed securities as possible on the public purse and thereby increase the fiscal costs. AQR stress tests to be performed by institutions that are independent of the central bank and the government are important in this context. The standards for non-performing loans should then be harmonised based on the results.

The economic policy options set out above are designed to revive lending activity as quickly as possible – and at the latest in the medium term – by solving the problem of non-performing loans. The calculations indicated that this solution offers considerable potential for expanding lending activity.

4. Capital inflows and real appreciation

4.1. OBJECTIVE AND STATUS OF THE CHAPTER

This chapter examines the cross-border capital flows in terms of their causal relationships with real exchange rates.

4.2. OVERVIEW OF TRENDS

In balance of payments statistics, capital flows comprise 'foreign direct investment', 'portfolio investment' and 'other investment'. They are reported as gross and net amounts in the financial account.

However, the current account also contains income and transfers, whose offsetting entries may appear in various items of the trade balance or the financial account, whereby it is not always possible to unequivocally identify the offsetting item. Some countries in the Western Balkans recorded considerable inflows of wage income from international organisations (Bosnia and Herzegovina) and/or from remittances. These financial transactions are rarely included in research into real exchange rates. However, because they affect the trade balance – either directly through being used in consumption or investment, or indirectly through the real exchange rate – they are also addressed here in addition to capital flows.

Just like the new EU Member States (NMS), all countries in the Western Balkans (WB) registered substantial capital and financial inflows prior to the outbreak of the global financial crisis and the resulting downturn in international demand.

Montenegro and Bulgaria attracted the most (net) direct investment in relation to their gross domestic product (GDP). In all other countries, foreign investors were rarely responsible for investing more than 10% of national GDP, and if they did, it was only for a short period. The significance for the Polish and Slovenian economies was astonishingly low. A general trend observed is that the relevant importance of direct investment has tended to decrease since the outbreak of the crisis. This is particularly evident for the former primary recipients Montenegro and Bulgaria.

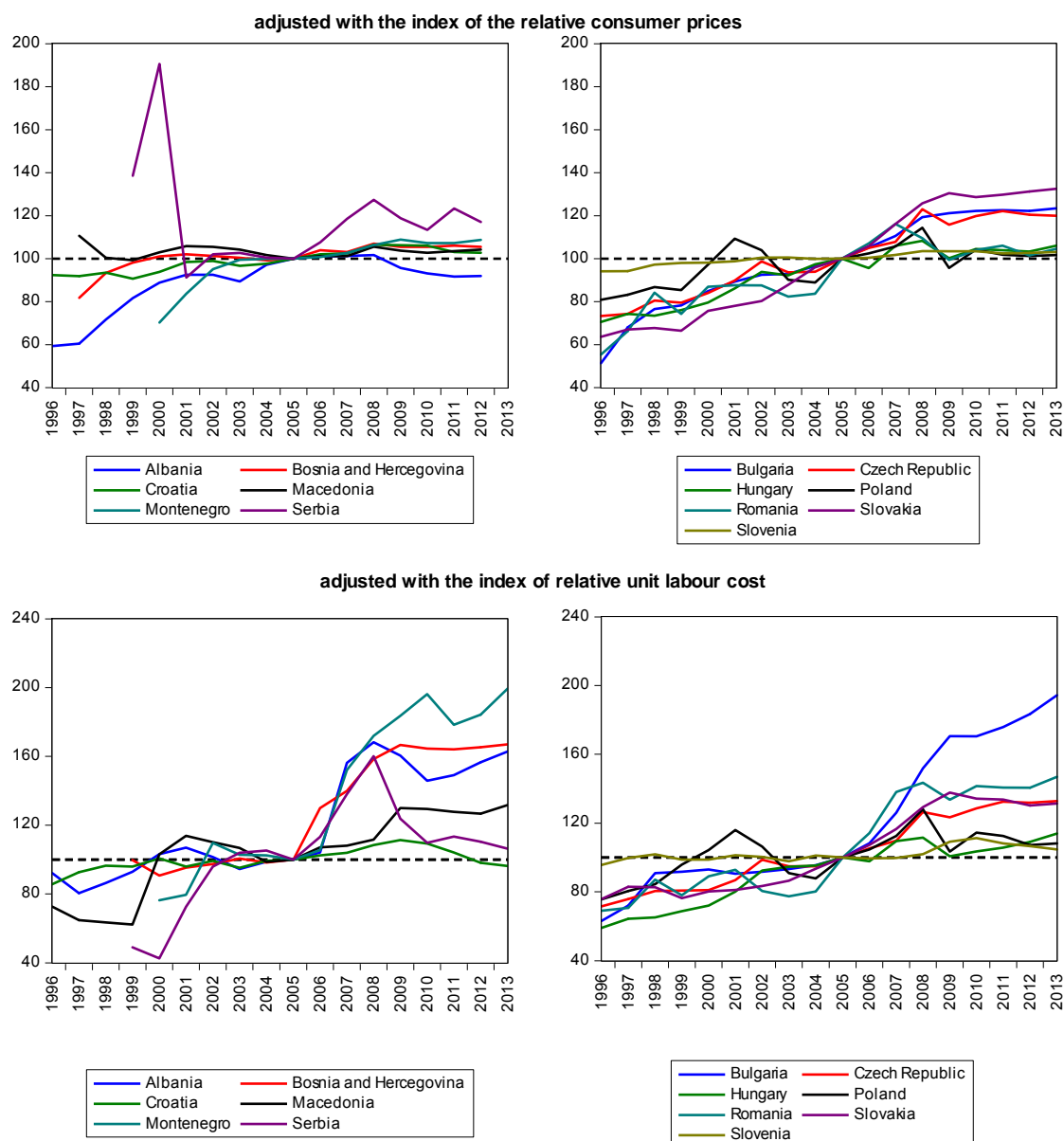
The picture for portfolio investment is very different. It accounted for a much lower share of GDP than direct investment in the Western Balkan countries. Although the same holds true for the NMS, the gap between the two forms of capital flows was not as pronounced (so uniform scaling does not deliver any additional insights). If nothing else, this difference also reflects the more mature financial sectors in the NMS (see chapter 3 of the study). The second immediately evident difference compared with direct investment is the greater volatility, which is something in the nature of portfolio flows. Purchases and sales of securities in the financial markets respond considerably faster and more strongly to financial shocks than, for example, the liquidation of real capital.

The net other investment position also exhibits a similar volatility pattern. As a ratio to GDP, the Western Balkan countries and the eastern Balkan country Bulgaria recorded the highest net inflows until the crisis. Following the onset of the crisis, the balance tilted heavily into negative territory at times. Because this position consists largely of loans and credits of all forms – in contrast to direct and portfolio investment – a higher level of external debt financing was evident for the Western Balkans and Bulgaria than for the rest of the NMS. The share accounted for by this financing declined significantly for the entire region following the outbreak of the global and European financial crisis and the ensuing recession. This is particularly conspicuous for Croatia and Serbia, but not for Bosnia and Herzegovina, where other investment continued to dominate capital inflows, albeit at a lower level. This picture reflects the initially easy but latterly increasingly difficult refinancing of the local credit business via foreign (EU) banking groups, as explained in chapter 3.

From the second half of the 1990s up to 2009, a continuous real appreciation of the currencies of all countries (no (or no comparable) data were available for Kosovo) against the euro or its predecessor currencies was observed, in line with the net capital and financial inflows. The inflows have dropped considerably since then, whereas the real exchange rate recorded at most a delayed downward adjustment in those countries whose economies reacted to the financial crisis by devaluing their nominal exchange rate (Poland, Hungary, Serbia, Albania). The Baltic states (which are not included here) used 'internal devaluation' to make this adjustment, because they were unable to use exchange rates as an instrument. This internal devaluation consisted in particular of cutting labour costs. Of the countries analysed here, Albania is an exception in this respect because its inflation-adjusted exchange rate devalued, but not its exchange rate adjusted for unit labour costs.

In most cases, the deterioration in competitiveness was driven mainly by growth in relative labour costs, and less by the general rate of inflation. It is very clear that real exchange rates actually continued to appreciate during the crisis in four of the Western Balkan countries. This could be an indicator that distribution objectives, the inflexibility of collective bargaining agreements and non-economic objectives dominated in the macroeconomic wage function.

This is likely to have been a pivotal factor in countries without their own currency (Montenegro) or where a currency board does not permit any flexibility (Bosnia and Herzegovina). However, it was probably also a factor in Croatia and Macedonia, whose exchange rate regimes have limited flexibility. These countries could have followed the path taken by the Baltic states, which adjusted their real exchange rates through internal devaluation – i.e. effectively by cutting nominal wages – but they chose not to do so. However, no systematic picture emerges of the relationship between exchange arrangements and real exchange rates on the one hand and the transmission of capital flows on the other. Serbia's exchange rate regime is more flexible than Croatia's, but real exchange rates still experienced a downward adjustment in both countries (and this was more pronounced in Serbia than in Croatia). An analysis of the exchange rate adjusted using the inflation differential reveals a sharp real devaluation for Albania after 2009 – in contrast to a continued strong real appreciation adjusted for relative unit labour costs – although the Albanian exchange rate regime is de facto close to that of Serbia. Despite the recent slide of the euro against the dollar, the real effective exchange rates for the Serbian and Albanian currencies have continued to devalue. This process, which has a positive effect on the price competitiveness of exports from the two countries, generally suggests that nominal exchange rates are flexible.

Figure 4.1 / Development of the real exchange rate index (2005 = 100)^a

a Relative consumer price index: vis-à-vis the respective index of the EU. Relative labour unit cost index: vis-à-vis the respective index of the Euro-12 area (see also Appendix).

Source: wiiw Database; Eurostat; own calculations.

4.3. EMPIRICAL ANALYSIS AND DISCUSSION OF RESULTS

At first glance, the previous section merely indicates that cross-border capital inflows were 'accompanied' by an appreciation in real exchange rates.

Tests for the Western Balkan region reveal that a deterioration in the current account (= increase in net capital inflows) was statistically causal for a real appreciation, and not vice versa. The significance of a correlation with relative unit labour costs was distinctly higher than with the inflation differential, meaning that different transmission channels are likely to have been in play here. It is evident that a rise in unit

labour costs was not reflected in a corresponding rise in domestic inflation, in part because import competition diminished inflationary pressures. The conclusion from this for the economic policy discussion is that macroprudential measures to improve competitiveness in the Western Balkan region should also include – and possibly even be centred on – action to defend against destabilising capital inflows.

However, the causality analysis does not allow any reliable conclusions to be drawn about the transmission mechanisms for cross-border capital flows. In terms of the components of capital inflows, a clear contribution to an increase in relative unit wage costs – but not to the inflation differential – was evident for the Western Balkan countries. The marginal productivity-enhancing effect in the Western Balkan countries can be explained by the large proportion of direct investment flowing into traditional services and the real estate sector. This shows the signs of the sort of real estate bubble that was already described for Ireland and Spain. The same applies to portfolio investment and other investment, which have a high explanatory power for unit labour cost trends, but less for the inflation differential. Here, too, there are differences to the NMS, where portfolio investment does not have any significant influence on labour cost trends – for example through speculative financial investments. This is already more likely in the Western Balkan countries, where it is probable that such an asset price bubble was transmitted via the capital goods industry to the real economy – and hence also to the labour market.⁵

4.4. ECONOMIC POLICY DISCUSSION

Until the outbreak of the crisis, capital inflows led to a massive real appreciation of the currencies of the Western Balkan countries. The slowdown in these inflows and their partial reversal during the crisis did not contribute to any adjustment in real appreciation, although they did result in a domestic credit crunch and higher borrowing costs. The problem now facing these countries is to achieve export surpluses (= net capital outflows) without risking further curbs on domestic financing and income levels. If no social consensus can be reached that will allow the competitive position to be improved in the near term by cutting nominal wages ('internal devaluation'), the only alternative left is the longer-term solution of keeping wage increases below the rate of productivity growth, which demands a corresponding realignment of labour market and wage policies. The discussion in the following is restricted to options for defending against undesirable – and encouraging desirable – capital inflows: adjustments to the exchange arrangement and measures for managing capital inflows.

4.4.1. Exchange rate policy and arrangement

The exchange rate policy that can be operated in light of the challenges posed by capital inflows and outflows depends on the choice of exchange arrangement. However, this choice is based on broader considerations than just aspects of foreign currency inflows – in particular monetary policy objectives, the objectives of holding international reserves and defending against international financial crises. In this respect, the effectiveness of exchange rate policy in avoiding an undesirable real defence declines with the number of objectives that exchange rate policy has to take into consideration.

⁵ Detailed information about the quantitative assessments can be found in Appendix C to the German version of the study or in Gabrisch, H.: 'Net capital flows to and the real exchange rate of Western Balkan countries' *Economic Annals*, Belgrade, Vol. LX, 2015, No. 205/April-June, pp. 31-52.

Table 4.1 / Classification of de-facto exchange rate arrangements in the Western Balkans after the reclassification 2009

	De-facto arrangement	Implication	Monetary framework	Inflation differential to EUR 2013 in pp
Albania	Floating	Restricted flexibility vis-à-vis the euro; with foreign exchange interventions	Inflation target 2009- 2011 and 2012-2014: 3%	0.9
Bosnia and Herzegovina	Non-floating	Currency board (euro)	Rule-based	-1.4
Kosovo	No own currency	Euro as official currency	No separate monetary policy	
Croatia	Non-floating	Crawl-like ^a	Exchange rate target	1.3
Macedonia	Non-floating	'Stabilised arrangement' ^b (peg-like) (band)	Exchange rate target	1.9
Montenegro	No own currency	Euro as official currency	No separate monetary policy	1.2
Serbia	Floating	Without foreign exchange interventions	Inflation target: 2009-2011: 2-4%; 2014-2016: 4%	13.1

a) Crawl-like: spot market exchange rate remains for at least six months within the limits of a 2% deviation from a statistically identified trend. – b) 'Stabilised arrangement': spot market exchange rate remains for at least six months within the limits of 2%.

Source: International Monetary Fund (2013); Eurostat; wiiw Database.

No Western Balkan country has a conventional fixed exchange rate. Although the currency board operated by Bosnia and Herzegovina features a fixed rate, the above-mentioned sterilisation policy considerations do not apply in a monetary environment featuring a currency board. In such a case, monetary policy could not even be operated via interest rate or open market policy instruments if there were a market for sovereign debt. However, experience shows that a certain degree of leeway in a minimum reserve policy can be preserved (see the example of Estonia until the adoption of the euro), though this instrument can only be applied if the foreign exchange reserves in the banking system are sufficiently high. In a currency board, a minimum reserve policy will be effective at most in those cases where the central bank is convinced that all it is facing is a short-term minor liquidity crisis. The only alternative solution is to abandon the currency board or to impose an internal devaluation that results in the necessary export surplus by cutting domestic real incomes. Bosnia and Herzegovina, Montenegro and Kosovo are also facing these alternatives, with the euro being the official currency in the latter two countries. As is well known, the Baltic states chose the second option in the global financial crisis because they received massive financial support from EU funds, encouraged labour emigration and exhibited a high level of integration of their export sector with Scandinavian producers. These were not characteristics that applied to the three countries listed above.

Bosnia and Herzegovina turns out to be a special case here because opting for a currency board evidently followed general policy rather than economic policy considerations. In assessing the option for Montenegro and Kosovo to return to their own currency, however, it should be considered that these economies would then hardly be in a position to operate their own monetary and exchange rate policy. They are too small and their economies are too heavily integrated internationally to give them effective room for manoeuvre. Another factor is that, in light of the existing financial integration, the markets would immediately start testing the monetary and exchange rate policy, which could lead to an overshooting devaluation. Introducing a fixed exchange rate or some sort of exchange rate band would be particularly problematic. In this case, the central bank would have to have sufficient currency reserves at its disposal to enable it to defend the exchange rate.

For Serbia and Albania, the costs of shifting from a floating to a less flexible exchange rate are comparatively low. Even if it has a floating exchange rate, no country of this size can run an independent monetary policy if the trade and finance components of its economy are liberalised and euroised. Nevertheless, moving to an entirely fixed exchange rate hardly appears to be an attractive option for promoting net exports and avoiding sudden capital outflows and speculative capital inflows. An intermediate system, like the ones in Croatia and Macedonia, combines the best, but unfortunately also the less positive, features of the other two arrangements. Among the positive aspects are that the restrictions imposed by an orthodox monetary policy with monetary policy rules such as the Taylor rule – with a direct or indirect inflation target – can be eased by less orthodox instruments. The central bank does not leave it up to the forex markets alone to determine the exchange rate within a band around the central parity. Depending on requirements, it can narrow or expand the band, modify the central parity or change the rate of sliding devaluation. If capital inflows are too strong, there is still scope for sterilisation measures, and if their cost is too high, the central bank can expand the band or modify the central parity without fully covering any existing inflation differential. Another positive factor is that the volatility within the band reduces speculative pressure.

Among the more problematic features is the risk that the individual parameters will be insufficient either to withstand market pressure or to maintain control over monetary developments in the domestic economy. The fluctuation band of 1% for Croatia and 2% for Macedonia certainly stops the exchange rate from overshooting in the event of sudden capital outflows, but it does not prevent the monetary base from being heavily compressed because of the negative volume effect. On top of this, there is always the problem that political considerations will delay the necessary adjustments to the parameters.

Under the conditions currently prevailing in the Western Balkans – capital outflows and a credit crunch, plus declining macroeconomic demand, plus a weak export base – a floating exchange arrangement, a currency board or the total lack of an own currency are proving to be a barrier to boosting export activity in the short to medium term. For this reason, Albania and Serbia should consider shifting to an intermediate exchange rate regime, while Croatia and Macedonia should consider expanding their bands. In the case of Albania, the no more than minor inflation differential to the euro (0.9 percentage points in 2013) means that the band could be larger than for Serbia (13 percentage points). The wider band for Albania would help curb speculative market pressure and prompt the commercial banking sector to seek longer-term funding opportunities. In light of the still high inflation rate, a narrower, sliding band is justified for Serbia. For Macedonia and Croatia, the existing band appears to be too low, given the threat of capital outflows at present. Moving to their own currency cannot be recommended for Montenegro and Kosovo.

4.4.2. Measures to control capital inflows

As opposed to defining exchange rate policy objectives, measures to control capital inflows can be employed more accurately in order to manage capital inflows and outflows as the conflict between several targets can be avoided. In practice, those measures can be used to fend off short-term capital inflows without barring the entry of foreign direct investment. From a theoretical viewpoint they serve to increase welfare in an environment of non-efficient markets with considerable externalities. The argument is that individual investors accept aggregated prices and financial conditions and do not internalise their own contribution to financial instability. In the following we discuss control and steering

options that impact on unwelcome capital inflows, i.e. basically minimum reserve ratios and tax measures, also called macroprudential controls in the more recent literature (for an overview of all controls see Neely, 1999).

Most countries, and also those of the Western Balkans, have so far tended to prevent undesired capital inflows and outflows by non-interest-bearing minimum reserve ratios. The minimum reserve on foreign-currency deposits acts as a tax on banks which decreases, via a possible reduction of deposit rates for customers, the attractiveness of capital inflows (and vice versa in the case of outflows). According to our estimates, with a minimum reserve requirement of 30% on deposits up to two years, this implicit tax rate on deposits in euro stood at about 1.05% in Serbia in 2011 – thus taxing away about one third of interest income given an interest rate of 3.33%.⁶ For the central bank, setting the minimum reserve ratio is easier in a system of floating exchange rates than in the case of a fixed exchange rate regime. In the former, the minimum reserve policy is one instrument of sterilisation policy, aimed at net capital inflows rather than at individual components of capital inflows. Under a fixed exchange rate regime, if the central bank intends to sterilise the impact of capital inflows on the monetary base, minimum reserves may also reduce the inflow of FDI or long-term credits; or else, the central bank would have to set an extremely high minimum reserve ratio on short-term inflows, which would in practice prevent not only speculative inflows but also those necessary to increase liquidity. Conversely, if there is a risk of capital outflows, reducing the minimum reserve ratio to about zero will prevent those outflows, but may also – given inflation that is still considered too high – reduce the market interest rate to a level too low. This applies in particular to countries such as Croatia, which wish to follow the inflation path of the euro area and prepare for introducing the euro, respectively, and therefore have to meet the convergence criteria.

One variant of the minimum reserve policy that focuses even more strongly on preventing unwelcome capital inflows is the cash deposit requirement, i.e. a non-interest-bearing deposit that residents have to pay into a special account with the central bank. The cash deposit requirement is an instrument that was and still is used by many countries. The Federal Republic of Germany had introduced it in an environment of floating exchange rates after the fall of the Bretton-Woods system in 1972, but abandoned it in 1974 because several opportunities for circumvention had made it ineffective. Subsidiaries of foreign multinational corporations stepped up lending activities with domestic non-banks, which frequently resulted in substantial capital inflows in phases of restrictive policy (Kohler and Meyer, 1979). Argentina introduced the cash deposit requirement in 2005 in order to curb speculative inflows from abroad; in 2013 it loosened the restrictions because of the threat of foreign currency shortage and as the central bank's reserves had fallen by nearly one quarter within a short period.

One rather unconventional instrument is charging an explicit tax on diverse forms of capital inflows (such as the 'Tobin Tax'). Independently of the exchange rate regime and the monetary framework, this tax could be set at different levels for the individual types of capital inflows and absorb part of the interest rate differential between domestic and foreign markets. As such it is clearly a regulatory tax. Whether a tax should be levied is first of all a legal question; the answer to it depends on whether its introduction or amendments need the approval of the legislator. The preferred application of the minimum reserve policy is due to its advantage that it falls under the exclusive competence of the government or the central bank and can be designed, as necessary, at short notice, whereas a tax falls in effect under the competence of the legislator and thus perhaps cannot be adjusted in time. Brazil represents the country

⁶ Calculated according to official data of the National Bank of Serbia. The minimum reserve ratio on euro deposits up to two years was 30% in 2011 and was reduced to 29% in 2012. For comparison, the implicit tax on borrowing abroad of Chilean banks was close to 4% at the beginning of the 1990s.

most often cited in the literature because it has experimented with several different forms of controls of capital inflows – initially focusing on the restriction of currency carry trades, later on introducing measures that curbed the trade with domestic securities abroad bypassing approval procedures (American Depositary Receipts). Brazil is a special case in so far as a tax on capital inflows existed already and the finance ministry may change it (even setting a zero interest rate) without parliamentary approval. The country is thus an example of great flexibility of controls with regard to the level, duration and object of taxation. Studies have shown that the controls in Brazil seem to have been effective in as much as they reduced the net revenues from local assets – which was in fact the target of the internalisation of general costs in the microeconomic calculation. The controls may have helped Brazil to avoid an asset price bubble.

In an intermediate exchange rate regime, an explicit tax on selected capital inflows is better suited to ward off short-term capital inflows as compared to changes in the minimum reserve ratios. However, the central bank should be given the right to vary the tax rate, depending on the situation in the foreign exchange markets and on the level of the real exchange rate. This recommendation does not apply to monetary systems in which neither the exchange rate is freely floating nor an independent monetary policy can be pursued (Kosovo, Montenegro, Bosnia and Herzegovina). In those cases a combination of the two measures – taxation and minimum reserve ratios – would be appropriate.

4.5. SUMMARY

The Western Balkan countries should focus primarily on ensuring that they do not create any incentives for capital inflows that will facilitate no more than slow progress in exports and productivity. There are a number of ways they can do this:

Under the conditions currently prevailing – capital outflows, a credit crunch, declining macroeconomic demand and a weak export base – a floating exchange arrangement, a currency board or the total lack of an own currency are proving to be a barrier to boosting export activity in the short to medium term. For this reason, Albania and Serbia should consider shifting to an intermediate exchange rate regime, while Croatia and Macedonia should expand their bands. Wider bands would help curb speculative market pressure and prompt the commercial banking sector to seek longer-term funding opportunities. By contrast, a narrower, sliding band is justified for Serbia in light of the still high inflation rate. For Macedonia and Croatia, the existing band appears to be too low, given the threat of capital outflows at present.

An intermediate exchange rate regime would relieve pressure on the minimum reserve policy, which can be regarded as an instrument for managing capital inflows. In both a fixed and a floating exchange rate regime, higher minimum reserves could also reduce desirable capital inflows. Additionally, specific minimum reserves can always be stipulated depending on the nature of the capital inflows. The institutional problem affecting a minimum reserve policy is the conflict between the goals of monetary stability and the management of capital inflows, which limits its effectiveness.

The introduction of a diversified tax on various forms of capital inflows is an alternative to a minimum reserve policy. This solution is appropriate for countries with an intermediate exchange rate regime and does not conflict with the central bank's stability policy. Countries without their own monetary policy or with a floating exchange rate can consider a combination of a minimum reserve policy and a tax.

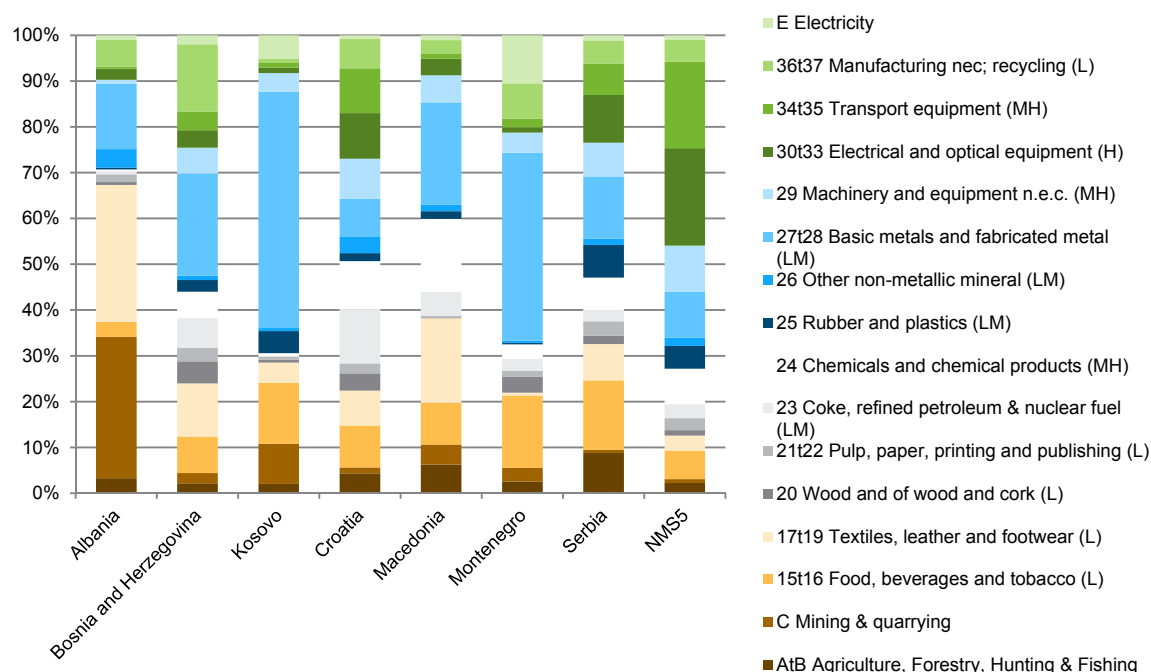
5. Integration into production networks and developments in the trade in goods

The Western Balkan countries are characterised by a relatively weak manufacturing sector whose weighted average share as a percentage of GDP amounted to 12.7% in 2012. This share is fuelled by countries such as Croatia and Serbia, whose shares are slightly above 14%, while countries such as Albania and Montenegro only have shares of 7.6% and 4.3%, respectively. The high and relatively persistent current account deficit of around 10% of GDP throughout the Western Balkan countries with the exception of Croatia and Macedonia is mainly due to this small-sized industrial sector. Integration into international production networks is weak, too.

60% of the exports from Western Balkan countries come from 'low- and medium-tech' industries. The metal production and metal processing industry has traditionally been strong. However, the comparative advantages of the Western Balkan countries in the lower-tech industries have diminished since 2000. At the same time, the comparative disadvantages in higher-tech industries have become smaller, and a gradual transition towards a medium-tech industry is well underway in many countries.

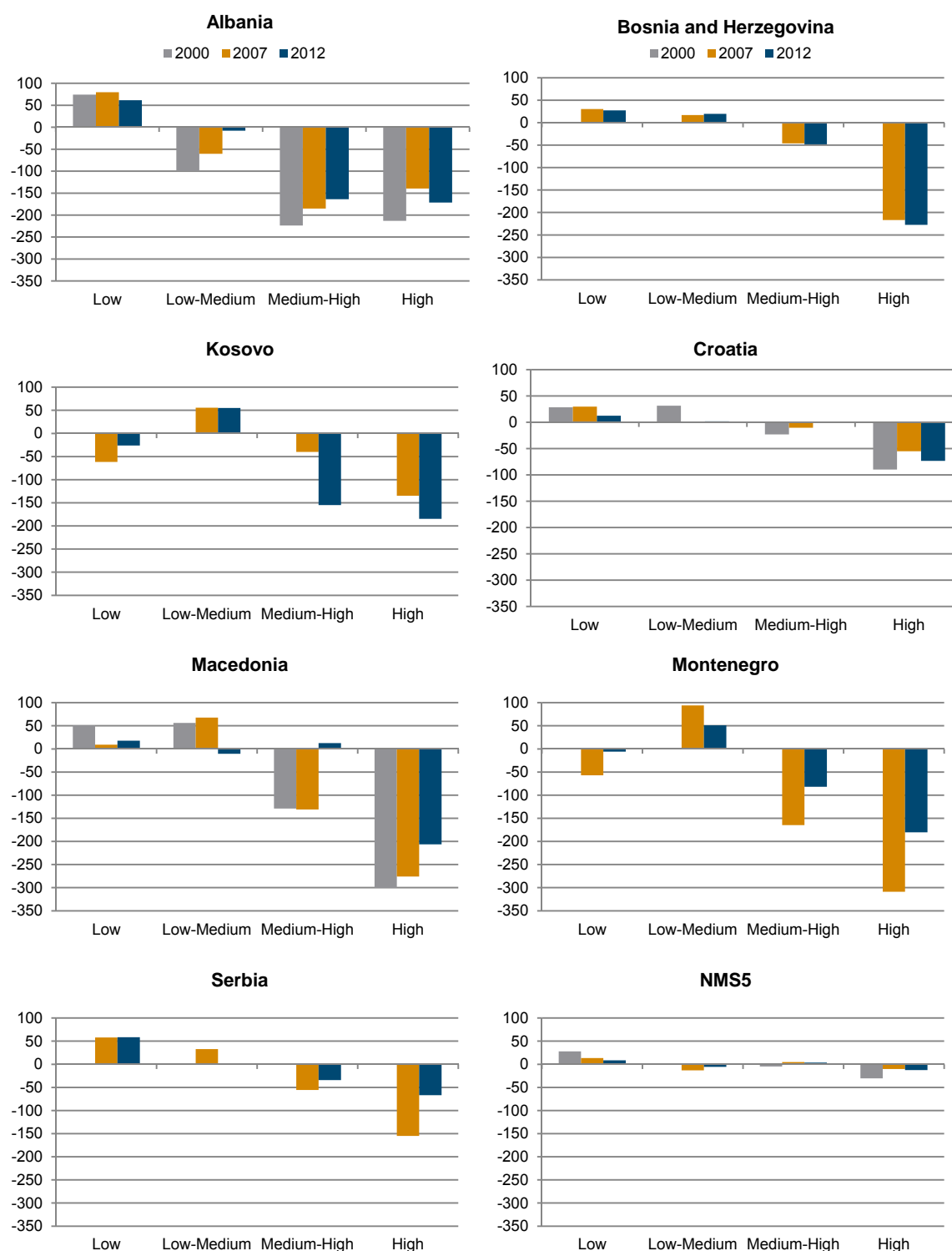
Figure 5.1 / Structure of goods exports according to NACE Rev. 1 (2012)

and classification of industries by technology intensity into low- (L), medium-low- (ML), medium-high- (MH) and high-tech (H)



Source: Comtrade, Comext.

Figure 5.2 / Revealed Comparative Advantages by industries' technology intensity

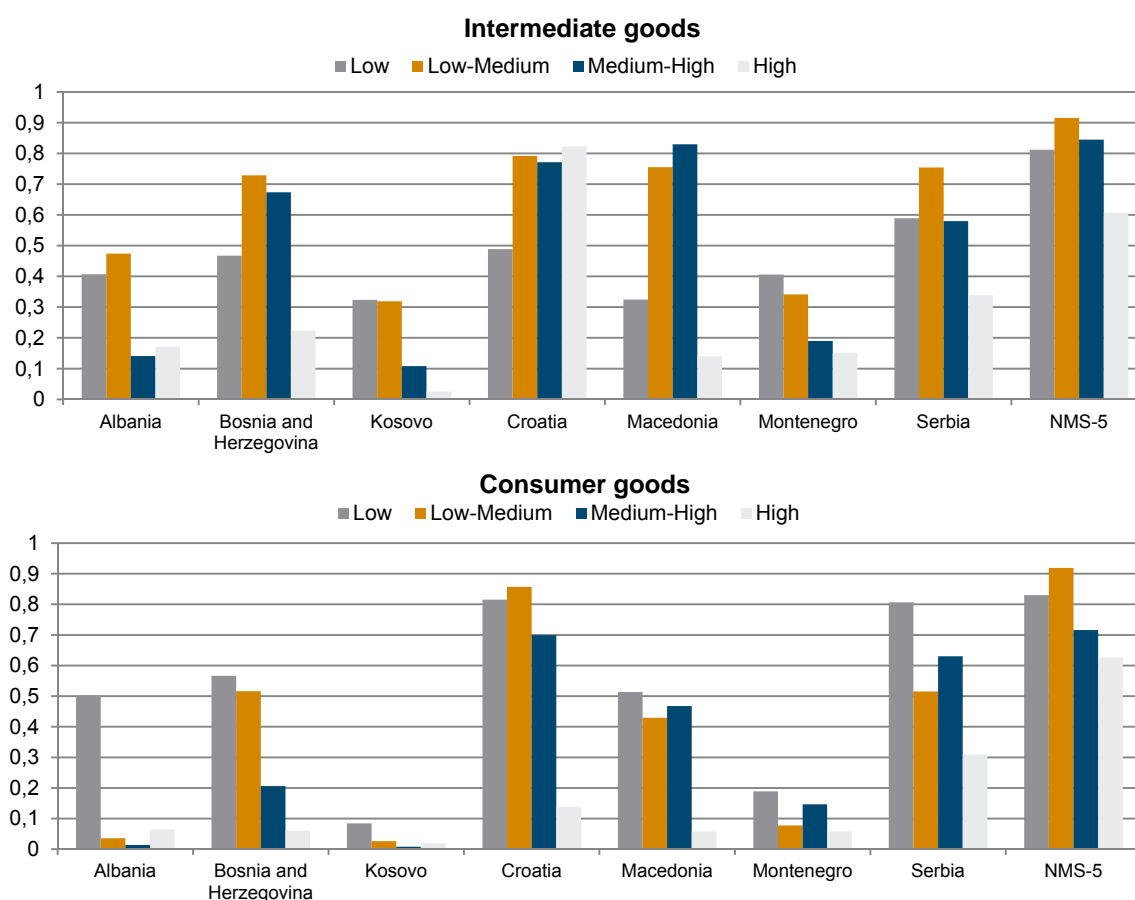


Source: Comtrade, Comext.

An analysis of trade with intermediate goods reveals that intra-industry trade in intermediate goods is relatively strong in Croatia, Serbia, Macedonia and Bosnia and Herzegovina. In contrast, Albania,

Kosovo and Montenegro are integrated poorly into international production networks. The EU-15 is the most important partner region, accounting for 41% of the exports and 46% of the imports of intermediate goods. Prior to the crisis there was a growing interdependence within the Western Balkan countries; however, during the crisis this interdependence declined slightly. Apart from the poor integration into international production networks, the export rate of the manufacturing sector is relatively low in countries such as Albania, Kosovo and Croatia. Relatively speaking, this implies that more companies in these countries are not competitive on the international markets. The export rate of Macedonia, Montenegro and Bosnia and Herzegovina, on the contrary, is comparable to that of the NMS-5.

Figure 5.3 / Grubel-Llyod index by intermediate goods and consumer goods, 2012



Source: Comtrade, Comext.

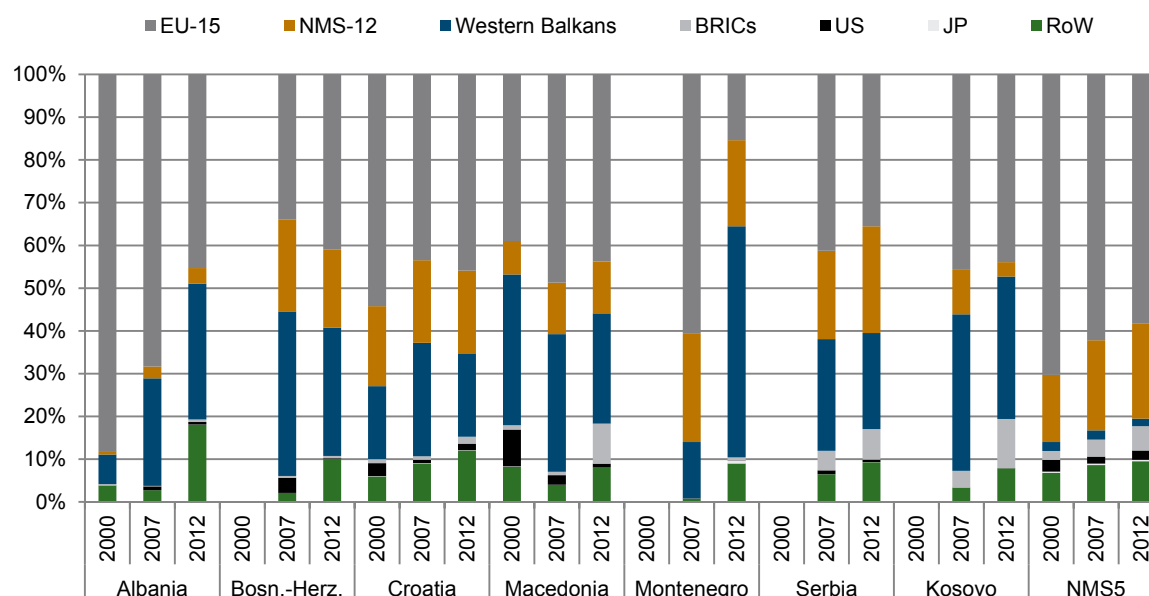
This analysis leads to two different policy recommendations:

- (1) Countries such as Montenegro and Albania mainly need an active industrial and FDI policy to promote the founding and settlement of companies. The manufacturing sectors in these countries contribute very little to GDP, which in turn leads to constant current account deficits.
- (2) The export rate of companies situated in e.g. Kosovo, Croatia and Albania is below average, which suggests a low level of productivity or competitiveness. It is much more difficult to find the right measures for that. Possible measures could include reducing tariff and non-tariff barriers to trade, cutting

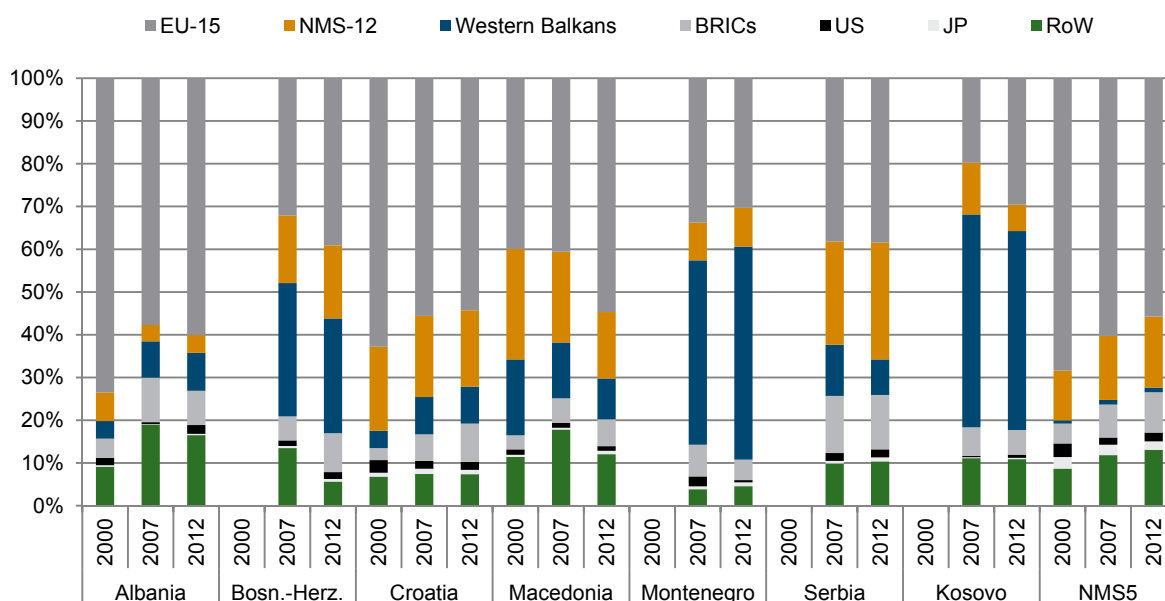
back on red tape which impedes the founding and settlement of businesses, and reducing subsidies for 'national champions'. Drawing on subsidies and their market power, they are in a position to squeeze up-and-coming companies out of the market, thereby undermining structural change.

Figure 5.4 / Exports and imports of intermediate goods, by partner

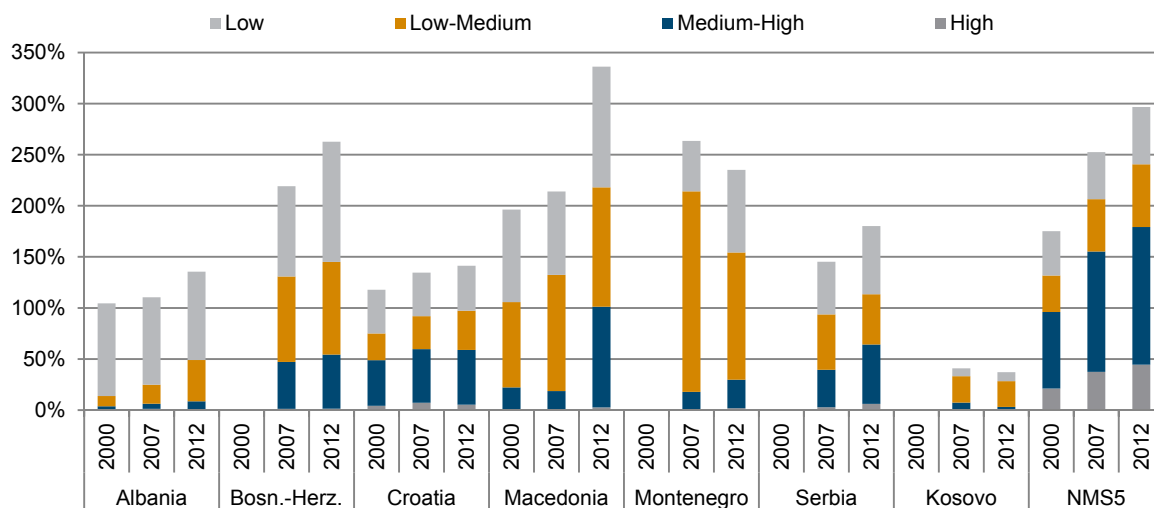
Exports



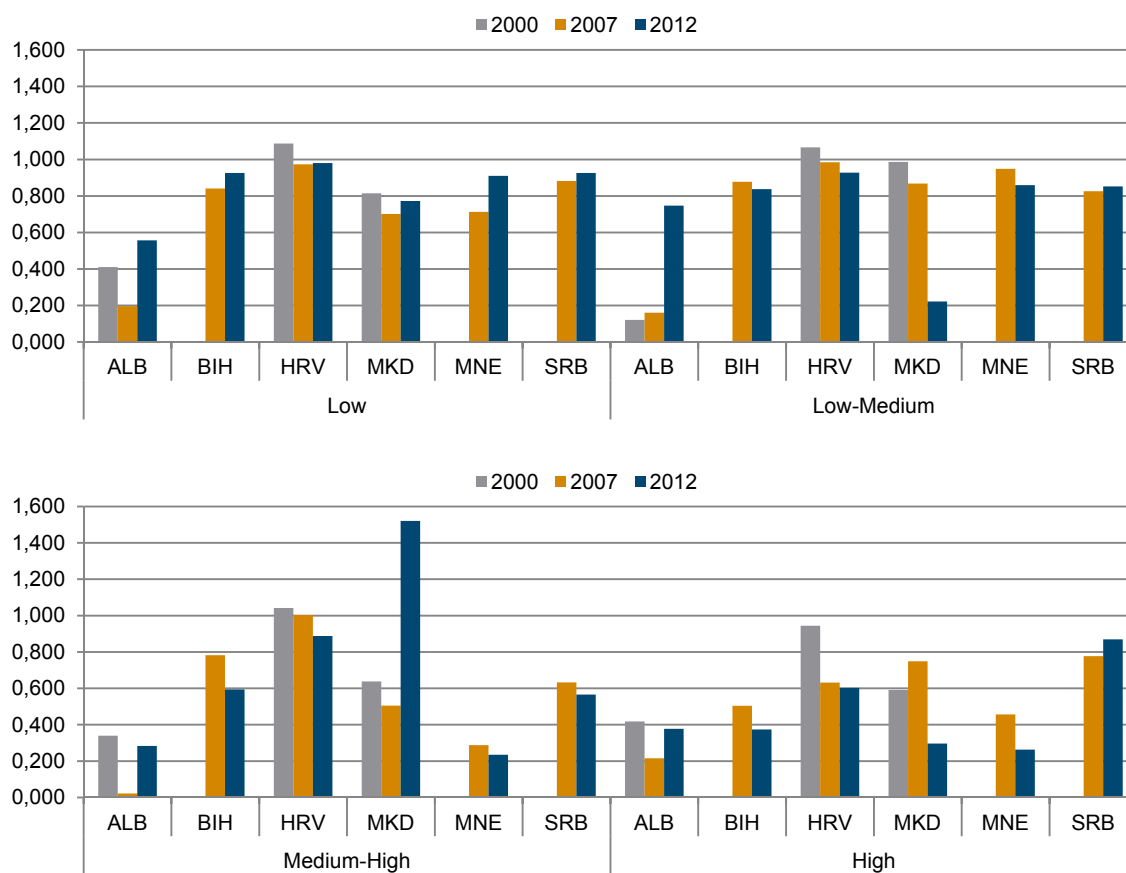
Imports



Source: Comtrade, Comext.

Figure 5.5 / Exports of goods in % of value added of the manufacturing sector, by industry

Source: Comtrade, Comext, wiiw Database, national sources.

Figure 5.6 / Development of unit value ratios as compared to NMS-5

Source: Comtrade, Comext.

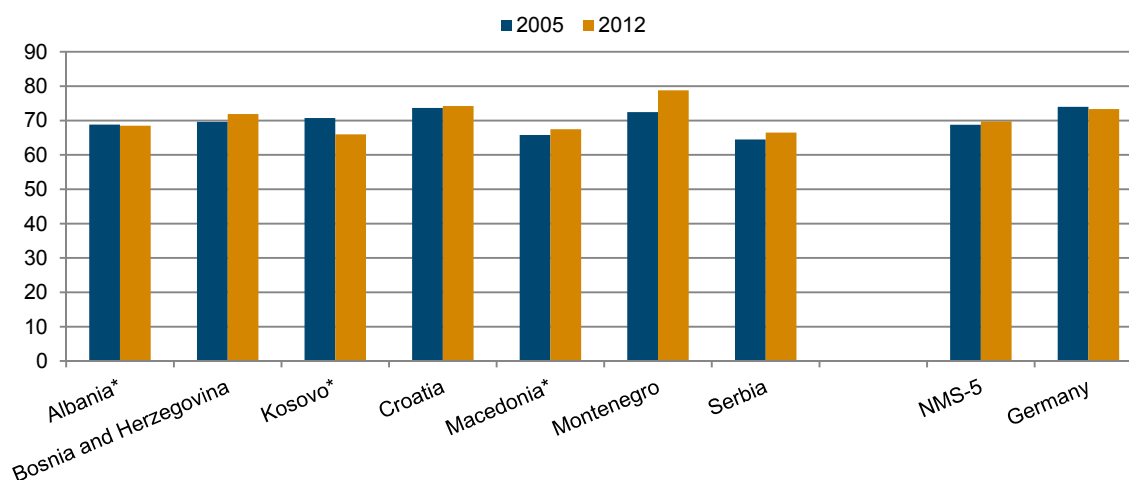
The analysis of the quality developments of exports compared to the NMS-5 yields a relative improvement in product quality in lower-tech industries and a relative decline in higher-tech industries. All in all, it should be noted that the NMS-5 countries, too, have undergone an enormous development in the reference period so that the benchmark for comparison is high. The geographic proximity of the NMS-5 to the European manufacturing core (notably Germany, northern Italy and Austria) contributed significantly to their strong integration into production networks. This situation is different, however, for Western Balkan countries that are geographically closer to other Southern European countries, as Greece and Southern Italy are struggling with similar problems regarding their industrial development.

Therefore, a future EU strategy for the manufacturing sector should not only place emphasis on the developments in the high-tech segment and the manufacturing core countries but, above all, develop strategies for the industrial future of Southern Europe. Not every EU country will be able to specialise in car manufacturing and electronic products in the future. Given their comparative advantages, the Western Balkan countries play a crucial role in such a strategy. The EU could, for example, aim at promoting the integration of the Southern and Southeastern European countries into international production networks with a special focus on lower and medium tech industries.

6. The competitiveness of the services sector in the Western Balkan countries

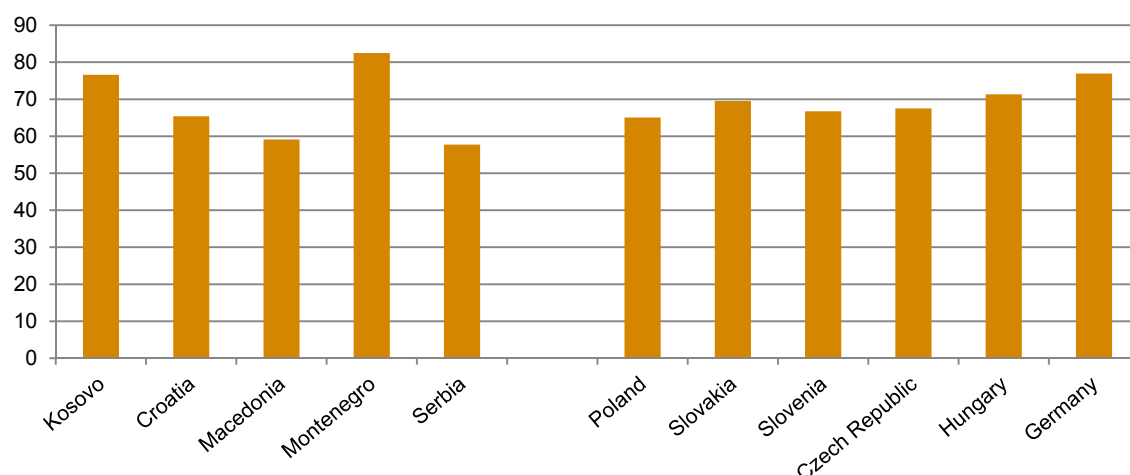
The services sector (including construction) is the most important economic sector in all Western Balkan countries, and its size is similar to that of neighbouring countries (66%-79% of the gross value added, 60%-82% of total employment). The most important services branches in the region are trade, real estate and housing. In general, this sector contributed significantly to economic growth prior to the crisis. There were some structural imbalances favouring the construction industry and non-tradable services sectors in Croatia, Montenegro and Serbia. FDI inflows occurred relatively late, but once they did, the services sector was one of the main targets (45%-71% of total FDI). In all countries, the financial services sector (banks) is the services sector holding the largest share of FDI assets, followed by the 'transport and communications' (telecom companies) and trade sectors. In 2013, new greenfield projects focused primarily on the retail sector.

Figure 6.1 / Share of the services sector in gross value added (at current prices)



Note: * Albania 2011, Kosovo 2006 and 2011, Macedonia 2011.

Source: wiiw Database, Eurostat.

Figure 6.2 / Share of the services sector in total employment (LFS), 2012

Source: wiiw Database.

Table 6.1 / Most important services sectors in the region – I (NACE Rev. 2)
Share in total gross value added, in %

	Croatia	Macedonia	Montenegro	Serbia	NMS-5	Germany
	2012	2011	2012	2012	2012	2012
F Construction	5.4	7.4	5.5	4.8	6.4	4.7
G Trade	11.1	15.4	14.7	11.0	13.6	9.0
H Transportation	4.6	3.9	4.9	5.4	6.0	3.8
I Accommodation and food service activities	4.3	1.4	8.0	1.2	1.6	1.7
J Information and communication	4.7	4.7	5.9	5.2	4.5	4.0
K Financial and insurance activities	7.0	2.8	4.9	3.8	4.4	4.0
L Real estate activities	11.0	7.8	8.6	11.6	7.2	12.1
M Professional, scientific and technical services	5.3	2.6	3.4	4.2	5.4	6.1
N Other services	2.0	1.1	1.1	1.8	2.4	5.0

Source: wiiw Database, Eurostat.

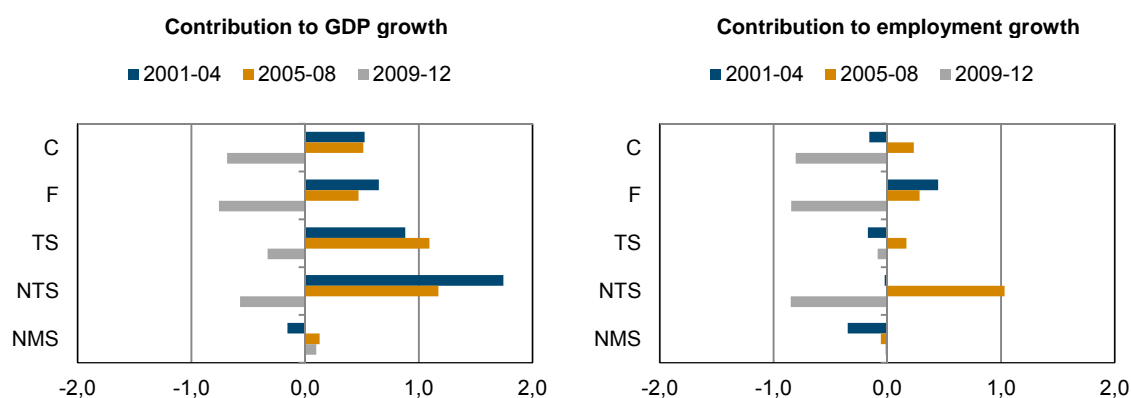
While the foreign trade in goods shows a high deficit in the Western Balkan countries, the balance of services is positive. Services exports play a particularly important role in Albania, Croatia and Montenegro because of tourism. Free trade in services is promoted under GATS and CEFTA and by closer links with the EU. However, there is still a substantial need for action in this area.

Table 6.2 / Most important services sectors in the region – II (NACE Rev. 1)
Share in total gross value added, in %

	2010	2011	2012
Albania			
F Construction	11.0	10.7	.
G Trade, hotels and restaurants	21,0	21.8	.
I Transport and communication	9,5	9.4	.
J-0 Other services	27,5	26.7	
Bosnia and Herzegovina			
F Construction	5.1	4.8	4,7
G Trade	15.6	15.5	15,9
H Hotels and restaurants	2,5	2.4	2,7
I Transport and communication	8,1	8.1	8,0
J Banking and insurance	4.5	4.6	4,7
K Real estate, renting and business services	10,4	10.5	10,7
Kosovo			
F Construction	9,5	10,1	9,8
G Trade	16,3	16,6	17,9
H Hotels and restaurants	0,9	1,7	0,9
I Transport and communication	4,2	4,3	5,1
J Credit and insurance	5,4	5,3	5,7
K Real estate, renting and business services	10,8	9,7	6,6

Source: wiiw Database.

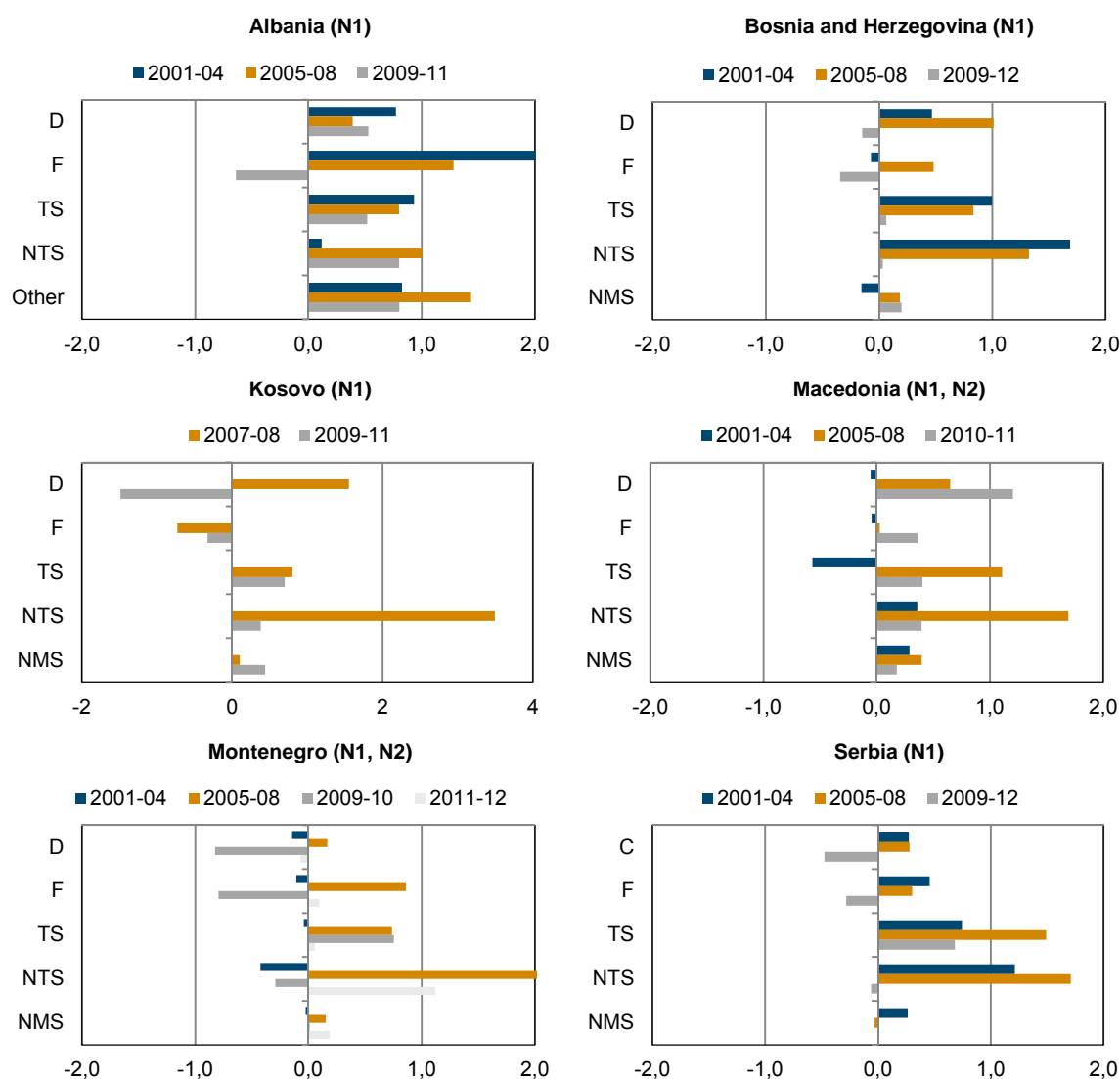
Figure 6.3 / Croatia: contribution of individual sectors to GDP growth (at constant prices) and to employment growth
Period averages



Note: Croatia based on NACE Rev. 2 classification: C (Manufacturing), F (Construction), TS (Tradable services H, J, K, M), NTS (Nontradable services G, I, L, N, R, S, T), NMS (Public services O, P, Q). Contributions are calculated by multiplying the share in total GDP at current prices with the real growth rate at previous-year prices. Employment 2001-2008 based on NACE Rev. 1 classification.

Source: wiiw Database based on national and Eurostat statistics.

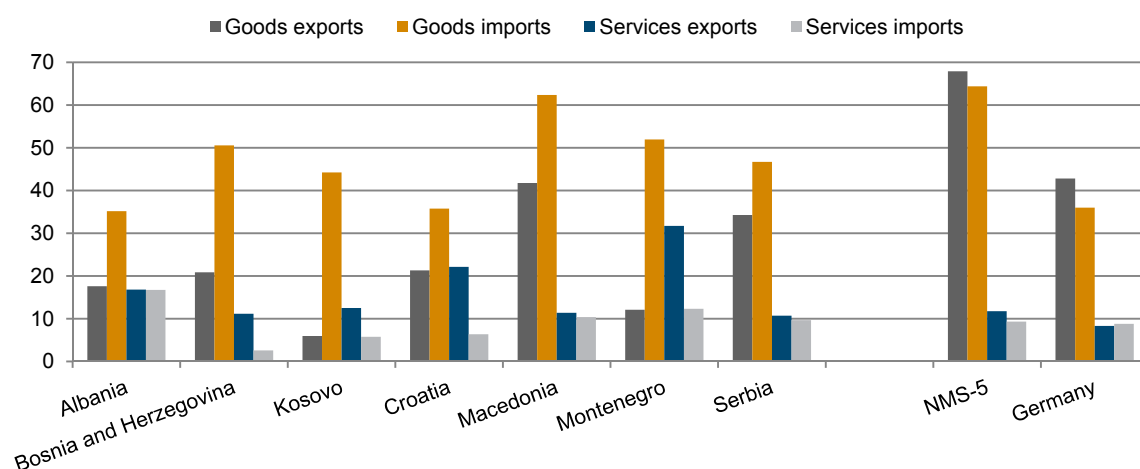
Figure 6.4 / Contribution of individual sectors to GDP growth (at constant prices) and to employment growth
Period averages



Note: **NACE Rev. 1 Classification (N1)**: D (Manufacturing), F (Construction), TS (Tradable services I, J), NTS (Nontradable services G, H, K, O, P), NMS (Public services L, M, N).

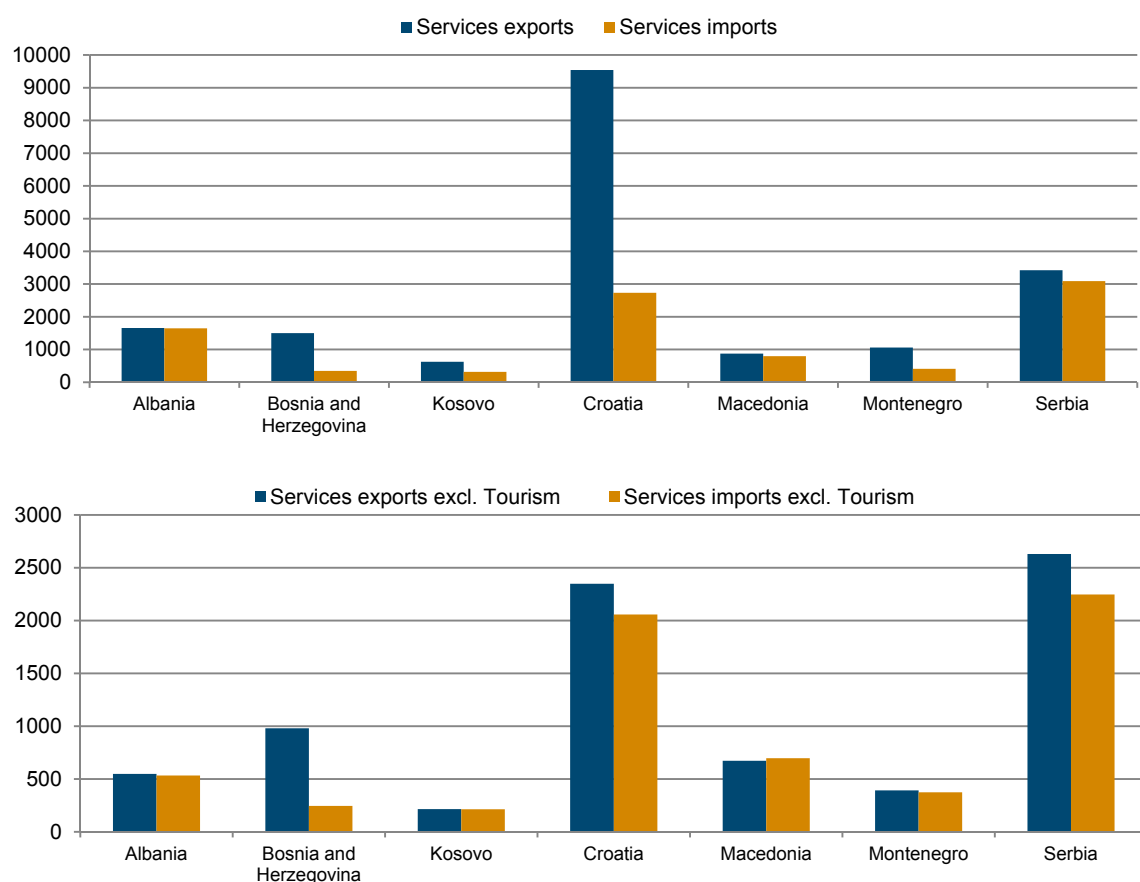
NACE Rev. 2 Classification (N2): C (Manufacturing), F (Construction), TS (Tradable services H, J, K, M), NTS (Nontradable services G, I, L, N, R, S, T), NMS (Public services O, P, Q). Contributions are calculated by multiplying the share in total GDP at current prices with the real growth rate at previous-year prices.

Source: wiiw Database based on national statistics.

Figure 6.5 / Trade in goods and services in % of GDP, 2013

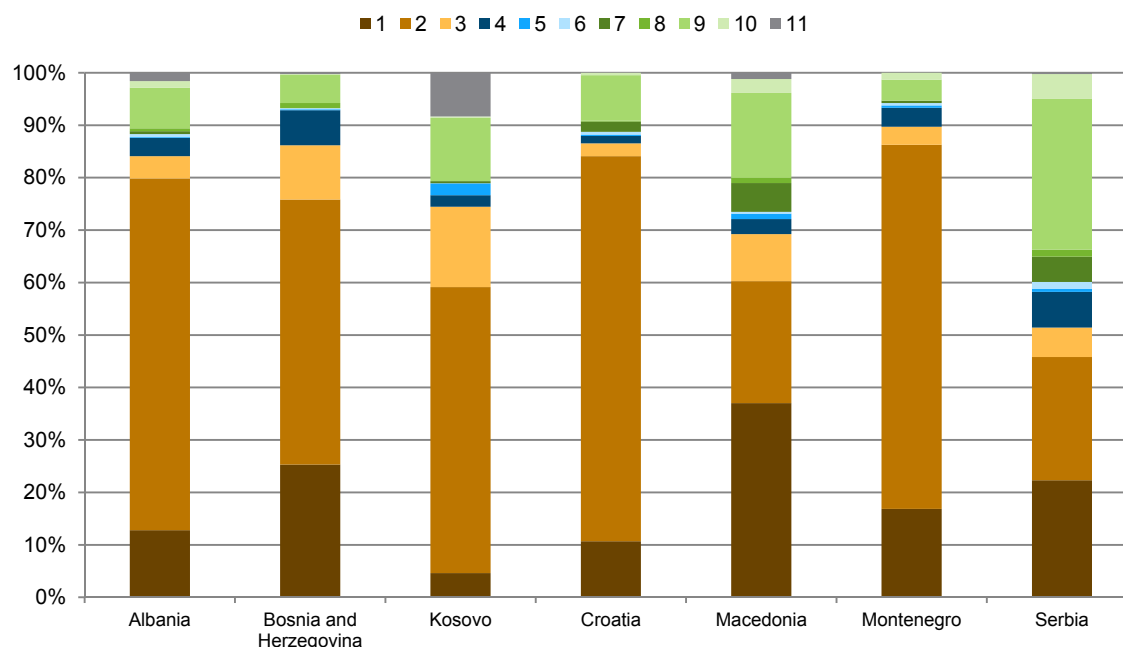
Note: Bosnia and Herzegovina BOP 6th Edition.

Source: wiiw Database, Eurostat.

Figure 6.6 / Exports and imports of services, 2013, in EUR million

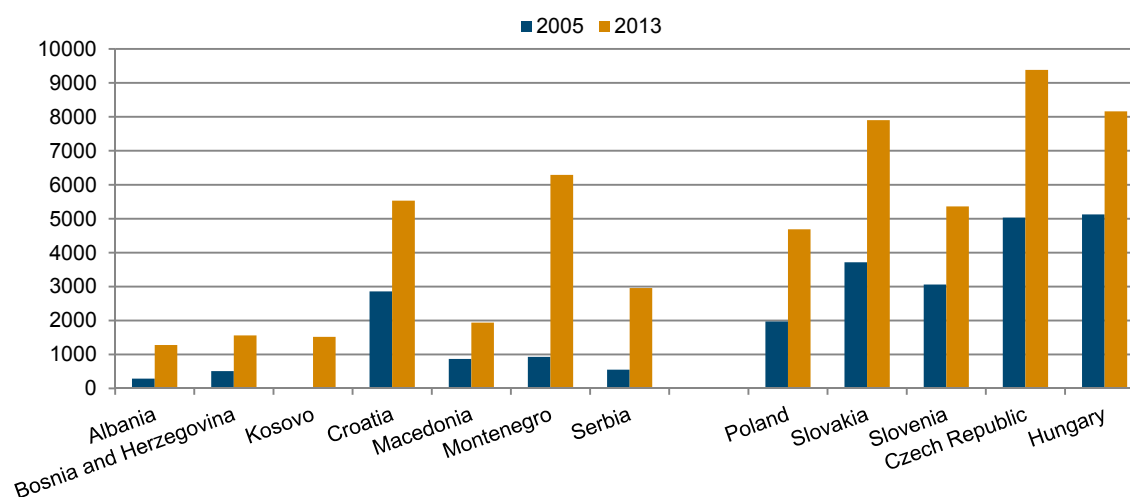
Note: Bosnia and Herzegovina BOP 6th Edition.

Source: wiiw Database.

Figure 6.7 / Structure of services exports, 2011, in %

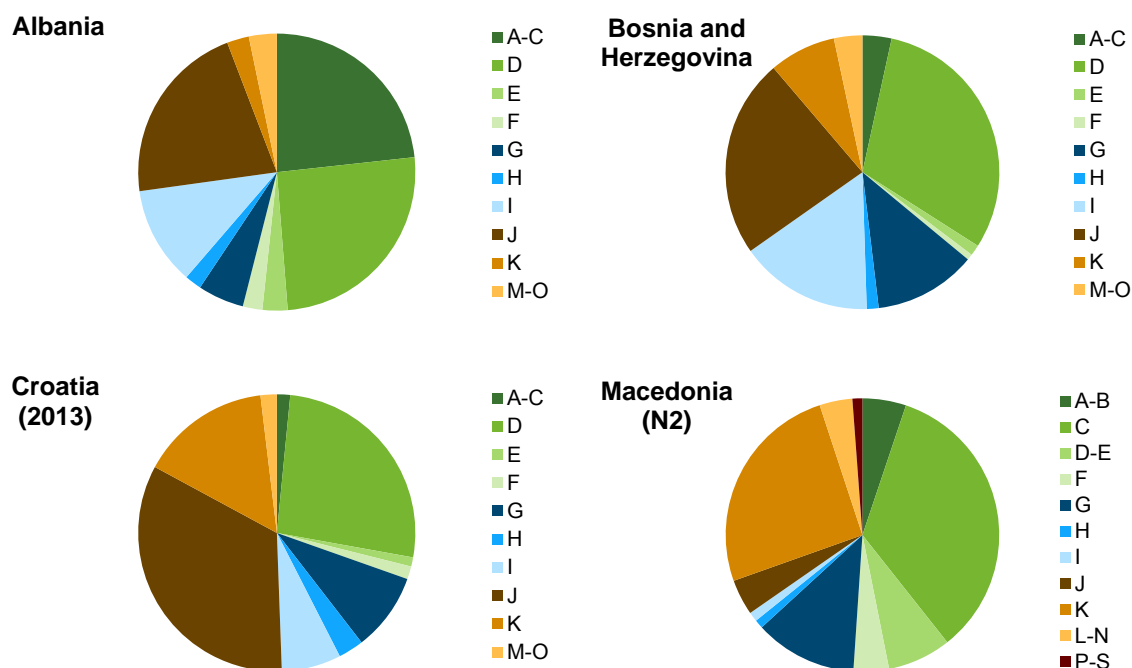
Note: Extended Balance of Payments Services Classification (EBOPS): Transport (1), Travel (2), Communication services (3), Construction services (4), Insurance services (5), Financial services (6), Computer and information services (7), Royalties and licence fees (8), Other business services (9), Personal, cultural and recreational services (10), Government services, n.i.e. (11).

Source: wiiw Trade in Services Database, Kosovo National Bank.

Figure 6.8 / FDI stock, in EUR per capita

Source: wiiw FDI Database.

Figure 6.9 / FDI stock by industry, 2012

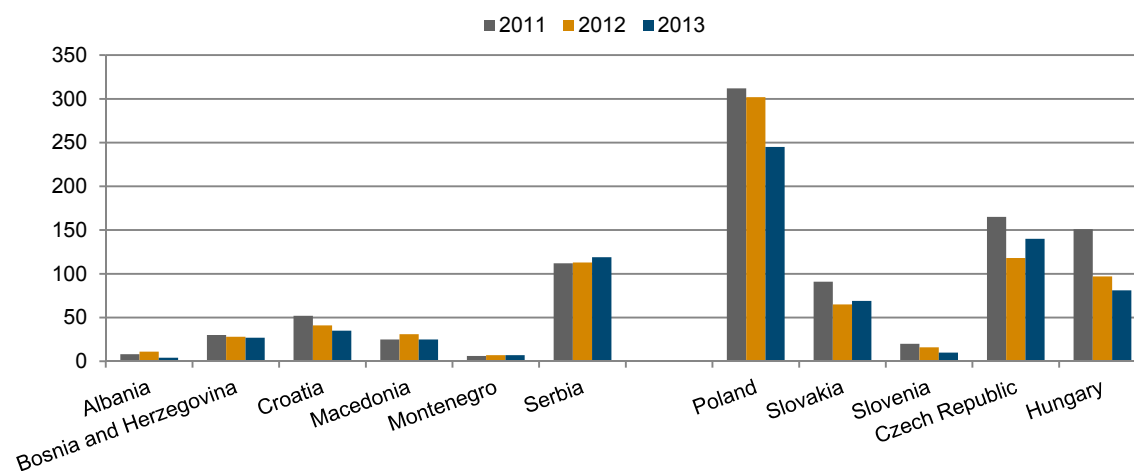


Note: **NACE Rev. 1 Classification** (all countries except Macedonia): A-C (Agriculture, Mining and quarrying), D (Manufacturing), E (Electricity, gas and water supply), F (Construction), G (Trade), H (Hotels and restaurants), I (Transport and communications), J (Financial intermediation), K (Business services), M-O (Public services).

NACE Rev. 2 Classification (Macedonia): A-B (Agriculture, Mining and quarrying), C (Manufacturing), D-E (Electricity, gas, steam and air conditioning), F (Construction), G (Trade), H (Transport), I (Accommodation and food service activities), J (Information and communication), K (Financial and insurance activities), L-N (Business services), P-S (Public services).

Source: wiiw FDI Database.

Figure 6.10 / Number of greenfield projects (total economy), 2011, 2012 and 2013



Source: fDi Markets.

General recommendations:

The services sector is the largest sector of the economy in Western Balkan countries. Therefore, it should be perceived as such in future strategies and not be given less attention than the industrial sector.

‘Strengthening strengths’: The tourism sector is a crucial export arm in countries bordering the Adriatic Sea (Croatia, Montenegro, Albania). This potential should be recognised and promoted further.

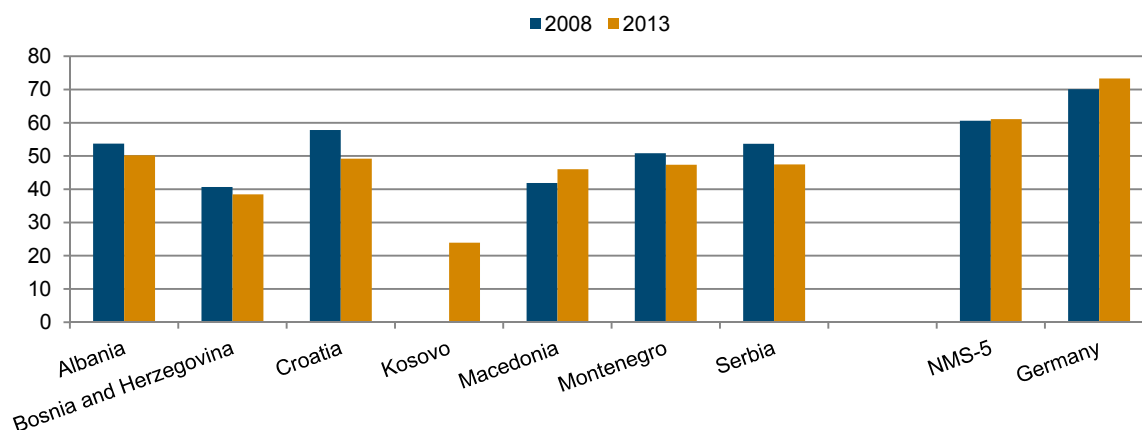
Enhancing the potential in higher valued-added sectors: The IT sector and business-related services sector are higher value-added areas. While the IT sector has great potential, its export share is low. In both areas, exports could be promoted and incentives be provided to attract FDI.

7. Labour market and migration in the Western Balkans

7.1. EMPLOYMENT

In 2013, around 6.3 million people were employed in the Western Balkans, which is 800,000 fewer than in 2008, the last year before the crisis. On average, employment in agriculture is at around 20% (more than 50% in Albania) while the industrial sector and the services sector account for 25% and 55%, respectively. The latter, however, is much more prominent in Montenegro (77%), where tourism plays an important role, and in Kosovo (65%). If one takes into account the high share of activity in the shadow economy which traditionally includes parts of the services sector, then the actual share of employees working in this sector is likely to be higher. Labour migration has been a key factor in mitigating labour market problems for decades. Private sector employment is dominant in Albania and Macedonia, with the share of employment amounting to 83% and 75%, respectively. In contrast, private sector employment is only at 55% in Montenegro where the State still plays a crucial role as employer.

Figure 7.1 / Employment rate (share of employed in working-age population 15-64), in %

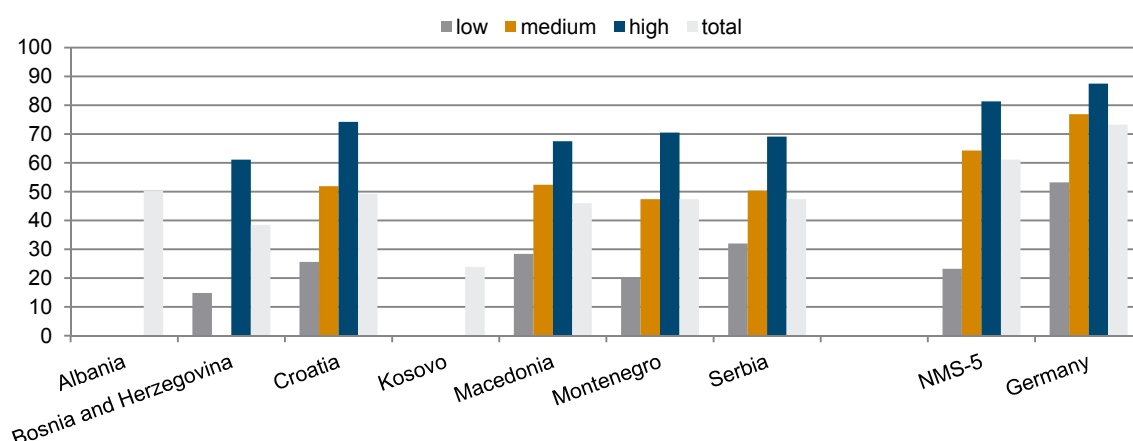


Source: Eurostat and national statistics.

The Western Balkan countries are characterised by low participation and employment rates. Albania is the only country with an employment rate reaching 50%. In all other countries, especially in Kosovo and Bosnia and Herzegovina, this figure is sometimes substantially lower. By comparison, the employment rates in Germany and the NMS-5 are above 70% and approximately 60%, respectively. With the exception of Macedonia, all the countries in the region experienced a decline in their employment rate between 2008 and 2013. In some countries there is a large gender gap: in Kosovo, the employment rate difference between men and women is 27 percentage points, in Bosnia and Herzegovina 19 pp, in Macedonia 17 pp, and in Serbia 15 pp (Germany 9 pp). These differences decrease the higher one's level of education or training, and for people with tertiary education they are even substantially lower than in the NMS-5 or Germany. All in all, the sometimes considerable gender specific differences can be

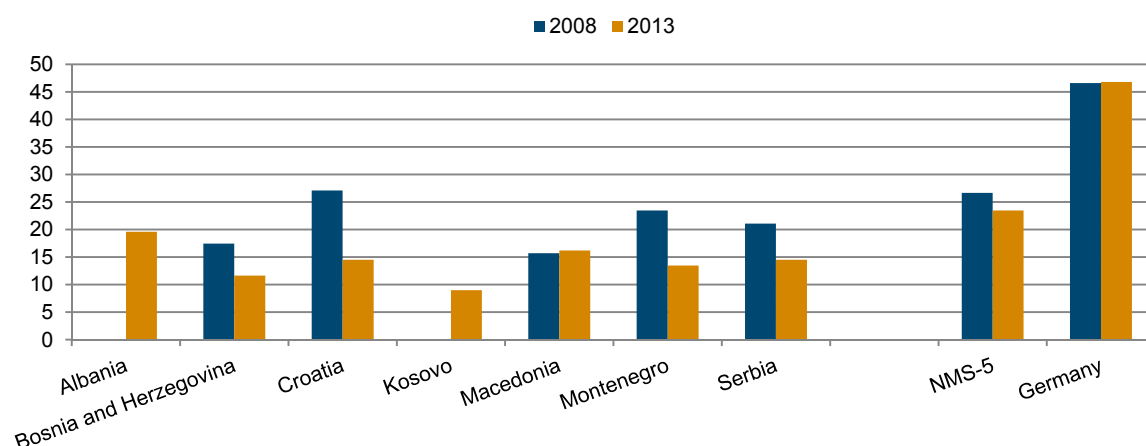
traced back to social, cultural and institutional factors. Often there is a lack of childcare facilities and facilities for older persons, who are often cared for by women, as well as a lack of flexible employment models.

Figure 7.2 / Employment by educational attainment level, in %



Source: Eurostat and national statistics.

Figure 7.3 / Employment rate (share of employed in working-age population 15-24), in %



Source: Eurostat and national statistics.

Although employment rates increase the higher the level of one's education or training, there are clear differences compared to the NMS-5. While people with a secondary or higher level of education enjoy higher employment rates than those with a lower level of education, employment rates are still significantly lower (by 16 and 13 percentage points, respectively) than among the NMS-5. Compared with Germany, the differences are yet greater.

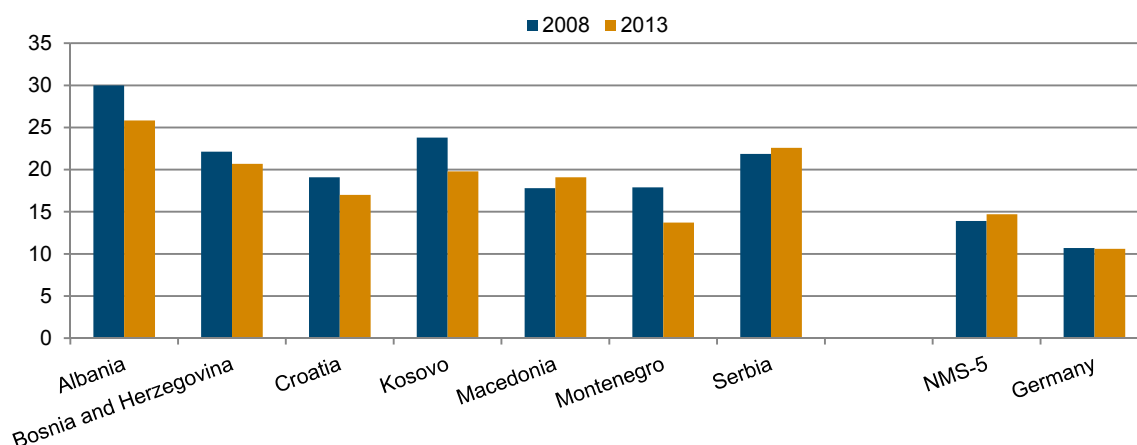
Youth employment rates are particularly low. Given the low level of job creation, young people face a difficult transition from school to work and often enter the labour market only after a period of unemployment (WIBF, 2012). The employment rate of young people in Kosovo is only 9%, in Bosnia

and Herzegovina slightly above 10%, and in the other countries, with the exception of Albania, around 15% (Germany 47%, NMS 24%), see Figure 7.3.

EMPLOYMENT IN THE INFORMAL SECTOR OF THE ECONOMY

The fact that a relatively significant share of employees continues to work in the informal economy makes it difficult to carry out a thorough analysis of the labour market. The labour force surveys (LFS) conducted for Serbia and Macedonia – the only countries in the region for which data was collected – show that in 2012/2013, the number of workers working in the informal sector was 19.3% and 22.5%, respectively. This share is significantly higher among adolescents, namely 31% in Serbia and even 42% in Macedonia. According to the surveys conducted for Serbia, those working in the shadow economy have a low level of education and work in the agriculture, construction, hotel and restaurant sector or in private households.

Figure 7.4 / Self-employed persons in % of total employed

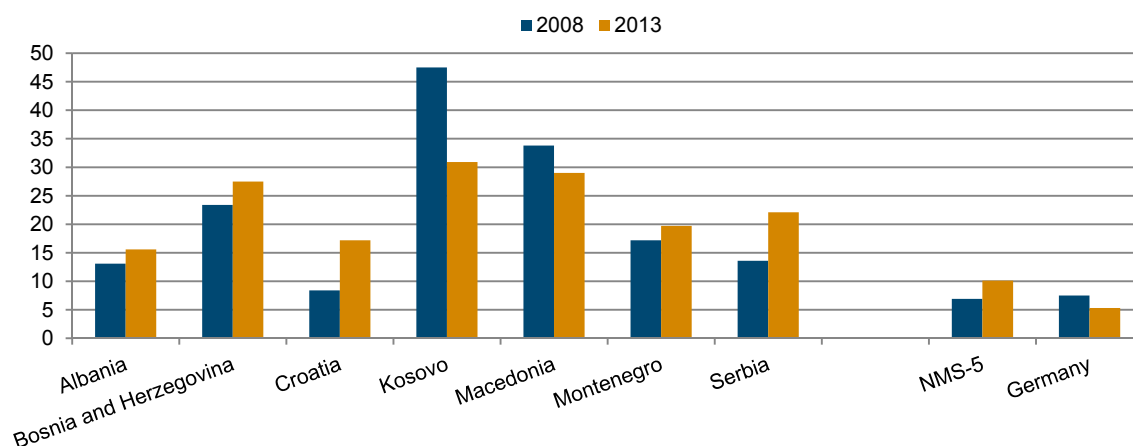


Source: Eurostat and national statistics. Kosovo: data refer to 2012 instead of 2013.

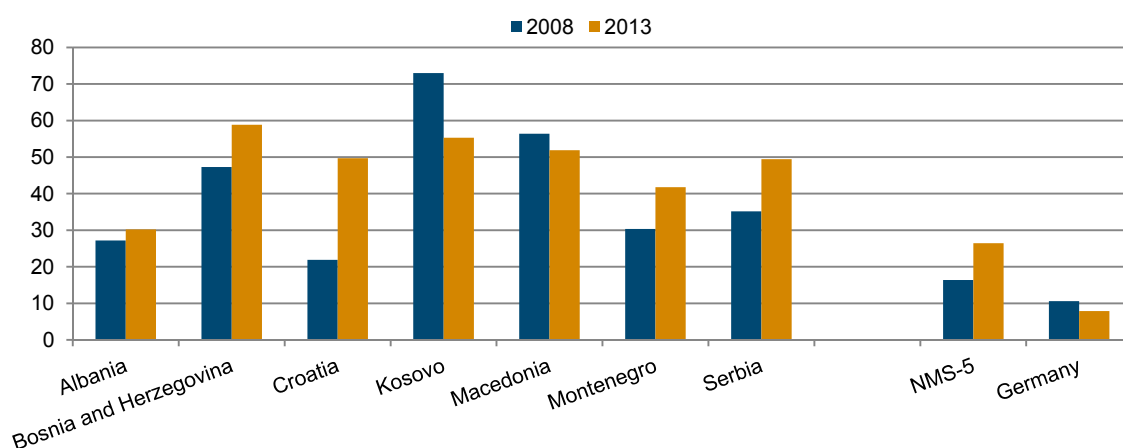
If one uses data on the self-employed persons of the other countries that have not recorded corresponding information in their respective LFS – which is often used to measure the size of the shadow economy – then on a regional average around 20% of the employees are likely to work in the informal sector; in Albania even a quarter. This figure is around 15% in the NMS-5 and in the EU-15. Between 2008 and 2013, the number of self-employed persons declined as a whole in all countries but Macedonia and Serbia. In 2013, Montenegro's share was similar to that of the EU-15.

7.2. UNEMPLOYMENT

In former Yugoslavia, unemployment was already high among the Western Balkan countries, but it differed between the republics; this differing development continued during the transformation phase. In 2013, the unemployment rate ranged between 31% (Kosovo) and 17% (Croatia); the average unemployment rate of the region as a whole was 23%, i.e. more than twice as high as in the NMS-5 or in the EU-15. Germany's reference value was 5.3%.

Figure 7.5 / Unemployment, in %

Source: Eurostat and national statistics.

Figure 7.6 / Youth unemployment (15-24), in %

Source: Eurostat and national statistics.

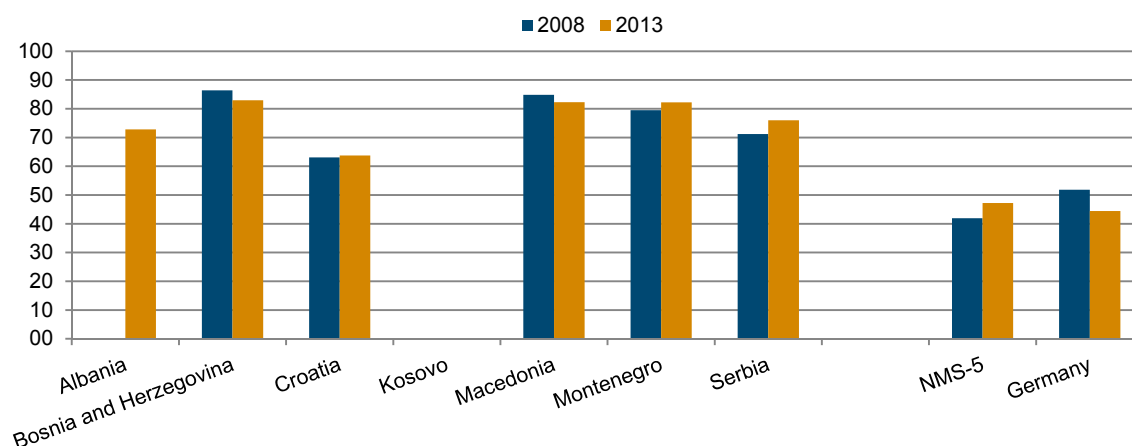
The unemployment rate of all Western Balkan countries but Macedonia was higher than in 2008, the year before the crisis. Serbia and Croatia were, and still are, particularly affected by this rise in unemployment. The marked reduction in unemployment in Kosovo is due to changes in the calculation method and thus not meaningful.

Just like unemployment in general, youth unemployment has been persistently high for years and has aggravated since the start of the crisis. With the exception of Macedonia, youth unemployment rose in all countries between 2008 and 2013, but particularly drastically in Croatia and Serbia. Youth unemployment in Bosnia and Herzegovina and Kosovo is at about 60%; in Serbia, Macedonia and Croatia, nearly 50% of the youth is unemployed with women and men being affected alike.

In virtually all Western Balkan countries, as in the EU, young people with poor qualifications are affected the most by unemployment; In Serbia, however, the unemployment rate is highest among young people with tertiary education. Another feature of youth unemployment is the high share of the long-term

unemployed. In general, the majority of young people have precarious jobs (part-time or fixed-term) or work in the informal sector, that is without a social safety net and wages that are lower than in the official sector. Migration is often a way out of the crisis.

Figure 7.7 / Long-term unemployment (unemployed for more than one year), in % of total unemployed



Source: Eurostat.

Another feature of the labour markets in the Western Balkans is the high and persistent level of long-term unemployment which has been much higher than in the NMS-5 for years. As Figure 7.7 shows, in most countries between 70 and 80% of the unemployed are long-term unemployed. Among those that are particularly affected are older people who have lost their jobs due to privatisation, women, low skilled workers or people in rural areas, members of minorities (Roma) and young people. As in other countries, permanent long-term unemployment reduces chances for employment due to a loss of skills and know-how and entails the risk of dropping out of the labour market altogether.

7.3. WAGES

Overall, wage differentials are high in the Western Balkan countries. The highest wage level can be found in Croatia, followed by Montenegro and Bosnia and Herzegovina, whereas Albania lags far behind and is at the lower end of the wage scale. Most Western Balkan countries recorded very high growth dynamics prior to the crisis: the growth in real wages was twice as high as in the NMS-5. However, as in the NMS-5, growth has decelerated sharply in the past five years, and the situation on the labour markets is very difficult. The comparatively low wages in Serbia are, inter alia, due to a two-year long wage freeze (2009-2010) and devaluations of the dinar.

As in the NMS-5, wage setting takes place mainly at company level and not in a centralised way at industry level as in Germany or Austria.

Table 7.1 / Average monthly wages (gross) at exchange rates and real change in %

	2005	2006	2007	2008	2009	2010	2011	2012	2013
Albania	161	177	221	279	273	252	260	268	291
Bosnia and Herzegovina	405	444	488	569	615	622	650	660	660
Croatia	844	906	961	1044	1051	1054	1049	1048	1048
Kosovo	.	.	.	.	.	.	.	.	.
Macedonia	348	376	394	428	488	491	497	498	504
Montenegro	326	377	497	609	643	715	722	727	726
Serbia	307	377	485	561	470	460	517	508	537
Czech Republic	616	690	755	906	883	944	995	997	965
Hungary	638	648	736	790	713	735	763	771	777
Poland	587	636	706	838	717	807	826	844	870
Slovakia	448	504	596	697	745	769	786	805	824
Slovenia	1157	1213	1285	1391	1439	1495	1525	1525	1523
<i>real change (gross) in national currency, in %</i>									
Albania	2.6	6.7	21.6	21.3	2.9	-7.0	1.5	0.2	7.4
Bosnia and Herzegovina	2.9	2.7	8.2	8.5	8.6	-1.0	0.7	-0.5	-0.1
Croatia	1.1	2.9	3.2	0.9	-0.2	-1.5	-0.8	-2.3	-1.4
Kosovo	.	.	.	.	.	.	.	.	.
Macedonia	2.2	4.6	2.4	0.3	15.0	-0.6	-2.6	-3.0	-1.6
Montenegro	5.4	12.2	10.2	14.1	2.1	10.6	-2.1	-3.3	-0.1
Serbia	6.8	11.4	14.1	3.9	0.2	0.6	0.1	1.0	-1.9
Czech Republic	3.1	4.0	4.3	1.4	2.3	0.7	0.6	-0.8	-1.3
Hungary	5.0	4.1	0.0	1.3	-3.5	-3.4	1.3	-0.9	1.7
Poland	1.8	4.0	5.5	5.9	2.0	1.4	1.4	0.1	2.5
Slovakia	6.3	3.3	4.3	3.3	1.4	2.2	-1.6	-1.2	1.0
Slovenia	2.3	2.3	2.2	2.5	2.5	2.1	0.2	-2.4	-2.0

Source: wiiw Database.

TRADE UNIONS

Although trade union membership has declined in most Western Balkan countries, it is still higher than in the NMS-5; organisations are fragmented. Trade unions continue to have a strong presence in the public sector but hardly any in the private sector of the economy. In most countries, with the exception of Bosnia and Herzegovina and Kosovo, statutory provisions govern trilateral consultations, albeit mostly on paper. Often there is no dialogue between the government and social partners.

7.4. LABOUR MARKET POLICIES

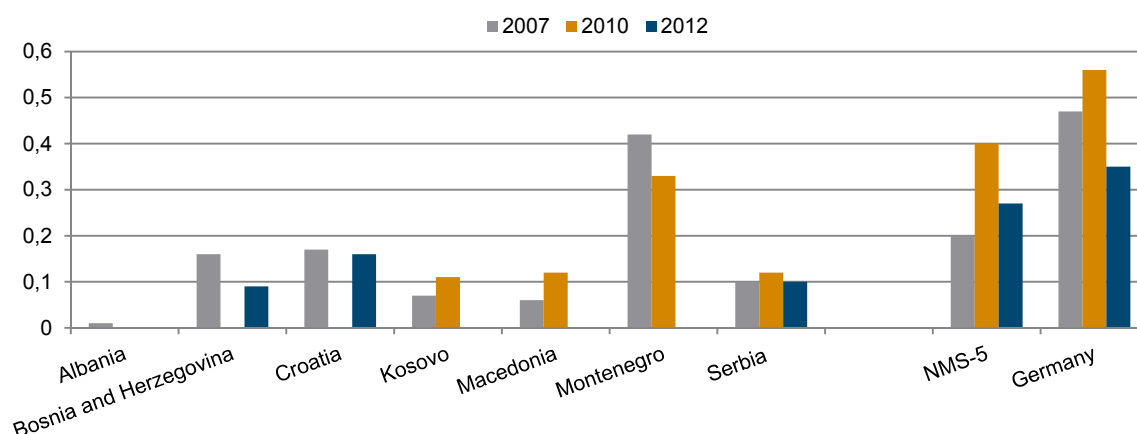
The labour market policies in the Western Balkan countries are primarily passive and focus on unemployment benefits. With the exception of Kosovo, unemployment insurance schemes were introduced throughout the region in the early 1990s; compared to those in the EU countries, however, they are very limited in terms of coverage, duration and amount of benefits.

Active labour market policies were introduced in most Western Balkan countries beginning in the mid-1990s. In many countries, notably Kosovo and Macedonia, these active policies were primarily backed by international organisations (UNDP and the World Bank). Generally speaking however, active labour market policies are limited to a few instruments, and by international comparison, the number of

beneficiaries is low. Also, the number of well-trained personnel in labour market administrations is too small to implement the programmes.

Despite the ongoing provision of funds for active labour market policy programmes, their amount in terms of GDP is still low: on average, funds amounted to about 0.1% of GDP in the Western Balkan countries in 2012, compared to 0.3% in the NMS-5. Only in Montenegro a significantly higher proportion was used. In general, this situation has been exacerbated by the economic crisis; spending on active labour market policy programmes had to be partially cut back (Croatia, Serbia) as more funds were required for unemployment benefits.

Figure 7.8 / Expenditures on active labour market policies, in % of GDP



Note: NMS-5 (2011).

Source: Eurostat and CEPESEE.

The labour market administrations in the Western Balkans are both understaffed and underfunded. This leads to a very heavy workload and prevents the enforcement of effective labour policy measures. In Kosovo, Macedonia and Bosnia and Herzegovina, there are more than 600 unemployed persons for every labour market administration official, which is a very high ratio by international standards; in the EU the average ratio is 1:150 and in many countries it is below 100. Montenegro is the only country with a better ratio. Although the labour market administrations have been reformed and modernised and become more service-oriented in recent years, their role is limited due to the low level of funding and heavy workloads.

7.5. LABOUR MARKET REGULATIONS AND EMPLOYMENT PROTECTION

Making the labour market more flexible in the sense of simplifying hiring and firing rules while at the same time protecting the unemployed and pursuing a proactive employment policy (concept of flexicurity) is considered an important factor to boost competitiveness. Labour market regulations, and the protection against dismissal in particular, are sometimes associated with high unemployment and hiring restrictions due to high costs involved.

That is why the Western Balkan countries have conducted a number of labour market reforms over the last decade, just like the NMS. All countries, except for Macedonia and, to some extent, Croatia and

Bosnia and Herzegovina, now have a level of liberalisation that is similar to that of the EU-15. Regular employment contracts are most flexible in Albania, but Serbia, too, ranks below the EU-15 average.

Table 7.2 / EPL index for the Western Balkan countries

	EPL index	EPL comprehensive index	Regular labour contracts	Fixed-term labour contracts	Mass dismissals
	end-1990s	2007			
Albania	2.0	2.1	1.8	1.9	3.4
Bosnia and Herzegovina	3.2	2.6	2.0	3.3	2.6
Croatia	3.6	2.7	2.7	2.8	2.5
Macedonia	2.8	3.1	2.1	3.8	3.8
Montenegro	2.9	2.2	2.6	1.9	3.6
Serbia	2.9	2.2	2.0	1.9	3.6
EU-10	2.4	2.1	2.6	1.2	3.4
EU-15	2.5	2.4	2.3	2.0	3.4

Note: EPL – employment protection legislation. EU-10 excluding Romania and Latvia; data for EU-10 and EU-15 refer to 2003.

Source: ILO – William Nero, March 2010.

Regulations governing fixed-term contracts are more restrictive in some Western Balkan countries (Macedonia, Croatia and Bosnia and Herzegovina) than in the EU-15. In Bosnia and Herzegovina and Croatia there is greater flexibility regarding collective dismissals than in the EU-15. However, it is to be assumed that the individual indicators have continued to evolve in recent years to allow greater liberalisation. All in all, the results suggest that labour market regulations do not restrict productivity growth or economic growth.

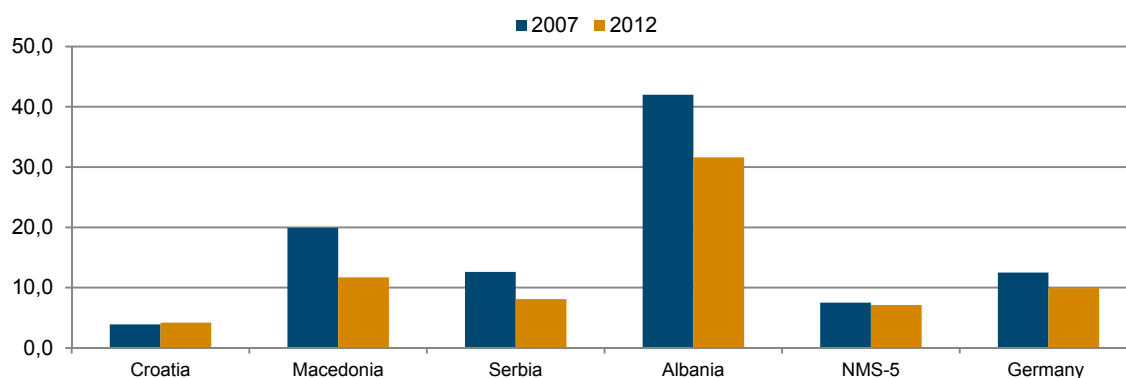
7.6. EDUCATION

The qualification of employees and the underlying education system are an important basis for competitiveness. Studies on the education system of the Western Balkan countries show that the education and training system is adapting only slowly to the needs of the labour market. This is, inter alia, due to factors such as the reform-resistance of teachers, corruption in the public education system, insufficient quality controls for private educational institutions, and low incentives for new providers of vocational training.

A recent study concludes that vocational school enrolment varies greatly in the region. While Albania's share of students enrolled at vocational schools is very low, Serbia, Croatia and Montenegro have rates comparable to that of Austria; this, however, does not mean that the level of effectiveness as regards the acquisition of technical expertise is equally high. Due to a lack of investments in equipment and buildings, the infrastructure of vocational schools is poor. Moreover, curricula are outdated and do not cater for what is now required on the labour market. Also, the knowledge and teaching methods of teachers do not correspond to current needs. The time spent on internships at companies differs by school and region. On the whole, the practical training provided is not sufficient to teach a sound level of professional know-how and expertise.

One important feature regarding tertiary education has been the boom of private universities in virtually all Western Balkan countries over the last decade. Both legislative amendments and the lack of funding for public institutions at the outset of this transformation process enabled this development. There were 47 public universities and approximately 250 private universities and higher education institutions during the academic year 2010/11. Kosovo saw the highest share of students enrolled at private universities (37%) and Croatia the smallest. The authorisation requirements for private universities bear problems: In most cases licenses can be obtained without any major bureaucratic hurdles, and the quick rise in the number of private study institutions has not gone hand in hand with rules governing quality assurance and the accreditation of programmes and institutions. Only 14 out of the 53 private educational institutions located in Albania, for example, hold an accreditation.

Figure 7.9 / Rate of early school leavers, in %

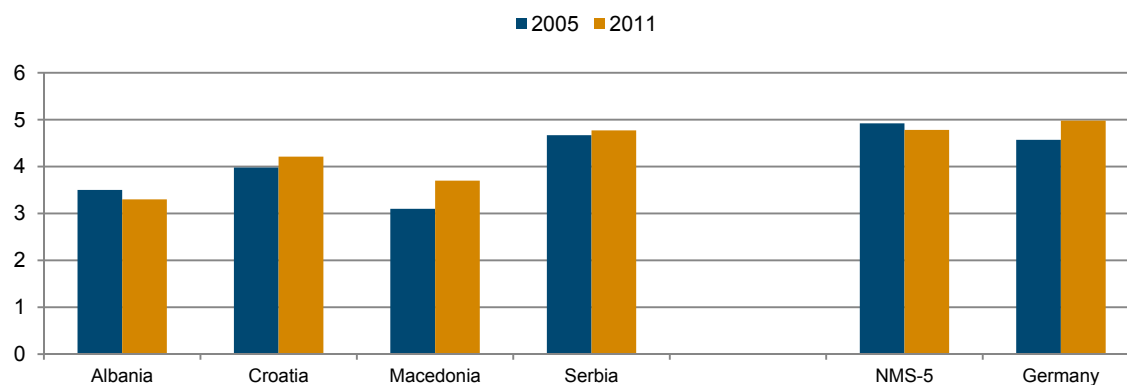


Source: Eurostat.

In some countries of the region, a major part of the resources earmarked for education has been spent on the tertiary sector in recent years, which has resulted in excess capacities in that sector. At the same time the primary and secondary education sectors have been neglected. Consequently, the basic education of pupils is poor and the school drop-out rate remains high.

In terms of gross domestic product, spending on education in the Western Balkan countries is significantly lower than the value calculated for Germany. Albania and Macedonia have the lowest education expenditure ratio, followed by Croatia. Meanwhile, Serbia's ratio is comparable to that of the NMS-5. All in all, spending on education increased in all three countries between 2005 and 2011 (most recent available figures).

The PISA tests provide further information on the partially insufficient state of education in the Western Balkans. Despite improvements in the survey period, the maths, science and reading comprehension skills of 15-year-olds in Albania and Montenegro are among the poorest in the Western Balkan region. Also by international comparison they lag far behind the NMS-5 (Table 7.3). In relative terms, Croatia's results are the best in the region (ranking 41st in maths, 37th in science, 36th in reading comprehension), followed by Serbia.

Figure 7.10 / Expenditure on education, in % of GDP

Source: Eurostat; for Albania: Progress Report 2013.

Table 7.3 / Results of the PISA studies

Country	Mathematics					Science					Reading				
	2000	2003	2006	2009	2012	2000	2003	2006	2009	2012	2000	2003	2006	2009	2012
Albania	381			377	394	376			391	397	349			385	394
Croatia			467	460	471			493	486	491			477	476	485
Macedonia	381					401					373				
Montenegro			399	403	410			412	401	410			392	408	422
Serbia		437	435	442	449		436	436	443	445		412	401	442	446
Analogue countries															
Poland	470	490	495	495	518	483	498	498	508	526	479	497	508	500	518
Slovakia		498	492	497	482		495	488	490	471		469	466	477	463
Slovenia			504	501	501			519	512	514			494	483	481
Czech Republic	498	516	510	493	499	511	523	513	500	508	492	489	483	478	493
Hungary	488	490	491	490	477	496	503	504	503	494	480	482	482	494	488
Germany	490	503	504	513	514	487	502	516	520	524	484	491	495	497	508

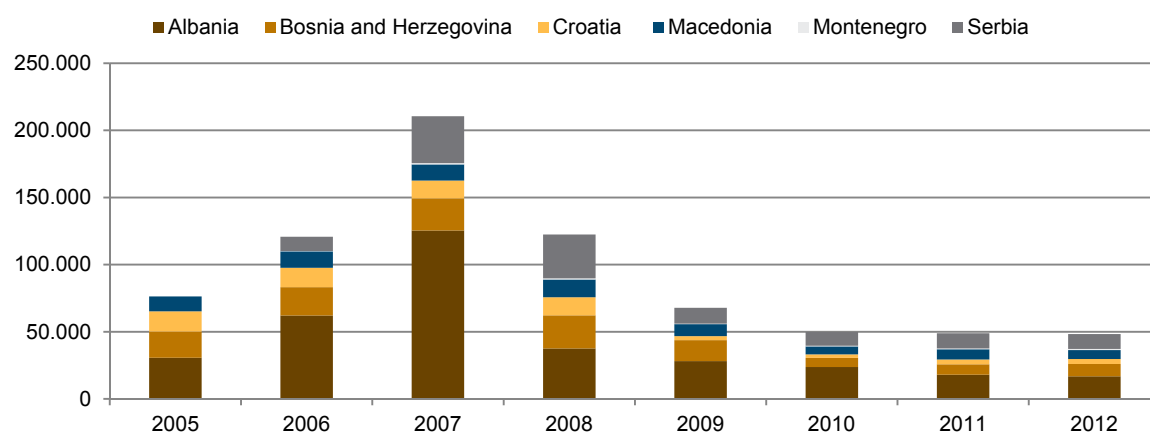
Source: OECD.

7.7. MIGRATION

One response to a lack of competitiveness and employment opportunities in one's own country is labour migration. Starting with the labour recruitment contract between Germany (and Austria) and former Yugoslavia in the 1960s and immediately gaining traction, labour migration has been a tradition in the Western Balkan region for decades. Overall, the number of migrants from the Western Balkans totals 4.5 million, with Bosnia and Herzegovina and Albania accounting for one-third. More than two-thirds of the migrants from the Western Balkans live in the EU. Albanian nationals prefer Italy and Greece as host countries, nationals from Bosnia and Herzegovina primarily live in Germany, Austria, Slovenia and Sweden, and migrants from Croatia tend to live in Germany, France and Austria. The EU-27 saw the highest influx of migrants from the Western Balkans in 2007. In the course of the economic and financial crisis, this number fell dramatically.

Croatia, a member of the EU since 1 July 2013, has free access to the labour markets in 14 EU countries. In all other countries, including Germany, transitional arrangements apply for the time being. Third-country regulations apply to all other Western Balkan countries.

Figure 7.11 / Immigration of nationals from the Western Balkans to the EU-27, 2005-2012



Source: Eurostat.

Table 7.4 / Remittances, in USD million

	2007	2008	2009	2010	2011	2012	2013e
Albania	1468	1495	1318	1156	1126	1027	779
Bosnia and Herzegovina	2686	2718	2127	1822	1958	1849	1896
Croatia	1072	1234	1208	1212	1348	1385	1499
Kosovo	919	1042	1055	997	1122	1059	1125
Macedonia	345	407	381	388	434	394	409
Montenegro	196	298	303	301	343	333	357
Serbia	3062	2708	3933	3349	3271	2763	3234
WB countries	9749	9902	10326	9225	9602	8810	9298
NMS-5	16476	17314	14247	13674	14235	13677	14286

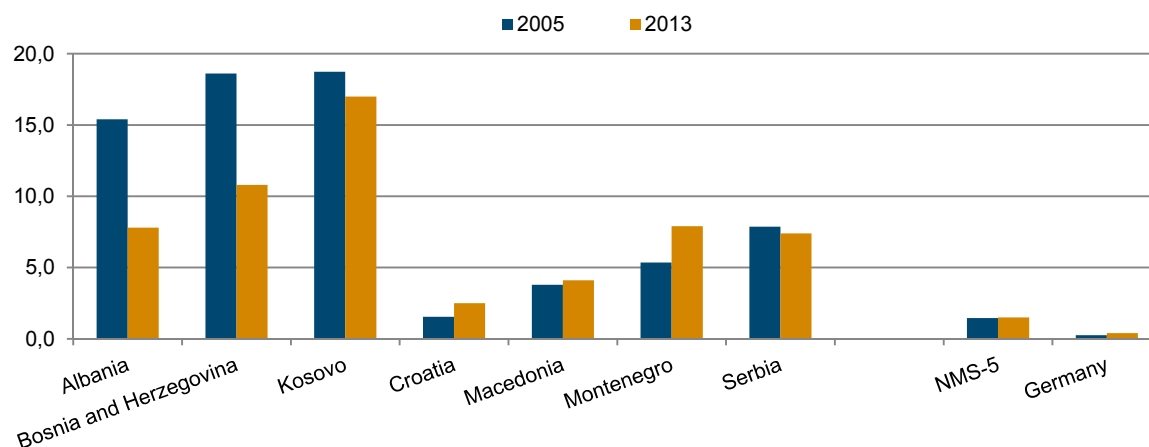
Source: World Bank.

The remittances of guest workers, among the highest worldwide, constitute an important source of income for the Western Balkans. They play a particularly important role in Kosovo, Bosnia and Herzegovina and Albania and accounted for 17%, 11% and 8%, respectively, of GDP in 2013. To some extent, this was a substantial decline compared to 2005, when the respective shares were 2 percentage points higher in Kosovo and 8 percentage points higher in Bosnia and Herzegovina and Albania (Figure 7.12). In retrospect, remittances peaked in 2009 (USD 10.3 billion) throughout the region, slumped during the crisis and increased again to USD 9.3 billion in 2013 (Table 7.2). Serbia accounts for around one-third of the overall remittances and Bosnia and Herzegovina for approximately 20%. With the exception of Albania and Bosnia and Herzegovina, the amount of remittances in 2013 exceeded pre-crisis levels in all Western Balkan countries.

Remittances are primarily spent on consumption and the construction and renovation of homes. A rather small share – 6% in Bosnia and Herzegovina and 10% in Albania – is used to establish companies.

Studies also illustrate the importance of remittances as a social safety net and as a means to fight poverty in some countries of the region. In Kosovo, for example, many more households receive foreign remittances than social benefits. The high cash flows from abroad are said to also affect the labour market dynamics in the region: It takes recipients of remittances longer to find suitable work and they are not willing to take on a job that pays below the reservation wage.

Figure 7.12 / Remittances, in % of GDP



Source: World Bank.

Labour mobility has increased in the Western Balkan countries in recent years. With the exception of Serbia and Kosovo, the employment of foreign workers is based on quota arrangements. According to the number of work permits issued, Montenegro is by far the most important country of destination for migrant workers from the region (about 15,000 in 2012), followed by Croatia which only allowed 2,500 regional migrant workers. Serbia and Bosnia and Herzegovina are the most important sending countries. Often job migration is seasonal and takes place in the tourism, agriculture and construction sectors. Despite the increase in migrant workers, their share in overall employment is low except in Montenegro. The aim (SEE 2020 Strategy) is to fully liberalise the regional labour market by 2020.

However, achieving the targets outlined in the strategy proves difficult: just between the start of the crisis in 2008 and 2013, more than 800,000 jobs were lost in the region with Serbia and Croatia being affected the most. With the exception of Albania, the employment rate is clearly below the target figure which is already very low compared to the rest of Europe.

7.8. SUMMARY AND RECOMMENDATIONS

Recommendations for improving the labour market situation:

- › The cooperation between educational institutions and enterprises should be promoted to improve the functioning of the labour market. Currently, the education and vocational training systems are poorly aligned with the needs of the labour market. In this context, it would be advisable to conduct regular surveys among entrepreneurs to recognise required skill sets early on (qualification monitor).

- › Vocational schools need to receive more funding, the training of teachers and the transfer of knowledge to students needs to be improved and the curricula need to be updated in coordination with social partners.
- › There needs to be a better matching of the supply of and demand for skilled workers to tackle high youth unemployment. One option would be to introduce a dual system of vocational training similar to that in Germany or Austria. However, implementing such a dual system takes time and cannot happen overnight. This also requires the support of political decision-makers and cooperation with enterprises. Further, companies would have to create positions for apprentices and provide qualified trainers, vocational schools and companies would have to coordinate, and trade unions would have to negotiate training contracts.
- › There should be targeted active labour market policies, i.e. target groups should be identified, such as adolescents, the long-term unemployed, members of minorities and older people.
- › Active labour market policies designed for adolescents should focus on enhancing their qualifications (e.g. training guarantee) while policies for older people and the long-term unemployed should concentrate on wage subsidies and community-based work. Also, intensive help should be provided to encourage people to start their own business.
- › Labour market administrations should be strengthened: The number of employees should increase and their qualifications should be enhanced as well. Labour market administrations should be relieved of 'unrelated work', e.g. pursuing health insurance agendas.
- › The education sector needs assistance in establishing processes and criteria governing the accreditation of educational institutions as private universities and the accreditation of degree courses and university courses at private universities.
- › As regards university education, it would be desirable to intensify cooperation among universities and promote student exchanges within the EU and the region to foster the exchange of knowledge.
- › Provide assistance to migrants returning: Information should be provided on establishing businesses and tax breaks.
- › In general, entrepreneurship, currently neglected, should be promoted by removing legal barriers to business start-ups or by reducing tax burdens and by making it easier to receive financial re-sources. Activities initiated already, e.g. as part of the SEECEL (South East European Centre for Entrepreneurial Learning) activities, are to continue and be intensified.
- › Pre-accession assistance and resources from the European Social Fund should be used more effectively to support active labour market policies, and there should be greater use of twinning projects.
- › Improving labour market statistics and developing a labour market research project in all countries: Surveys on informal sector employment should be carried out in all Western Balkan countries as part of the Labour Force Survey.

8. SWOT analysis and cost-benefit analysis of measures to effectively increase competitiveness – Country-by-country reports

Preliminary remarks:

In this chapter, a SWOT and cost-benefit analysis of measures to effectively increase competitiveness will be carried out for each of the seven Western Balkan countries. The SWOT analysis will focus on the target state of a competitive national economy and describe the current situation but it will not outline specific measures designed to reach that target state. The acronym SWOT stands for internal Strengths and Weaknesses and external Opportunities and Threats, which can be entered into a matrix. Then, starting from the upper left quadrant and going clockwise, strategic goals can be set in order to (i) match strengths and opportunities, (ii) turn weaknesses into strengths to seize opportunities, (iii) fend off risks in spite of weaknesses and (iv) neutralise risks by using existing strengths.

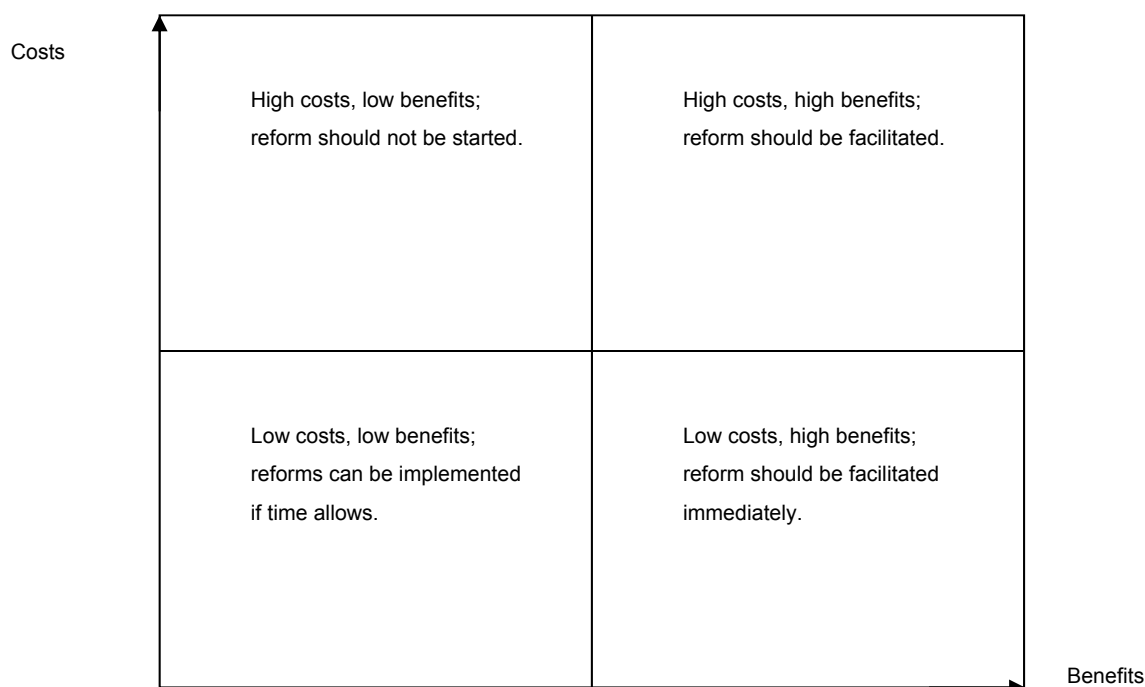
Figure 8.1 / SWOT analysis matrix with derived strategic targets

		Internal analysis	
		Strengths	Weaknesses
External analysis	Opportunities	Match of strengths and opportunities	Transformation of weaknesses into strengths in order to make use of opportunities
	Threats	Elimination of threats with the help of strengths	Defence against threats in spite of weaknesses

Note: The SWOT analysis focuses on the target state of a competitive economy; it describes states of things and not concrete measures.

In terms of external opportunities, most Western Balkan countries have a geographical advantage in one form or another. The countries located along the Adriatic Sea, i.e. Croatia, Montenegro and Albania (Bosnia and Herzegovina's sea access is negligible), have coastal sections and islands that can be used for tourism and sea ports for international trade. The Western Balkan countries located along the main ridge of the Dinaric Alps, i. e. Bosnia and Herzegovina, Montenegro, Albania and Kosovo (as well as Macedonia along the foothills), have the potential for developing summer and winter tourism in the mountains.

Figure 8.2 / Cost-benefit analysis matrix



Sizeable agricultural areas only exist in the eastern part of Croatia and, above all, in northern Serbia. Nearly all Western Balkan countries have large areas of woodland.

Moreover, water and fossil energy reserves, which can be used for energy production, are in abundance in the Western Balkans. A wide range of natural resources such as bauxite, iron, nickel, cobalt, lead, zinc, silver, copper and chrome can be found in the region as well. Croatia, Macedonia, Serbia and, to a certain extent, Bosnia and Herzegovina are integrated into international production networks. However, only Croatia and Serbia are well integrated into international transport networks due to their geographic location as transit countries and their position on the Danube river. Croatia's EU-membership and the participation of the other Western Balkan countries in the EU integration process are an important institutional external opportunity for growth and for enhancing competitiveness.

Accordingly, the exclusion of many Western Balkan countries from international transport networks and, in the case of Albania, Kosovo and Montenegro, also from international production networks constitutes an external risk as does the landlocked position of some Western Balkan countries. The process of

political transition, which is currently underway in one form or another in all countries of the Western Balkans, also poses a significant risk. The political situation in Bosnia and Herzegovina, Kosovo and Macedonia is particularly fragile and their governments have yet to gain full sovereignty over their entire national territory. This is especially true for Bosnia and Herzegovina where a lack of functioning government structures (a strong fiscal centre) – one of the key factors for achieving international competitiveness – hampers the internal integration of the economy. Experience has shown that the problems related to competitiveness and the internal integration process cannot be solved by handing over government functions to guarantor powers (for Bosnia and Herzegovina these include Croatia and Serbia).

Internal strengths include a long-standing history of tourism, mining, agriculture, forestry and energy production in some areas. There is an equally long tradition of circular migration in these countries, which has led to excellent foreign language skills in some places. Most recently, the majority of the Western Balkan countries were able to function as politically stabilising factors within the region's provisional political arrangements, or they were at least able to build the capacities to survive under these circumstances.

The list of internal weaknesses includes the poorly developed and not very innovative industrial and business- and export-oriented service sectors, the institutions, the labour markets, the quality of human capital, the cooperation between social partners, the entrepreneurial traditions and the macroeconomic policy framework. With the exception of Albania and Kosovo, most Western Balkan countries are also facing demographic challenges due to their ageing populations.

All these weaknesses together put the countries in the Western Balkans at a significant disadvantage, in particular with regard to the risks posed by the provisional nature of their political systems. Nonetheless, all policy makers should be able to make credible political, institutional, economic and infrastructural commitments under these provisional arrangements, which would have a stabilising effect in the event of destabilising elements threatening the political system.

The measures put forward in the country-by-country reports are fairly similar for all seven countries. High-cost, high-benefit measures include investments in transport infrastructure, not only with a view to promoting cross-border road construction projects but also – as is the case for Bosnia and Herzegovina – to support internal integration. Moreover, the poorly developed railroad and energy infrastructure should be upgraded and expanded.

Investments should also be directed towards the introduction of a dual system of education and training. Promoting exports of the manufacturing and export-oriented services sectors coupled with an industrial policy that will facilitate the transition from a low to a medium-tech industrial base would be just as expensive but likely yield significant benefits. Similar effects could be achieved by a more targeted FDI policy which could also be implemented at short notice, for instance by expanding already existing subsidies in this area. More complex inter-regional structural policies would also be desirable although major difficulties would likely arise in terms of political implementation. A more active labour market policy, on the other hand, could be implemented rather quickly.

As regards low-cost, high-benefit measures, a number of reforms can be proposed for these countries, in particular a reform of their exchange rate systems, which might contribute to ensuring and

promoting competitiveness. Albania and Serbia, the two countries with floating exchange rates, are advised to adopt an intermediate exchange rate system with a floating rate linked to the euro, which would offer more certainty for export-oriented companies in terms of currency risks. Croatia and Macedonia with their fixed exchange rates, on the other hand, should consider widening their exchange rate band against the euro in order to reduce the risk of undesired capital inflows negatively affecting the real exchange rate. Montenegro and Kosovo, where the euro was adopted unilaterally, and Bosnia and Herzegovina, which is pegged to the euro through a currency board, are advised to keep their current exchange rate regime as the risk of speculation against an individual currency would be too high given the low level of currency reserves.

Instead of depreciating the nominal exchange rate, which would lead to a sudden increase in competitiveness but would not be realistic due to the widespread euroisation, in particular in the lending business, fiscal devaluation policies could be imposed. This can be achieved by raising VAT and excise taxes and lowering income taxes and social security contributions. Political opposition to regressive effects on income distribution could be countered by presenting a sound concept for the implementation of these fiscal devaluation policies. Another efficient alternative over the long term would be to strengthen cooperation between social partners in order to integrate the wage policy into a macroeconomic development policy supported by major social partners.

The economic development is currently held up in all countries by the high costs of investment financing, in particular through bank loans. One key factor for this is a high and fast-growing level of non-performing loans (NPL) in the banks' portfolios. To overcome these obstacles to growth, governments and regulatory authorities must reduce incentives for banks to continue their hesitant behaviour and instead create incentives for them to solve the issue of non-performing loans on their own. Likewise, independent assessments of the banks' loan portfolios and stress tests based on international standards must be carried out as quickly as possible in order to lay the foundations for a potential bank recapitalisation and restructuring. The creation of a bad bank for mortgage loans is especially recommended for Bosnia and Herzegovina, Montenegro and Croatia. However, due to the possibly high costs involved, political opposition must be expected.

Like most measures mentioned in this group, measures to control capital inflows (in particular those related to minimum reserves) could also be introduced quickly, just like taxes on potentially destabilising capital inflows. Reforming the land registry and the private bankruptcy law would probably take more time, just like the implementation of measures to improve the absorption capacity of EU funds or those aimed at supporting circular migration in the home and host countries. Reducing non-tariff barriers to trade would be another measure affecting competitiveness in the short run. Frequently, however, these barriers were introduced to protect certain groups from foreign competition and policy makers might oppose their removal.

The group of low-cost, low-benefit measures includes long-term measures such as a professional country branding, the benefits of which, however, are difficult to assess. Other potential measures in this group, which could be implemented rather quickly, are the hosting of economic forums or exchanging best practices in different areas that play an important role in improving competitiveness.

High-cost measures whose benefits cannot be foreseen or will likely be very low in the current environment are to be avoided. Thus, for the time being, most Western Balkan countries, where no

major research institutions or larger companies implementing those research results exist, should refrain from costly public investments in research and development. These include support for start-up companies aimed at financing innovations or the establishment of support funds for outstanding research.

In the following section, all these aspects will be analysed in detail for each of the seven Western Balkan countries. Since these countries are quite similar in many respects, some repetitions could not be avoided. In some areas, recommendations for action can be given for the European Union. The European Commission is well advised to continue and step up their support for national and regional investment committees developing 'single project pipelines', which are designed to identify priority infrastructure projects. The EU should reinforce their demand for regional coordination and increase their support in this area in order to allow for more cross-border infrastructure investments and inter-regional structural initiatives in general to actually be carried out. These include additional help for local organisations to improve their absorption of EU funds. The EU also plays a significant role in promoting circular migration, which should be actively supported and seen as an opportunity for all parties involved. As for the dual education system, it would be desirable for the EU to increase their focus on supporting apprentices and trainees in candidate countries. As part of a wider-reaching industrial strategy, the European Union should then increase their support for the Western Balkan countries' efforts to integrate their manufacturing sectors into international networks. In addition, the EU should assist these countries in aligning their statistical data collection even quicker with European standards in order to promote evidence-based policy making based on comparable data.

8.1. ANALYSIS BY COUNTRY - ALBANIA

Assessment of Albania's competitiveness

Albania is one of the poorest countries in Europe. Its income level is only about 25% that of Germany, measured as gross domestic product (GDP) per capita in purchasing power parities (PPP). At the same time, together with Poland, Albania is one of the few successful transition economies in terms of income convergence with western industrialised countries.

Albania's low level of competitiveness is reflected by a persistent double-digit current account deficit as a share of GDP, thus running the risk of accumulating external debt that will be unsustainable over the long term. Although Albania has managed to double its share of goods exports in GDP since 2005, they currently account for less than 20% and are therefore still below the average of the Western Balkan countries. Goods exported by Albania are low-tech and mainly consist of raw materials, energy, textiles and shoes. Albania hardly exports higher-quality goods such as machinery, vehicles or chemical products. Despite a slight increase in unit labour costs, Albania was able to expand its initially low market share for goods exports into the European Union, thus suggesting a higher quality of the range of goods available for export. The freely floating exchange rate (recently, it has become a rather 'managed float') allows for a depreciation of the nominal rate in the event of external shocks. This has had a beneficial effect on export activities in the past. Non-tariff barriers to trade on the other hand, which include the inadequate adoption of EU standards, impose a significant burden on the export industry.

Another deficit is the lack of integration into international production networks. Intra-industry trade is extremely weak and primarily takes place in the low-tech sector. Overall, Albania imports more intermediate goods than it exports. These goods are mainly required for maintaining machinery and vehicles whereas a smaller part is used for manufacturing final goods for export. The overall export performance of Albania's manufacturing sector is poor. Albania's main export market is Italy. Other important export markets are the Southern European and Western Balkan countries. Tourism plays an important role in Albania's tradable services sector. The tourism industry, however, is still in its infancy and currently attracts mainly regional guests. Consequently, net services exports are not sufficient to improve Albania's current account balance.

Surveys on the quality of public institutions consistently rank Albania behind other Western Balkan countries – a region that, as a whole, is not performing particularly well compared to the new EU Member States from Central Europe. In Albania, protection of property rights is weak, the independence of the judiciary is limited and corruption is rampant. To a certain extent, this can be attributed to Albania joining the EU integration process at a later stage. Over the last years, Albania's regulatory quality has indeed seen some significant improvement whereas public management still lags behind.

Given the fact that up until 25 years ago, Albania did not have any private motor vehicle traffic or a modern road network, a considerable motorway network has been developed in the last decade with the help of massive investments. Rail traffic accounted for a large portion of transportation activities in communist times but was entirely neglected during the period of transformation. Electricity supply remains a weak point although the situation has improved significantly in recent times. The country's

dependence on hydroelectric power stations and the resulting vulnerability to rainfall fluctuations as well as the outdated electrical grid lead to frequent power outages.

Albania ranks last among the Western Balkan countries on nearly all education and innovation indicators and Albania's students scored poorly on the PISA tests. Nonetheless, Albania's very young population is known for their foreign language skills, which they put to use for migration purposes and studies abroad. Within the country itself, however, the environment for researchers and technicians is not very favourable. A significant obstacle to expanding local production capacities is the extremely low share of adolescents enrolled in technical apprenticeships or higher vocational secondary education coupled with a lack of qualified teachers. Overall, Albania's spending on education is very low and has even been falling in the last years.

Despite an unemployment rate of almost 15%, which is comparatively low for the Western Balkans, the poor absorptive capacity of the labour market is reflected by an extremely high rate of migration, the large number of self-employed individuals (an indicator of a shadow economy) and the fact that over one-third of Albania's population is still employed in subsistence farming. An over-regulated labour market or excessive wages are probably not to blame as 'hire and fire' is extremely common and the average gross salary is about EUR 300. The few industrial companies in Albania at least seem to have somewhat cooperative relations between employees and employers, and wage-setting tends to be relatively coordinated.

Modern banking is rather new to Albania. The few banks in the country are primarily foreign-owned. Automatic cash dispensers are still few and far between and the lending volume is low. Like in most Western Balkan countries, lending has dropped dramatically in recent years and interest rates in real terms are very high. On top of this, a quarter of the loans are non-performing presenting an obstacle to expansive credit financing by much needed private investors.

Assessment of Albania's policies to date

The overall political climate in Albania can be described as confrontational. Social democrats and conservatives take turns being in power and while in office, they show an unwillingness to compromise, play power politics and often adopt a revanchist attitude. The common goal of joining the EU, however, is largely undisputed. Thus, the EU integration process is seen as crucial for Albania's democratic development towards a functioning state governed by the rule of law.

The essentially free exchange rate acts as a buffer against external shocks like the one that occurred in 2009. While the share of foreign currency loans is at 60%, it is still lower than in the other Western Balkan countries. Therefore, the central bank has more leeway for implementing monetary policies. With gross external debt below 60%, Albania ranks in the middle of the pack in the region. In recent years, however, the central bank has set an exchange rate target which restricts the scope of monetary policy.

Albania's recent fiscal measures have been characterised by an overall crisis-related drop in revenues from direct and indirect taxes and an increase in social spending. Most recently, public spending on fixed investments, which has been stagnating for a long time, was drastically reduced. However, declining public revenues can also be attributed to the reduction of the top income tax rate and the employers'

social contributions. This has likely led to a fiscal devaluation over the last years with positive effects on Albania's competitiveness, but lately these tax cuts have been reversed. To date, Albania has not implemented any targeted activation measures aimed at modernising the country's labour market policy. The share of public spending on active labour market policies is negligible.

Albania's structural policy involving the strategic promotion of investments is poorly developed. The already low government expenditures on subsidies have largely been eliminated over the last few years. While the share of foreign direct investment in the manufacturing sector has increased in recent years, it is still very low compared to other countries in the region. Albania's regulatory policy is essentially determined by the EU integration process.

Like other Western Balkan countries, Albania is actively seeking international cooperation in the area of transport and energy infrastructure. In this context, projects aimed at improving access to Kosovo, be it through the construction of motorways or erecting high-voltage power lines, were given priority. Moreover, specific plans have been adopted to establish a connection to international gas pipeline networks and to build a liquid natural gas terminal on the Adriatic coast.

Swot analysis - Albania

Internal strengths few and far between

Albania's population is very young compared to other European countries. Albanians are also extremely flexible and mobile and have considerable experience with migration and moving abroad for educational purposes, resulting in excellent foreign language skills. Albania is practicing a very cautious approach to foreign policy, which has a stabilising effect on the region.

Internal weaknesses abound

The list of Albania's internal weaknesses is very long. A major deficit is the poorly developed and technologically backward industrial sector. Moreover, there is virtually no business- and export-oriented services sector or, if it exists, it is only inadequately developed. Public institutions are of poor quality and the public infrastructure needs improvement. Albania's labour market is not very efficient. The quality of human capital is low, in particular with regard to technical and vocational higher secondary education. Cooperation between social partners could also be strengthened. Moreover, the country lacks entrepreneurial traditions other than in retail trade and the macroeconomic policy framework could be improved as well.

External opportunities exist

Albania has access to the sea as well as picturesque coastal and mountain sections that provide favourable conditions for sea trade and tourism. Natural resources and water are in abundance. Aside from oil and natural gas, Albania also has chrome, copper, nickel and coal reserves as well as vast areas of woodland. Large quantities of annual rainfall feed into a number of rivers with steep slopes so that the dependency on energy imports could be reduced. The country was given the opportunity to

participate in the EU integration process, thus reducing the risks for foreign investors wanting to invest in Albanian production capacities.

External threats also exist

Not least due to its geographical location far away from international transit routes and Europe's industrial centres, Albania is excluded from international transport and production networks. It is also surrounded by politically unstable states, in particular Kosovo and Macedonia. Both neighbouring countries are still going through political transition and have not yet managed to gain full sovereignty. Moreover, the political situation in Greece and Italy – Albania's most popular emigration destinations – has become fragile.

Cost-benefit analysis of efficient measures for Albania

Low-cost, high-benefit measures – imperative

Efficient measures include the reform of the land registry and the private bankruptcy law. Their implementation, however, would take some time and the benefits would only materialise in the distant future. Promoting circular migration by cutting red tape would be beneficial as well. Improving the absorption capacity of EU funds by implementing relevant administrative reforms seems to be another particularly important aspect. Public administrations must have the ability to identify and co-finance beneficial projects.

Short-term efficient measures include for example the adoption of an intermediate exchange rate system with a fluctuation band against the euro, which would offer more certainty for exporters and serve as shield against destabilising capital flows. Measures to control capital inflows in the areas of minimum reserve policies and capital taxation could achieve a similar effect. Another important measure that could be implemented quickly is to solve the issue of non-performing loans which have reached alarming levels in Albania.

As an alternative to a sharp nominal depreciation of the exchange rate, which would hardly be effective given the increasing euroisation in Albania, fiscal devaluation policies could be imposed even at short notice. However, political opposition to a tax reform that could have regressive effects on income distribution might be quite strong.

Policy makers might also try to prevent a reduction of non-tariff barriers to trade, especially since some of these barriers are designed to protect vested interests. Reducing these barriers, however, in particular for the export sector, would be an efficient way to increase Albania's competitiveness in the short term. In Albania, these barriers include poorly developed technical conformity assessments, the lack of cooperation with regional agencies responsible for sanitary and phytosanitary matters and administrative burdens associated with customs documents and customs automation.

High-cost, high-benefit measures – advisable

Costly measures that would yield high benefits over the long term include public investments in transport infrastructure. These are likely to reduce domestic production costs and to encourage industrialisation in many sectors. In this context, it is not only necessary to improve the local transport infrastructure but also to ensure the connectivity of transport networks across regions. Albania has already invested heavily in its motorways but it should now channel its investments into the railroad infrastructure and port facilities in order to facilitate the emergence of larger companies relying on this infrastructure. Moreover, these investments would stimulate growth over a short period of time, which could lead to long-term self-financing using the resulting additional tax revenues. The same is true for investments in energy infrastructure to ensure the supply of electricity. The introduction of a dual system of education would be just as expensive and it would take a long time for the benefits to materialise. The combination of in-company training and teaching theoretical knowledge in vocational schools produces skilled workers for the gradual transition from a low- to a medium-tech industrial base, which is only slowly taking place in Albania. This process should be accompanied by an active industrial policy and a promotion of exports for the manufacturing sector and the export-oriented services sector. Specific measures in this context could include the establishment of modern industrial zones in the vicinity of ports. Implementing a wage policy based on cooperation between social partners, which is aimed at achieving full employment while maintaining a low inflation rate, would be another measure with beneficial effects over the long term. A more complex inter-regional structural policy would certainly be desirable but seems difficult to implement at the political level given the large number of different interests. Incentives from and coordination by the EU could probably help overcome these obstacles.

A costly measure that could be implemented relatively quickly is to increase support for foreign direct investment (FDI), for example through solutions for business taxation aimed at attracting companies or tailored infrastructure investments, which would lead to a rapid transfer of technology driven by said FDI. Introducing an active labour market policy would be costly but could be implemented immediately, including through targeted measures to promote mobility among the workforce and increase transparency of the labour market or through hiring incentives, especially for adolescents.

The group of policy recommendations which are low-cost but would only yield limited benefits includes long-term measures such as a professional country branding or short-term measures like hosting regional economic forums or exchanging good practices in different areas that are important for promoting competitiveness. These measures however would take away already limited public resources from more promising projects.

High-cost measures whose benefits cannot be foreseen or will likely be very low in the current environment are to be avoided. Thus, a country like Albania, where no major research institutions or larger companies implementing those research results exist, should refrain from costly public investments in research and development. These include support for start-up companies aimed at financing innovations or the establishment of support funds for outstanding research.

Top five measures providing the maximum benefits

1. Investments in energy infrastructure (expensive, long-term)
2. Investments in transport infrastructure (expensive, long-term)
3. Increase support for foreign direct investment (expensive, short-term)
4. Improve absorption capacity of EU funds (inexpensive, long-term)
5. Reduce share of non-performing loans (inexpensive, short-term)

APPENDIX 1

Appendix Table 8.1.1 / Selected indicators of competitiveness – Albania, 2013

	AL	WB-7	NMS-5	DE
Current account balance, in % of GDP	-10.4	-6.1	1.7	7.5
Exports of goods, in % of GDP	17.6	22.0	67.9	42.7
Exports of machinery and vehicles, in % of GDP (SITC 7)	0.6	3.9	35.9	18.8
Exports of chemical products, in % of GDP (SITC 5)	0.1	2.3	6.8	6.3
Property rights, '7' = clearly defined and well protected by law	2.8	3.7	4.0	5.8
Judiciary independence, '7' = entirely independent	2.3	3.1	3.5	6.0
Motorways in km per 100 km ² land area	1.1	0.8	1.5	3.6
Power outages per firm per month	4.2	3.2	0.4	.
Researchers per 1 million inhabitants, in full-time equivalents	148	728	2789	3950
Enrolment rate in upper secondary technical and vocational education, in %	10.4	50.3	54.0	51.4
Unemployment rate in %, LFS	15.6	23.1	10.1	5.3
Employed persons in % of total employed	25.8	19.8	14.7	10.6
Automated teller machines per 100,000 adults	33.1	54.6	62.9	118.8
Non-performing loans in % of total loans	24.3	17.2	11.9	2.7

Note: Data refer to the year 2013 (in most cases), or to the latest available year. WB-7 = average of the seven West Balkan countries; NMS-5 = average of the five Central European new Member States.

Source: wiiw Database, Eurostat, IMF, WEF, UNESCO, WDI, national statistics.

APPENDIX 2

Appendix Figure 8.1.1 / SWOT analysis – Albania

		Internal analysis	
		Strengths	Weaknesses
External analysis	Opportunities	#young population with good language skills employable in #coastal tourism and #mountain tourism as well as in #energy generation and #mining	#EU integration process may help to strengthen #industry sector, #services sector, #institutions, #labour markets, #human capital, #social partners, #entrepreneurship and #macroeconomic framework
	Threats	#young mobile population may leave #transport- and #production-network-isolated home country and #crisis-ridden migration host countries Italy and Greece; #stabilising factor in a regional political #provisional arrangement	credible ex ante commitment in a regional political #provisional arrangement regarding #institutional, #economic and #infrastructure issues is possible

Note: The SWOT analysis focuses on the target state of a competitive economy; it describes states of things and not concrete measures.

Appendix Figure 8.1.2 / Cost-benefit analysis – Albania

Costs			Benefits
	#start-up support for innovation, #support fund for outstanding research	investment in #energy- and #transport infrastructure, #FDI promotion , #incomes policy, investment in #dual education system, active #export promotion, #industrial policy, <i>interregional #structural</i> , active #labour market policy	
	#country branding, regional #economic fora , #good practice exchange	absorption of #EU funds, #NPL resolution , #fiscal devaluation , #crawling exchange rate band , #management of capital inflows , reduction of #non-tariff trade barriers , #cadastre reform, #personal bankruptcy, support of #circular migration	

Note: Measures ranked according to benefit. Measures that can be realised in the short term are shown in bold type. Measures likely to encounter social or political resistance are shown in italics.

8.2. ANALYSIS BY COUNTRY – BOSNIA AND HERZEGOVINA

Assessment of Bosnia and Herzegovina's competitiveness

Bosnia and Herzegovina's income level is only about 25% that of Germany, measured as gross domestic product (GDP) per capita in purchasing power parities (PPP). Thus, together with Albania and Kosovo, it is not only one of the poorest countries in Europe but also in the whole Western Balkans. During the course of recent history, the country rarely managed to exceed its relative income level. In fact, the current level is identical to that of the early 1950s, the 1970s and even the 1990s. Moreover, Bosnia and Herzegovina still suffers from the aftermath of the 1992-95 war, which has not only brought human suffering and destruction. A bitter legacy of the war is the fragile governmental structure divided along ethnic lines and without strong central institutions, which is seen as a major obstacle towards a democratic and economic development. Lacking or weak central government institutions hamper the effectiveness of government action aimed at improving the country's competitiveness, for example in the area of infrastructure policy.

Bosnia's poor economic performance goes along with weak external competitiveness reflected by a persistent current account deficit. Structurally, the country is not yet able to finance the import of goods and services by its own exports, thus running the risk of accumulating external debt that is unsustainable over the long term. Although Bosnia and Herzegovina has managed to expand its initially low share of goods exports in GDP since 2005, they currently account for only a little more than 20% and are therefore still below the average of the Western Balkan countries.

Goods exported by Bosnia and Herzegovina are low-tech and mainly consist of metals, timber, furniture, textiles and shoes. The share of higher-quality exports such as machinery, vehicles or chemical products is on par with the relatively low average of the Western Balkan countries. Despite an increase in unit labour costs, Bosnia and Herzegovina was able to expand its initially low market share for goods exports into the European Union, thus suggesting a higher quality of the range of goods available for export. Since the exchange rate is pegged to the euro through a currency board, a depreciation of the nominal exchange rate is not an option in the event of external shocks. Non-tariff barriers to trade, which include in particular the inadequate adoption of EU standards, impose a burden on the export industry.

Nonetheless, the country is making efforts to integrate its economy into international production networks. Intra-industry trade primarily takes place in the medium-tech sector. Overall, however, Bosnia and Herzegovina imports more intermediate goods than it exports, a large part of which is required for maintaining machinery and vehicles. A smaller part is used for manufacturing final goods for export. The overall export performance of Bosnia's manufacturing sector is unsatisfactory. Key export markets include Germany, Croatia and Italy as well as Serbia, Austria and Slovenia. Tourism as well as transport services play a rather important role in Bosnia's tradable services sector. The tourism industry holds potential but is currently limited to only a few attractions. In any case, net services exports contribute to a significant improvement in Bosnia's current account balance.

Due to the complex governmental structure consisting of two entities, ten cantons and one special administrative unit, the quality of public institutions is more severely impaired than in other Western Balkan countries, which themselves perform poorly in comparison with the new EU Member States. In

recent years, however, the regulatory quality has seen improvements and the independence of the judiciary have been strengthened, not least thanks to the long-standing involvement of international organisations and the EU in rebuilding the country.

The transport infrastructure is not fit to push forward the internal integration of the economy or to intensify the country's participation in the international division of labour. The greatest obstacle in this context, however, is not the rugged terrain, which is undoubtedly difficult to access, but the country's political fragmentation. The road network has not been upgraded in decades and there are only a few dozen kilometres of motorway in Bosnia and Herzegovina. The railroad is primarily used for transporting heavy goods and is poorly developed as well. The expansion of the transport infrastructure is hindered by minefields, which apparently have not yet been cleared throughout the country. The supply of electricity is somewhat satisfactory with only a few power outages.

Bosnia and Herzegovina only ranks average to below average on a number of education and innovation indicators compared to other Western Balkan countries and does not even appear in some rankings. There are only very few researchers and technicians in the country. However, the share of adolescents enrolled in technical and vocational higher secondary training is at least average by regional comparison. Gross domestic spending on research and development is among the lowest in the Western Balkans. The reputation of the country's universities does not yet meet international standards although efforts undertaken by the universities' administration to introduce specialisations and seek international cooperation have been observed.

The unemployment rate of almost 28%, which is quite high even for the Western Balkans, reveals the poor absorptive capacity of the labour market. This is also reflected by an extremely high rate of migration, the large number of self-employed individuals (an indicator of a shadow economy) and the fact that over 20% of the population is still employed in subsistence farming. An over-regulated labour market or excessive wages are probably not to blame as 'hire and fire' is extremely common and the average gross salary is about EUR 660. Moreover, the efficiency of the labour market is severely limited since there is virtually no migration of labour between the different ethnic regions of the country. The few industrial companies in Bosnia and Herzegovina seem to have at least somewhat cooperative relations between employees and employers, and wage-setting tends to be relatively coordinated.

95% of bank assets in Bosnia and Herzegovina are under foreign ownership. Automatic cash dispensers are still few and far between and the lending volume is low. Like in most Western Balkan countries, lending has dropped dramatically in recent years and interest rates in real terms are high. On top of this, one-sixth of all loans are non-performing, presenting an obstacle to expansive credit financing by much needed private investors.

Assessment of Bosnia and Herzegovina's policies to date

The political climate in Bosnia and Herzegovina is poisoned. The smaller, Serbian-dominated entity 'Republika Srpska' does not contribute to strengthening national institutions and more or less blatantly pushes for a union with Serbia. The larger, Bosnian- and Croatian-dominated entity 'Federation of Bosnia and Herzegovina' is split into ten cantons. The administration of the entities, cantons and the special administrative unit 'Brčko District' does not appear to be very efficient, which in 2014 has led to violent protests among large parts of the population. Even the common goal of joining the EU is not undisputed. Nonetheless, the EU integration process is seen as crucial for Bosnia and Herzegovina's democratic development towards a functioning state governed by the rule of law.

The central bank of Bosnia and Herzegovina is one of the few recognised common institutions. However, it only has extremely limited powers in terms of monetary and exchange rate policies under what is known as a currency board. Thus, the common currency, the fixed exchange rate and the inability to succumb to the monetary policy interests of individual entities seem to be the only effective anchors holding the country together. However, this arrangement also has negative effects on economic development: The supply of central bank money depends on the net inflow of foreign currencies. This can result in stagnation if domestic willingness to invest and consume grows but there is not enough money to pay for it and the financial sector is not willing to grant loans. Foreign currency loans only account for just under 70% of all outstanding loans. Yet, private households, companies and the government take out loans exclusively in foreign currencies due to the chosen monetary and exchange rate arrangements. Thus, the country always faces the risk of a severe financial crisis in the event of sudden foreign capital outflows, just like the most recent one, during which 15% of all loans went into default. The total amount of gross external debt is unknown. However, the general government gross external debt is relatively low at 30% of GDP, not least due to the fact that the central government only plays a minor role in fiscal matters.

Bosnia's recent fiscal measures have been influenced by a small but persistent general government deficit. Decreased revenues from indirect taxes could be compensated by higher revenues from direct taxes. Social spending as well as public investments have increased. To date, Bosnia and Herzegovina has only implemented a few targeted activation measures aimed at modernising the country's labour market policy. The share of public spending on active labour market policies is extremely low.

The strategic promotion of investments by the state is poorly developed. Regulatory responsibilities for company formation and registration lie with the entities, which can be problematic if a company intends to operate throughout Bosnia and Herzegovina. Both entities tried to reduce the time and costs associated with the formation of a company. The Foreign Investment Promotion Agency (FIPA), operated by both entities, offers modest incentives for foreign investments, usually in the form of exemptions from customs duties for imported capital goods. Bosnia's regulatory policy is essentially determined by the EU integration process. In this context, the European Union serves as an anchor of institutional stability and the Public Administration Reform Coordinator's Office (PARCE) as a connecting link between the two entities in terms of implementing reforms.

Overlapping responsibilities within the government hinder the implementation of reforms through-out the country and restrict the efforts aimed at strengthening international cooperation in the areas of transport

and energy infrastructure. A small number of road construction projects are being implemented in order to provide a connection to the Croatian motorway network.

Swot analysis – Bosnia and Herzegovina

Internal strengths few and far between

Bosnia and Herzegovina's strengths are rooted in past experience and long-standing practices. Thus, a few long-standing traditions can be identified which the country can fall back on. The Bosnian capital Sarajevo, for example, hosted the 1984 Winter Olympics and some of the winter sports facilities are still in operation. The country has a long history of forestry, energy production and mining. Another strength involves the country's equally long tradition of being able to survive under provisional political arrangements.

Internal weaknesses abound

The list of Bosnia and Herzegovina's internal weaknesses is very long. A major deficit is the poorly developed and technologically backward industrial sector. Moreover, the business- and export-oriented services sector is inadequately developed and public institutions are of poor quality. In particular, government efficiency is severely limited due to its complex structure. The public infrastructure is in very poor condition with very few modern roads. Labour market efficiency is poor and the human capital is of relatively low quality. Cooperation between social partners could also be strengthened. Moreover, the country lacks entrepreneurial traditions other than in retail trade. The legacy of the ethnically-motivated wars weighs heavily on the economy and delays the development of a national identity. A unified state is not ensured. In this context, the macroeconomic policy framework could be improved as well.

External opportunities exist

Bosnia and Herzegovina boasts wide mountain ranges that provide favourable conditions for tourism. Moreover, the country has natural resources and water reserves in abundance. Aside from coal, iron ore and bauxite, Bosnia and Herzegovina also has copper, lead and zinc reserves as well as vast areas of woodland. Large quantities of annual rainfall feed into a number of rivers with steep slopes that can be used for energy production. Bosnia and Herzegovina was given the opportunity to participate in the EU integration process, however, progress so far has been limited and the country is still considered only a 'potential candidate' for EU membership. In the areas of engineering and vehicle construction, however, efforts can be observed to integrate these sectors into international production networks.

External threats abound

Not least due to its geographical location, de facto landlocked and far away from international transit routes, Bosnia and Herzegovina is excluded from international transport networks. Moreover, since the 1995 Dayton Agreement, the state must be considered provisional and is dependent on its guarantor powers. The lack of a strong fiscal centre is one of the reasons for the poor internal integration of the economy, which is a prerequisite for achieving international competitiveness.

Cost-benefit analysis of efficient measures for Bosnia and Herzegovina

Low-cost, high-benefit measures – imperative

Efficient measures include the reform of the land registry and the private bankruptcy law. Their implementation, however, would take some time and the benefits would only materialise in the distant future. Promoting circular migration by cutting red tape would be beneficial as well. Improving the absorption capacity of EU funds by implementing relevant administrative reforms is another important aspect. Public administrations must have the ability to identify and co-finance beneficial projects.

Efficient and short-term measures include for example implementing defensive mechanisms against destabilising capital flows through measures to control capital inflows in the areas of minimum reserve policies and taxation of selected capital imports. Another important measure that could be implemented quickly is to solve the issue of the high level of non-performing loans. To this end, the creation of a special purpose entity (bad bank) to reduce the high share of non-performing loans in the household sector should be taken into consideration. Other countries have achieved good results with such an instrument. However, this would require an assessment of the banks' claims according to international standards in order to reduce the potential fiscal risks to an acceptable level. Otherwise, political opposition must be expected given the potential rise in government debt.

As an alternative to the missing option of a nominal depreciation of the exchange rate, fiscal devaluation policies could be imposed even at short notice. However, political opposition to a tax reform that could have regressive effects on income distribution might be quite strong.

Policy makers might also try to prevent a reduction of non-tariff barriers to trade, especially since some of these barriers are designed to protect vested interests. Reducing these barriers however, in particular for the export sector, would be an efficient way to increase Bosnia's competitiveness in the short term. These barriers include the inadequate adoption of technical EU rules and of European sanitary and phytosanitary measures as well as administrative burdens associated with customs documents and customs automation.

High-cost, high-benefit measures – advisable

Quite costly measures which would yield high benefits over the long term include a comprehensive government reform to strengthen central government institutions, even against the opposition of policy makers, as well as public investments in transport infrastructure. The latter is a little more realistic and less controversial. These investments are likely to reduce domestic production costs and to encourage industrialisation in many sectors. In this context, it is not only necessary to improve the local transport infrastructure but also to ensure the connectivity of transport networks across regions. So far, Bosnia and Herzegovina has failed to upgrade its motorway network and it should intensify its efforts to establish a connection between the major cities of the country as well as to motorways in neighbouring Croatia. Moreover, these investments would stimulate growth over a short period of time, which could lead to long-term self-financing using the resulting additional tax revenues. The same is true for the railroad and energy infrastructure.

The introduction of a dual system of education would be just as expensive and it would take a long time for the benefits to materialise. The combination of in-company training and teaching theoretical knowledge in vocational schools produces skilled workers for the gradual transition from a low- to a medium-tech industrial base, which is also very slowly taking place in Bosnia and Herzegovina. This process should be accompanied by an active industrial policy and a promotion of exports for the manufacturing sector and the export-oriented services sector. Specific measures in this context could include the establishment of modern industrial zones, for example in the vicinity of the river port located in the special administrative unit Brčko. The current wage policy based on cooperation between social partners should focus more on wage setting according to productivity growth. A more complex inter-regional structural policy would certainly be desirable but seems difficult to implement at the political level given the large number of different interests. Incentives from and coordination by the EU could probably help overcome these obstacles.

A costly measure that could be implemented relatively quickly is to increase support for foreign direct investment (FDI), for example through solutions for business taxation aimed at attracting companies or infrastructure investments, which would lead to a rapid transfer of technology driven by said FDI. Introducing an active labour market policy would be costly but could be implemented immediately, including through targeted measures to promote labour mobility and increase transparency of the labour market or through hiring incentives, especially for adolescents.

Low-cost, low-benefit measures – advisable where possible

The group of policy recommendations which are low-cost but would only yield limited benefits includes long-term measures such as a professional country branding or short-term measures like hosting regional economic forums or exchanging best practices in different areas that are important for promoting competitiveness. These measures however would take away already limited public resources from more promising projects.

High-cost, low-benefit measures – to be avoided

High-cost measures whose benefits cannot be foreseen or will likely be very low in the current environment are to be avoided. Thus, a country like Bosnia and Herzegovina, where no major research institutions or larger companies implementing those research results exist, should refrain from costly public investments in research and development. These include support for start-up companies aimed at financing innovations or the establishment of support funds for outstanding research.

Top five measures providing the maximum benefits

1. Comprehensive government reform (expensive, long-term, politically charged)
2. Investments in transport infrastructure (expensive, long-term)
3. Increase support for foreign direct investment (expensive, short-term)
4. Reduce share of non-performing loans (inexpensive, short-term)
5. Fiscal devaluation (inexpensive, short-term, politically charged)

APPENDIX 1

Appendix Table 8.2.1 / Selected indicators of competitiveness – Bosnia and Herzegovina, 2013

	BA	WB-7	NMS-5	DE
Current account balance, in % of GDP	-5.5	-6.1	1.7	7.5
Exports of goods, in % of GDP	20.8	22.0	67.9	42.7
Exports of machinery and vehicles, in % of GDP (SITC 7)	4.2	3.9	35.9	18.8
Exports of chemical products, in % of GDP (SITC 5)	1.9	2.3	6.8	6.3
Property rights, '7' = clearly defined and well protected by law	3.7	3.7	4.0	5.8
Judiciary independence, '7' = entirely independent	3.9	3.1	3.5	6.0
Motorways in km per 100 km ² land area	0.1	0.8	1.5	3.6
Power outages per firm per month	1.0	3.2	0.4	.
Researchers per 1 million inhabitants, in full-time equivalents	193	728	2789	3950
Enrolment rate in upper secondary technical and vocational education, in %	55.0	50.3	54.0	51.4
Unemployment rate in %, LFS	27.5	23.1	10.1	5.3
Employees in % of total employed	20.7	19.8	14.7	10.6
Automated teller machines per 100,000 adults	40.0	54.6	62.9	118.8
Non-performing loans in % of total loans	15.1	17.2	11.9	2.7

Note: Data refer to the year 2013 (in most cases), or to the latest available year. WB-7 = average of the seven West Balkan countries; NMS-5 = average of the five Central European new Member States.

Source: wiiw Database, Eurostat, IMF, WEF, UNESCO, WDI, national statistics.

APPENDIX 2

Appendix Figure 8.2.1 / SWOT analysis matrix – Bosnia and Herzegovina

		Internal analysis	
		Strengths	Weaknesses
External analysis	Opportunities	#long tradition in #mountain tourism, #forestry, as well as in #energy generation and #mining and first steps towards integration in international #production networks	#EU integration process and #production networks may help to strengthen #industry sector, #services sector, #institutions, #labour markets, #human capital, #social partners, #entrepreneurship and #macroeconomic framework
	Threats	#survivability in a regional political #provisional arrangement and de facto #landlockedness	credible ex ante commitment in a regional political #provisional arrangement regarding #institutional, #economic and #infrastructure issues is conditionally possible

Note: The SWOT analysis focuses on the target state of a competitive economy; it describes states of things and not concrete measures.

Appendix Figure 8.2.2 / Cost-benefit matrix – Bosnia and Herzegovina

Costs			Benefits
	#start-up support for innovation, #support funds for outstanding research	<i>comprehensive #state reform, investment in #transport infrastructure, #FDI promotion, #incomes policy, investment in #dual education system, active #export promotion, #industrial policy, interregional #structural policy, active #labour market policy</i>	
	#country branding, regional #economic fora, #good practice exchange	absorption of #EU funds, #NPL resolution, #bad bank, #fiscal devaluation, #management of capital inflows, reduction of #non-tariff trade barriers, #cadastre reform, #private bankruptcy, support of #circular migration	

Note: Measures ranked according to benefit. Measures that can be realised in the short term are shown in bold type. Measures likely to encounter social or political resistance are shown in italics.

8.3. ANALYSIS BY COUNTRY - KOSOVO

Assessment of Kosovo's competitiveness

Kosovo's gross domestic product (GDP) per capita in purchasing power parities (PPP) amounts to only about 20% of Germany's income level. This makes Kosovo the country with the lowest income in the Western Balkans. In recent years, however, it has experienced the highest economic growth in the region. The country declared its independence from Serbia in 2008 (after the armed conflict in 1999) and so far has been recognised as a sovereign state by a small majority of the United Nations member states (including 23 EU member states), however, excluding Serbia. Moreover, the ethnically Albanian-dominated central government has not been able to gain control of the whole territory. The north of the country is largely controlled by Serbia, i.e. the local Serbian minority. In addition, elements of a protectorate still exist in the form of the European Union Rule of Law Mission in Kosovo (EULEX), which has extensive powers and is protected by the KFOR troops under UN auspices.

The economy's lack of competitiveness is reflected by a persistent current account deficit. Once a structurally neglected region of Serbia, it is not surprising that, as an independent state, Kosovo is structurally not yet able to finance imports of goods and services by its own exports. Although the current share of goods exports in GDP amounts to only 6%, the figure has tripled since 2005. However, it is still well below the very low average of the Western Balkan countries. Against this background, increasing the competitiveness of domestic production remains essential in order to prevent the still relatively low level of external debt (30% of GDP) from increasing to unsustainable levels in the long term.

Goods exported by Kosovo are technologically backward and mainly consist of base metals, mineral products and food. Kosovo hardly exports higher-quality goods such as machinery, vehicles or chemical products. Despite a sharp increase in unit labour costs, Kosovo was able to expand its initially very low market share for goods exports into the European Union substantially in recent years, suggesting, among other things, a higher quality of the range of goods available for export. Kosovo's unilateral adoption of the euro as official currency has eliminated the possibility of adjusting the exchange rate following an external shock (e.g. withdrawal of capital) or an internally caused real overvaluation. Non-tariff barriers to trade are substantial and also impose a burden on the export industry. These include the inadequate adoption of EU standards.

Another weakness is the lack of integration into international production networks. Intra-industry trade is extremely weak and primarily takes place in the low-tech sector. Overall, Kosovo imports more intermediate goods than it exports. These goods are mainly required for maintaining machinery and vehicles. A smaller part is used for manufacturing final goods for export. Kosovo's main export market is Italy. Other important export markets include Albania and Macedonia as well as, more recently, China and Germany. Tourism as well as construction play an important role in Kosovo's tradable services sector.

The tourism industry, however, is still in its infancy. Nevertheless, to a certain extent, net services exports contribute to improving Kosovo's current account.

Where available, surveys on the quality of public institutions rank Kosovo behind other Western Balkan countries – a region that is not performing particularly well compared with the new EU Member States from Central Europe anyway. Not least due to Kosovo's recent and contested sovereignty, public management remains limited and corruption is rampant. To a certain extent, this can be attributed to Kosovo joining the EU integration process at a later stage. Another major problem concerns the uncertain legal status of public ownership, in particular on the border with Serbian-controlled northern Kosovo (especially as regards the former Trepča Mines). The work of the EULEX mission, which assists the country in setting up a police force, judicial system and administration, can be regarded as largely beneficial (despite recent corruption allegations within the mission).

Kosovo's transport infrastructure is largely outdated and in poor condition. Nonetheless, about 60 km of motorway to the Albanian border were built in recent years and another stretch to the Macedonian border will follow. The airport of the capital Pristina has also been renovated recently. The main weakness is the unreliable supply of electricity, although Kosovo Polje is home to the world's fifth largest reserves of lignite. Two hopelessly outdated coal-fired power plants produce most of the energy, but are also the cause of heavy air pollution. Due to the frequent breakdowns of the up to 50-year-old power plant units and an outdated electricity grid, power outages are an everyday occurrence in Kosovo.

No data on comparable education and innovation indicators have been collected for Kosovo to date. Individual reports suggest that education is of poor quality and research is almost non-existent. However, Kosovo's very young population is known for their foreign language skills, which they put to use for migration purposes and studies abroad.

At more than 30%, Kosovo has the highest unemployment rate in the Western Balkans. The poor capacity of the labour market to absorb job-seekers is also reflected by the extremely high rate of migration and the large number of self-employed individuals (an indicator of the shadow economy). As in most of the other Western Balkan countries, this clearly reflects a lack of capacity in the industrial and other sectors, since there is neither an over-regulation of the labour market nor a wage level that is too high by international standards.

A modern banking system is only just emerging. Bank competition is comparatively low, with the few banks largely foreign-owned. The number of automatic cash dispensers is the lowest in the Western Balkans, the lending volume is very low and lending interest rates in real terms are very high. As a result, credit financing provides little impetus for economic development and the financing of competitive projects.

Assessment of Kosovo's policies to date

Overall, the political climate in Kosovo can only be described as confrontational. The political camps are very aware of their power, and the intervention of the US embassy is frequently necessary in order to reach compromises. The most recent government formation took several months. Instead of pursuing a path of dialogue and joint efforts, a revanchist attitude prevails. Only the goal of joining the EU seems undisputed. The EU integration process is thus seen as crucial for Kosovo's democratic development towards a generally recognised state governed by the rule of law.

The independent state of Kosovo first unilaterally adopted the Deutsche Mark and then the euro as official currency. As a result, the central bank is left with very little leeway for monetary policy action to promote growth and development by influencing the supply of money. Thus, the entire loan portfolio is in foreign currency.

Kosovo's recent fiscal measures have been characterised by a balanced development of revenues from direct and indirect taxes and a sharp increase in social spending and public fixed asset investment. Its budget deficit is small. As regards the tax structure, Kosovo increased the standard VAT rate while reducing the top income tax rate. This has led to a fiscal devaluation in recent years with a positive effect on the country's competitiveness. To date, Kosovo has not implemented any targeted activation measures aimed at modernising the country's labour market policy. As in other countries of the region (e.g. Bosnia and Herzegovina), the share of public spending on active labour market policies is low.

The policy of substantial public investment in fixed assets is not accompanied by a strategic promotion of investment in the private sector. The policies are limited to regulatory measures: a one-stop shop option is available as a means of simplifying the company formation process. The electronically based registration can be carried out in 22 registration centres. It is free of charge and only takes a few days to be processed. One of the few fiscal investment incentives involves the possibility of offsetting taxes or losses against income within the following seven years. However, the recent flow of foreign investment in the manufacturing sector is hardly worth mentioning. Kosovo's regulatory policy is essentially determined by the EULEX mission and the EU integration process. In this respect, the European Union is an anchor of institutional stability.

Like other Western Balkan countries, the government is actively seeking international cooperation in the area of transport and energy infrastructure. In this context, projects aimed at improving access to Albania were given priority, be it through motorway construction or erecting cross-border high-voltage power lines. Other road construction projects aim at connecting the capital Pristina with the Macedonian and then the Serbian border. Currently, there is no natural gas market in Kosovo. The only pipeline extending from the Macedonian capital Skopje to Pristina has been out of service for nearly 30 years. Practical difficulties frequently arise regarding the responsibility for the transmission of electricity due to conflicts between the Kosovar and the Serbian operators.

Swot analysis - Kosovo

Internal strengths few and far between

Kosovo's population is very young compared with other European countries. The Kosovar people are also extremely flexible and mobile and have relevant experience in circular migration and studying abroad, resulting in excellent foreign language skills. Another strength involves their proven ability to survive in situations of political transition.

Internal weaknesses abound

The list of Kosovo's internal weaknesses is very long. The country's main weakness is the barely existent and technologically backward industrial sector, which is unable to absorb job-seekers.

Moreover, there is virtually no business- and export-oriented services sector or it is only inadequately developed. Public institutions are of poor quality. Government efficiency, in particular, is hampered by the unresolved issue of Kosovo's status. The country's public infrastructure is in need of significant investment. This applies in particular to the electricity sector. Labour market efficiency is limited by sectoral productive capacity. The quality of human capital is low. Cooperation between social partners could also be strengthened. Also, the country lacks entrepreneurial traditions other than in retail trade. The macroeconomic framework could be improved as well.

External opportunities definitely exist

Kosovo has picturesque mountain ranges that provide favourable conditions for tourism. Moreover, natural resources are in abundance. Aside from housing the world's fifth-largest lignite reserves, Kosovo also has zinc, lead, silver and chrome reserves. Kosovo was given the opportunity to participate in the EU integration process, however, progress so far has been limited and the country is still considered only a 'potential candidate' for EU membership. The fact that both principal destination countries for Kosovar migrants, Germany and Switzerland, are very stable economies presents a major opportunity for the country.

External threats abound

Not least due to its geographical location, landlocked and far away from international transit routes and Europe's industrial centres, Kosovo is excluded from international transport and production networks. Moreover, due to its lack of full sovereignty, the unresolved issue of its status and the resulting non-recognition by Serbia, the state of Kosovo must be regarded as a provisional political entity. In addition, it is surrounded by politically unstable states. These include, in particular, Macedonia, which has not been recognised by its largest neighbour Greece either and which is characterised by internal ethnic tensions.

Cost-benefit analysis of efficient measures for Kosovo

Low-cost, high-benefit measures – imperative

Efficient measures include the reform of the land registry and the private bankruptcy law. Their implementation, however, would take some time and the benefits would only materialise in the distant future. Promoting circular migration by cutting red tape would be beneficial as well. Improving the absorption capacity of EU funds by implementing relevant administrative reforms is another important aspect. Public administrations must have the ability to identify and co-finance beneficial projects when applying international standards.

Efficient and short-term measures include for example measures to control capital inflows through minimum reserve policies and selective taxation of undesirable capital imports. Solving the problem of non-performing loans is another important measure that could be implemented quickly. Fiscal devaluation policies that build on the experience of recent years could be imposed in the short term as a substitute for exchange rate depreciation. However, political opposition to a tax reform that could have regressive effects on income distribution might be quite strong.

Policy makers might also try to prevent a reduction of non-tariff barriers to trade, especially since some of these barriers are designed to protect vested interests. Reducing these barriers, however, in particular for the export sector, is an efficient way to increase Kosovo's competitiveness in the short term. These barriers include poorly developed information and notice mechanisms, the inadequate adoption of technical EU rules and of European sanitary and phytosanitary measures as well as administrative burdens associated with customs documents and customs automation.

High-cost, high-benefit measures – advisable

Costly measures that would, however, yield high benefits over the long term include the final resolution of the status issue, even against the strong opposition of policy makers, in order to strengthen central government institutions as well as public investments in transport infrastructure, which is a little more realistic and less controversial. This could reduce transport costs and encourage industrialisation along the new routes. In this context, it is not only necessary to improve the local transport infrastructure but also to ensure the connectivity of transport networks across regions. Kosovo has already invested heavily in its motorways but it should now increasingly channel its investments into the railroad infrastructure in order to facilitate the emergence of larger companies relying on this infrastructure. Moreover, these investments would stimulate growth over a short period of time, which could lead to long-term self-financing using the resulting additional tax revenues. This applies in particular to energy infrastructure. Ensuring a steady supply of electricity, which is essential in the medium term, should be given top priority.

The introduction of a dual system of education would be just as costly and it would take a long time for the benefits to materialise. The combination of in-company training and teaching theoretical knowledge in vocational schools produces skilled workers for the gradual transition from a low- to a medium-tech industrial base, which is also slowly taking place in Kosovo. This process should be accompanied by an active industrial policy and a promotion of exports for the manufacturing sector and the export-oriented services sector. Specific measures in this context could include promoting the establishment of modern industrial zones. Implementing a wage policy based on cooperation between social partners aimed at achieving full employment while maintaining a low inflation rate would be another measure with beneficial effects over the long term. A more complex inter-regional structural policy would be desirable, but seems difficult to implement at the political level given the large number of different interests. Incentives from and coordination by the EU could probably help overcome these obstacles.

A costly measure that could be implemented relatively quickly is to increase support for foreign direct investment (FDI), for example through solutions for business taxation aimed at attracting companies or tailored infrastructure investments, which would lead to a rapid transfer of technology driven by said FDI. Introducing an active labour market policy would be costly but could be implemented immediately, including through targeted measures to promote labour mobility and to increase transparency of the labour market or through hiring incentives, especially for adolescents.

Low-cost, low-benefit measures – advisable where possible

The group of policy recommendations which are low-cost but will yield only limited benefits includes long-term measures such as a professional country branding or short-term measures like hosting regional economic forums or exchanging good practices in different areas that are important for

promoting competitiveness. These measures however would take away already limited public resources from more promising projects.

High-cost, low-benefit measures – to be avoided

Measures known from experience to be very costly but whose benefits cannot be foreseen or will likely be very low in the current environment are to be avoided. Thus, for the time being, a country like Kosovo, where no major research institutions or larger companies implementing those research results exist, should refrain from costly public investments in research and development. These include support for start-up companies aimed at financing innovations or the establishment of support funds for outstanding research.

Top five measures providing the maximum benefits

1. Resolution of the country's status issue (expensive, long-term, politically charged)
2. Investments in energy infrastructure (expensive, long-term)
3. Investments in transport infrastructure (expensive, long-term)
4. Increase support for foreign direct investment (expensive, short-term)
5. Fiscal devaluation (inexpensive, short-term, politically charged)

APPENDIX 1

Appendix Table 8.3.1 / Selected indicators of competitiveness – Kosovo, 2013

	XK	WB-7	NMS-5	DE
Current account balance, in % of GDP	-6.7	-6.1	1.7	7.5
Exports of goods, in % of GDP	6.0	22.0	67.9	42.7
Exports of machinery and vehicles, in % of GDP (SITC 7)	0.2	3.9	35.9	18.8
Exports of chemical products, in % of GDP (SITC 5)	0.1	2.3	6.8	6.3
Property rights, '7' = clearly defined and well protected by law	.	3.7	4.0	5.8
Judiciary independence, '7' = entirely independent	.	3.1	3.5	6.0
Motorways in km per 100 km ² land area	0.6	0.8	1.5	3.6
Power outages per firm per month	11.4	3.2	0.4	.
Researchers per 1 million inhabitants, in full-time equivalents	.	728	2789	3950
Enrolment rate in upper secondary technical and vocational education, in %	.	50.3	54.0	51.4
Unemployment rate in %, LFS	30.9	23.1	10.1	5.3
Employees in % of total employed	19.8	19.8	14.7	10.6
Automated teller machines per 100,000 adults	32.2	54.6	62.9	118.8
Non-performing loans in % of total loans	.	17.2	11.9	2.7

Note: Data refer to the year 2013 (in most cases), or to the latest available year. WB-7 = average of the seven West Balkan countries; NMS-5 = average of the five Central European new Member States.

Source: wiiw Database, Eurostat, IMF, WEF, UNESCO, WDI, national statistics.

APPENDIX 2

Appendix Figure 8.3.1 / SWOT analysis matrix – Kosovo

		Internal analysis	
		Strengths	Weaknesses
External analysis	Opportunities	<p>#young population with good language skills may enter into #circular migration to stable migration host countries Germany and Switzerland and are employable in #mountain tourism as well as #energy generation and #mining</p>	<p>#EU integration process may help to strengthen #industry sector, #services sector, #institutions, #labour markets, #human capital, #social partners, #entrepreneurship and #macroeconomic framework</p>
	Threats	<p>#young mobile population may leave their #transport- and #production-network-isolated #landlocked home country to enter into #circular migration; #survivability in a regional political #provisional arrangement</p>	<p>credible ex ante commitment in a regional political #provisional arrangement regarding #institutional, #economic und #infrastructure issues is conditionally possible</p>

Note: The SWOT analysis focuses on the target state of a competitive economy; it describes states of things and not concrete measures.

Appendix Figure 8.3.2 / Cost-benefit matrix – Kosovo

Costs			Benefits
	<p>#start-up support for innovation, #support fund for outstanding research</p>	<p><i>Final #resolution of political status, investment in #energy- and #transport infrastructure, #FDI promotion, #incomes policy, investment in #dual education system, active #export promotion, #industrial policy, interregional #structural policy, active #labour market policy</i></p>	
	<p>#country branding, regional #economic fora, #good practice exchange</p>	<p>absorption of #EU funds, #NPL resolution, #fiscal devaluation, #management of capital inflows, reduction of #non-tariff trade barriers, #cadastre reform, #private bankruptcy, support of #circular migration</p>	

Note: Measures ranked according to benefit. Measures that can be realised in the short term are shown in bold type. Measures likely to encounter social or political resistance are shown in italics.

8.4. ANALYSIS BY COUNTRY - CROATIA

Assessment of Croatia's competitiveness

Croatia is one of the less prosperous countries in Europe. Its income level is about 50% that of Germany, measured as gross domestic product (GDP) per capita in purchasing power parities (PPP). This makes it the most developed country in the Western Balkans. In the early 1980s, Croatia had an income level already almost two-thirds that of Germany but since then has experienced many economic setbacks. Since the onset of the recent economic crisis, its GDP has declined for six years in a row. Croatia's accession to the European Union on 1 July 2013 can be deemed a political success.

Until recently, Croatia, like the other Western Balkan countries, had a persistent current account deficit. Over the course of the continuing crisis, however, an adjustment of the current account occurred because the significant drop in private consumption and investment also entailed a dramatic reduction in imports. Currently, Croatia has a crisis-related current account surplus. At the same time, its exports as a share of GDP have been stagnating since 2005. At 21%, they are slightly below the low average of the Western Balkan countries and thus well below the recent rates of the new EU Member States from Central Europe of almost 70%.

Goods exported by Croatia are technologically diversified and mainly consist of machinery, refined petroleum products, medicines and ships. Croatia's exports thus include a number of higher-quality products. However, the traditional shipbuilding industry had to be scaled down significantly in the course of establishing closer ties with the EU, especially as the EU prohibited subsidising unprofitable companies. Against the background of a progressive de-industrialisation, it is thus not surprising that the market share for Croatian goods exported into the EU has also declined in recent years despite a slight decline in unit labour costs. The exchange rate, which is pegged to the euro within a narrow band, does not allow a stronger depreciation of the nominal rate in the event of external shocks and has thus long been a burden on the export industry.

Nonetheless, the country is making efforts to integrate its economy into international production networks. Intra-industry trade primarily takes place in the medium-tech sector, supplemented by some activity in the high-tech segment. Overall, Croatia imports more intermediate goods than it exports. The overall export performance of its manufacturing sector is satisfactory compared with other Western Balkan countries but below average compared with the new EU Member States from Central Europe. Croatia's key export markets include Italy, Bosnia and Herzegovina, Germany, Slovenia and Austria. The tourism industry plays an extremely important role in Croatia's tradable services sector. Overall, net services exports contribute significantly to improving Croatia's current account.

According to most surveys on the quality of public institutions, Croatia's level of development is average or above average compared with other Western Balkan countries. The protection of property rights and the independence of the judiciary could be improved. In recent years, Croatia's public management and regulatory quality have improved significantly. This is primarily due to the EU integration process that culminated in the country's recent accession to the European Union.

Croatia has built an impressive motorway network over the years, as a result of which it is well-connected within and beyond its borders. Although individual stretches are still missing, the overall motorway density in Croatia is higher than in the new EU Member States from Central Europe. Thanks to an electric and largely double-track railway line along the main transit route between the Slovenian border, the capital Zagreb and the Serbian border, Croatia has a large railway network by regional comparison. The country's supply of electricity is guaranteed. Power outages are very rare.

Croatia ranks first among the Western Balkan countries on nearly all education and innovation indicators but mostly below average compared with the new EU Member States from Central Europe. Researchers and technicians are available in Croatia. Croatia's students scored satisfactorily on the PISA tests. Gross domestic spending on research and development as well as public spending on education are comparatively high. Moreover, a large number of adolescents are enrolled in technical and vocational higher secondary training.

Despite an unemployment rate of 17%, which is comparatively low for the Western Balkans, the poor absorptive capacity of the labour market is reflected by the high rate of migration and the large number of self-employed individuals (an indicator of the shadow economy). Compared with other Western Balkan countries, Croatia has a regulated labour market, with many of the regulations similar to those in Germany. At around EUR 1050, the average gross wage of employees is relatively high compared with other Western Balkan countries. Even though productivity in Croatia is higher than in the other countries, the rate in real terms is likely to be overstated. Moreover, the few industrial companies in Croatia seem to have rather poor cooperative relations between employees and employers, and wage-setting in the individual companies is relatively uncoordinated.

Most of the country's banks are foreign-owned. The number of automatic cash dispensers is above average as is the lending volume. However, lending has dropped significantly in recent years and interest rates in real terms are high. On top of this, almost one-sixth of the loans are non-performing, which presents an obstacle to expansive credit financing by much needed private investors.

Assessment of Croatia's policies to date

Croatia's political scene is characterised by the paralysing polarisation of political camps. The differences in (economic) policy between the social democrats, i.e. the successor party to the League of Communists of Croatia, and the conservative Croatian Democratic Union, i.e. the party of the first democratically elected Croatian president, are relatively small. The main bone of contention between the 'Reds' and the 'Blacks' concerns the interpretation of the events during and after the Second World War. Moreover, following a six-year recession, confidence in the government is among the lowest in the Western Balkans. Although the EU is not held in particularly high regard in Croatia either, the aim of joining the EU was undisputed among the majority of Croats. Thus, the EU integration process is seen as crucial for Croatia's democratic development towards a functioning state governed by the rule of law. Today, the aim of joining the European Monetary Union is largely undisputed.

The Croatian currency is pegged to the euro within a narrow fluctuation band. The share of foreign currency loans amounts to over 70% of GDP and gross external debt is the highest in the region at over 100%. This leaves the central bank with very little leeway for monetary policy action.

Croatia's recent fiscal measures have been characterised by an overall crisis-related drop in revenues from direct and indirect taxes and an increase in social spending. Public spending on fixed asset investments was cut back significantly. To date, Croatia has implemented just a few targeted activation measures aimed at modernising the country's labour market policy. The share of public spending on active labour market policies is low.

Croatia is pursuing structural policies that involve the strategic promotion of investment. Attempts are being made to attract foreign direct investment using the Croatian Agency for Investments and Competitiveness. The Agency offers numerous investment incentives. These include 10-year reduced tax rates of 10% for investments of less than EUR 1 million creating five new jobs and going down to 0% for amounts in excess of EUR 3 million creating 15 new jobs. Capital investment subsidies are also available. Their amount depends on the labour market situation and can be as high as EUR 1 million. Investment projects with great potential for job creation benefit from additional grants of up to 100% if more than 500 new jobs are created.

In order to strengthen research and development, Croatia offers incentives for investment in this area, including tax reliefs and subsidies. Subsidies for eligible costs (costs for personnel directly involved in research and materials used in research) range from 100% for costs related to basic research to over 50% for costs related to applied research and up to 25% for costs related to development research. Additional support is available for small and medium-sized enterprises. Moreover, these enterprises are eligible for subsidised loans from the Croatian Bank for Reconstruction and Development (HBOR). However, such loans are also available to other companies and projects.

In recent years, government subsidies have stagnated at a comparatively high level. At approximately 2% of GDP, they are the third highest in the region. Foreign direct investment in the manufacturing sector as a share of GDP has increased in recent years and is comparable with the level in the new EU Member States from Central Europe. Even after joining the EU, Croatia's regulatory policy is determined by the EU integration process. In this respect, the European Union is an anchor of institutional stability.

Like other Western Balkan countries, Croatia is actively seeking international cooperation in the area of transport and energy infrastructure. In this context, road construction projects aimed at improving the north-south link between Hungary and Bosnia and Herzegovina and developing the long Adriatic coastal strip were given priority. In addition, the Croatian ports of Rijeka and Ploče are being expanded. Plans to build a large LNG terminal on the island of Krk aimed at improving the security of energy supply in Europe are also well on track.

Swot analysis - Croatia

Internal strengths exist to some extent

Croatia's strengths include a long history of coastal tourism, ocean and river shipping, agriculture, forestry, energy production and mining. The country's human capital is comparatively well trained. Another strength involves the largely stabilising effect of Croatia's foreign policy with respect to the region and Bosnia and Herzegovina in particular.

Internal weaknesses abound

Nevertheless, the list of Croatia's internal weaknesses is long. The export-oriented industrial sector could be built up, especially in terms of size. The business- and export-oriented services sector is moderately developed. The quality of public institutions and public infrastructure could be improved. The absorptive capacity of Croatia's labour market is limited. Cooperation between social partners is inadequate. Also, the country lacks entrepreneurial traditions other than in retail trade. The macroeconomic framework should be improved as well.

External opportunities exist

Croatia has access to the sea as well as picturesque coastal sections that provide favourable conditions for sea trade and tourism. The country also has extensive agricultural and forest land. Croatia's natural resources include oil, natural gas, bauxite and coal. Croatia's location on the border between Central and Southeast Europe and along the Danube is another advantage, facilitating the country's integration into international transport networks. The oil and chemical industry, in particular, are beginning to be integrated into international production networks. The country was given the opportunity to become a member of the EU, thus significantly reducing the risks for foreign investors wanting to invest in Croatian production capacities.

External threats also exist

In addition, Croatia is surrounded by politically unstable states. These include, in particular, Bosnia and Herzegovina, which still has not gained full sovereignty. Croatia, which is still burdened by the armed conflicts of the past but is now taking on a new constructive role, can make an important contribution to resolving the sovereignty issue.

Cost-benefit analysis of efficient measures for Croatia**Low-cost, high-benefit measures – imperative**

Efficient measures include the reform of the personal bankruptcy law. Implementation of the reform, however, would take some time and its benefits would only materialise in the distant future. Improving the absorption capacity of EU funds by implementing relevant administrative reforms seems to be a particularly important aspect. Public administrations must have the ability to identify and co-finance beneficial projects.

Short-term efficient measures include, for example, the adoption of a wider exchange rate band against the euro, which would serve as a shield against destabilising capital inflows, while providing exporters with certainty for planning. Measures to control capital inflows including, for example, higher minimum reserve requirements for selected capital inflows or their taxation could achieve a similar effect. Overcoming the problem of non-performing loans is another important measure that could be implemented quickly. After conducting a quality check of the outstanding claims, the creation of a special purpose vehicle (bad bank) as in Slovenia should also be taken into consideration.

As an alternative to a sharper nominal depreciation of the exchange rate, which would hardly be effective in stimulating exports given the increasing euroisation in Croatia and its external debt, fiscal devaluation policies could be imposed even at short notice. However, political opposition to a tax reform that could have regressive effects on income distribution might be quite strong.

High-cost, high-benefit measures – advisable

Costly measures that would yield high benefits over the long term include public investments in transport infrastructure. These are likely to reduce domestic production costs and to encourage industrialisation in many sectors. In this context, it is not only necessary to improve the local transport infrastructure but also to ensure the connectivity of transport networks across regions. Croatia has already made major investments in its motorways but it should now also channel larger investments into the railroad infrastructure. These investments would stimulate growth over a short period of time, which could lead to long-term self-financing using the resulting additional tax revenues. The same applies to the energy infrastructure.

The introduction of a dual system of education would be just as costly and it would take a long time for the benefits to materialise. The combination of in-company training and teaching theoretical knowledge in vocational schools produces skilled workers for the further transition to a medium- and high-tech industrial base, which is very slowly taking place in Croatia. In addition, this process should be accompanied by an even more active industrial policy and promotion of exports for the manufacturing sector and the export-oriented services sector.

Implementing a wage policy based on cooperation between social partners aimed at achieving full employment while maintaining a low inflation rate would be another measure with beneficial effects over the long term. A more complex inter-regional structural policy would certainly be desirable but seems difficult to implement at the political level given the large number of different interests. Incentives from and coordination by the EU could probably help overcome these obstacles.

A costly measure that could be implemented relatively quickly is to increase support for foreign direct investment (FDI), for example through additional solutions for business taxation aimed at attracting companies or tailored infrastructure investments, which would lead to a rapid transfer of technology driven by said FDI. Introducing an active labour market policy would be costly but could be implemented immediately, including through targeted measures to promote geographical labour mobility and to increase transparency of the labour market or through hiring incentives, especially for adolescents.

Low-cost, low-benefit measures – advisable where possible

The group of policy recommendations which are low-cost but will yield only limited benefits includes long-term measures such as a professional country branding or short-term measures like hosting regional economic forums or exchanging good practices in different areas that are important for promoting competitiveness. These measures however would take away already limited public resources from more promising projects.

High-cost, low-benefit measures – to be avoided

High-cost measures whose benefits cannot be foreseen or will likely be very low in the current environment are to be avoided. Thus, for the time being, a country like Croatia, where only a handful of major research institutions or larger companies implementing those research results exist, should refrain from costly public investments in research and development. These include support for start-up companies aimed at financing innovations or the establishment of support funds for outstanding research.

Top five measures providing the maximum benefits

1. Wage policies based on cooperation between social partners (expensive, long-term)
2. Investments in a dual system of vocational training (expensive, long-term)
3. Improve absorption capacity of EU funds (inexpensive, long-term)
4. Reduce share of non-performing loans (inexpensive, short-term)
5. Fiscal devaluation (inexpensive, short-term, politically charged)

APPENDIX 1

Appendix Table 8.4.1 / Selected indicators of competitiveness – Croatia, 2013

	HR	WB-7	NMS-5	DE
Current account balance, in % of GDP	1.3	-6.1	1.7	7.5
Exports of goods, in % of GDP	21.3	22.0	67.9	42.7
Exports of machinery and vehicles, in % of GDP (SITC 7)	5.3	3.9	35.9	18.8
Exports of chemical products, in % of GDP (SITC 5)	2.5	2.3	6.8	6.3
Property rights, '7' = clearly defined and well protected by law	3.8	3.7	4.0	5.8
Judiciary independence, '7' = entirely independent	3.0	3.1	3.5	6.0
Motorways in km per 100 km ² land area	2.2	0.8	1.5	3.6
Power outages per firm per month	1.0	3.2	0.4	.
Researchers per 1 million inhabitants, in full-time equivalents	1584	728	2789	3950
Enrolment rate in upper secondary technical and vocational education, in %	65.5	50.3	54.0	51.4
Unemployment rate in %, LFS	17.2	23.1	10.1	5.3
Employees in % of total employed	17.0	19.8	14.7	10.6
Automated teller machines per 100,000 adults	111.7	54.6	62.9	118.8
Non-performing loans in % of total loans	15.3	17.2	11.9	2.7

Note: Data refer to the year 2013 (in most cases), or to the latest available year. WB-7 = average of the seven West Balkan countries; NMS-5 = average of the five Central European new Member States.

Source: wiiw Database, Eurostat, IMF, WEF, UNESCO, WDI, national statistics.

Appendix 2

Appendix Figure 8.4.1 / SWOT analysis matrix – Croatia

		Internal analysis	
		Strengths	Weaknesses
External analysis	Opportunities	<p>#long tradition in #coastal tourism, #agriculture, #forestry, #energy generation, #mining, #shipping and first steps towards integration in international #transport networks and #production networks in the new #EU membership with the help of qualitative #human capital</p>	<p>#EU membership and #transport network and #production networks may help to strengthen #industry sector, #services sector, #institutions, #labour markets, #social partners, #entrepreneurship and #macroeconomic framework</p>
	Threats	<p>#stabilising factor in a regional political #provisional arrangement</p>	<p>credible ex ante commitment in a regional political #provisional arrangement regarding #institutional, #economic and #infrastructure issues is possible</p>

Note: The SWOT analysis focuses on the target state of a competitive economy; it describes states of things and not concrete measures.

Appendix Figure 8.4.2 / Cost-benefit matrix – Croatia

Costs			Benefits
	<p>#start-up support for innovation, #support fund for outstanding research</p>	<p>investment in #transport infrastructure, #FDI promotion, #incomes policy, investment in #dual education system, active #export promotion, #industrial policy, <i>interregional #structural policy</i>, active #labour market policy</p>	
	<p>#country branding, regional #economic fora, #good practice exchange</p>	<p>absorption of #EU funds, #NPL resolution, #bad bank, #fiscal devaluation, #widening the exchange rate band, #management of capital inflows, #private bankruptcy</p>	

Note: Measures ranked according to benefit. Measures that can be realised in the short term are shown in bold type. Measures likely to encounter social or political resistance are shown in italics.

8.5. ANALYSIS BY COUNTRY - MACEDONIA

Assessment of Macedonia's competitiveness

The former Yugoslav Republic of Macedonia (hereafter referred to as Macedonia) is one of the poorer countries in Europe. Its income level is only about one-third that of Germany, measured as gross domestic product (GDP) per capita in purchasing power parities (PPP). Nevertheless, Macedonia is one of the few countries in Europe that seems to have weathered the global economic crisis without any major downturn. One reason is likely the public investment of several hundred million euros in the prestigious urban development project 'Skopje 2014', which is a massive investment given Macedonia's relatively small size. The project was launched in 2010 and encompasses 20 government buildings, cultural institutions and bridges as well as 40 monuments to be constructed in Skopje in a nationalistic and historicist architectural style.

Like the other Western Balkan countries, Macedonia, too, has a persistent current account deficit. Measured in terms of GDP, however, it is much smaller compared with the other Western Balkan countries. Goods exports exceed 40% of GDP and have actually increased by 25% since 2005. This figure is considerably lower than in the new EU Member States but about the same as in Germany.

Technologically, Macedonian goods exports are average and mainly consist of metals, chemical products, textiles and machinery. In recent years, its main exports have included ferroalloy, catalytic converters, suits and centrifuges. Macedonia therefore also exports some higher-quality goods including machinery and vehicles as well as chemical products. Moreover, despite an increase in unit labour costs, Macedonia was able to expand its market share for goods exports into the European Union in recent years, suggesting, among other things, a higher quality of the range of goods available for export. The exchange rate, which is pegged to the euro within a narrow band, does not allow a stronger depreciation of the nominal rate in the event of external shocks.

Non-tariff barriers to trade, which still exist in some cases, impose a burden on the export industry. These include the inadequate adoption of EU standards. Nonetheless, the country is making efforts to integrate its economy into international production networks. Intra-industry trade primarily takes place in the medium-tech sector. Overall, Macedonia imports more intermediate goods than it exports. These goods are not only required for maintaining machinery and vehicles. A certain proportion is also used for manufacturing final goods for export. The overall export performance of Macedonia's manufacturing sector is satisfactory compared with other Western Balkan countries. Germany is by far Macedonia's most important export market. Other important export markets include Bulgaria, Kosovo, Italy and Serbia. The transport industry plays an important role in Macedonia's tradable services sector. Its tourism industry is comparatively underdeveloped and currently attracts mainly regional guests. Overall, net services exports hardly contribute to improving Macedonia's current account.

Surveys on the quality of public institutions consistently rank Macedonia first among the Western Balkan countries – a region that, as a whole, is not performing particularly well compared with the new EU Member States from Central Europe. Protection of property rights is comparatively high. The independence of the judiciary is likely to have improved recently. In addition, Macedonia's public management and regulatory quality have improved significantly in recent years. To a certain extent, this

can also be attributed to the country joining the EU integration process. Macedonia obtained EU candidate status as early as 2005. However, due to the naming dispute with Greece, accession negotiations have not been opened. A dialogue under the auspices of the United Nations has been ongoing for 19 years without producing any results. Meanwhile, the integration process seems to have reached a dead end, and the Commission has observed setbacks recently, especially with regard to the freedom of the media.

A motorway runs along most of the main transit route between the Serbian border, the capital Skopje and the Greek border. An electric railway line along the same route connects the country with the port of Thessaloniki. The country's supply of electricity is guaranteed. Power outages are very rare.

Macedonia ranks average on a number of education and innovation indicators compared with other Western Balkan countries. There are only few researchers and technicians in the country. Moreover, the share of adolescents enrolled in technical and vocational higher secondary training is below average by regional comparison. Macedonia's gross domestic spending on research and development is low. The country's universities have a modest reputation.

The unemployment rate of 29%, which is quite high even for the Western Balkans, reveals the poor absorptive capacity of the labour market. This is also reflected by the high rate of migration, the large number of self-employed individuals (an indicator of the shadow economy) and the fact that one-sixth of Macedonia's population is still employed in subsistence farming. An over-regulated labour market or excessive wages are probably not to blame. Macedonian labour law provides for very flexible hiring and firing practices, and the average gross wage of employees is about EUR 500. The industrial companies in Macedonia seem to have rather poor cooperative relations between employees and employers, and wage setting in the individual companies is relatively uncoordinated.

Like in the other Western Balkan countries, the few banks in the country are largely foreign-owned. The number of automatic cash dispensers is below average and the lending volume is low. Although lending has dropped in recent years like in most Western Balkan countries, credit growth remained positive during this period despite high interest rates in real terms. On top of this, only about 10% of the loans are non-performing. This is the lowest figure in the Western Balkans and thus corresponds to the figure in the new EU Member States from Central Europe. Obviously, however, even this figure presents an obstacle to more expansive credit financing by much needed private investors.

Assessment of Macedonia's policies to date

The overall political climate in Macedonia can be described as extremely confrontational. To date, the two main political camps, the nominal social democrats and the national conservatives, have taken turns being in power. The largest party of the country's substantial Albanian minority helps to secure majorities. Ideologically, the main bone of contention between the two political camps concerns the interpretation of the historic role of the League of Communists of Macedonia (predecessor of the social democrats). In fiscal matters, the social democrats stand for austerity, while the national conservatives led by the current Prime Minister Nikola Gruevski stand for expansionary policies. Instead of pursuing a path of dialogue and joint efforts, a revanchist attitude prevails. The common goal of joining the EU,

however, is largely undisputed. Thus, the EU integration process is seen as crucial for Macedonia's democratic development towards a functioning state governed by the rule of law.

The Macedonian currency is pegged to the euro within a narrow band, with the exchange rate target leaving the central bank with limited scope for monetary and exchange rate policy action. While the share of foreign currency loans stands at over 50%, it is still lower than in all the other Western Balkan countries. At almost 70%, Macedonia's gross external debt is comparatively high.

Macedonia's recent fiscal measures have been characterised by an overall drop in revenues from direct and indirect taxes and an increase in social spending as well as public spending on fixed asset investments. Declining public revenues were partly attributable to the reduction of the top income tax rate and the employees' social contributions. This has likely led to a fiscal devaluation in recent years with a positive effect on the country's competitiveness. To date, Macedonia has hardly implemented any targeted activation measures aimed at modernising the country's labour market policy. The share of public spending on active labour market policies is very low.

Macedonia is pursuing structural policies that involve the strategic promotion of investment and place a regional focus on expanding technological and industrial development zones. Ten-year tax exemptions as well as exemptions from VAT and customs duties for goods, raw materials and machinery have been introduced. In addition, government subsidies for construction costs are granted depending on the investment amount and the number of jobs created and amounting to up to EUR 500,000. The government is also trying to promote exports, although the funds for this largely come from international sources.

Strategic export sectors include the information and communication technology sector, the automotive supply industry and the textile sector. In recent years, government subsidies have increased considerably. At approximately 5% of GDP, they are the highest in the region. Foreign direct investment in the manufacturing sector as a share of GDP has also increased substantially in recent years. It is the highest by regional comparison and even higher than in the new EU Member States from Central Europe. Macedonia's regulatory policy is essentially determined by the EU integration process. In this respect, the European Union is an anchor of institutional stability.

Like other Western Balkan countries, Macedonia is actively seeking international cooperation in the area of transport and energy infrastructure. In this context, road construction projects aimed at improving the north-south link between Serbia and Greece and building a west-east link between Albania and Bulgaria were given priority. Moreover, there are specific plans to build a long-distance electricity transmission line to Albania.

Swot analysis - Macedonia

Internal strengths few and far between

Macedonia's few strengths include a decade-long tradition of lake tourism as well as cultural tourism centred around the Byzantine monasteries and churches close to Lake Ohrid. Another strength involves the country's equally long tradition of being able to survive in situations of political transition.

Internal weaknesses abound

The list of Macedonia's internal weaknesses is long. The business- and export-oriented services sector is inadequately developed. The quality of public institutions and public infrastructure could be improved. The absorptive capacity of Macedonia's labour market is limited. The quality of human capital is poor, in particular with regard to technical and vocational higher secondary education. Cooperation between social partners could also be strengthened. Also, the country lacks entrepreneurial traditions other than in retail trade. The macroeconomic framework could be improved as well.

External opportunities exist

Macedonia has a picturesque lake scenery that provides favourable conditions for tourism. Its central location in Southeast Europe is another advantage, facilitating the country's integration into international transport networks. The chemical industry, in particular, is beginning to be integrated into international production networks. The country was given the opportunity to participate in the EU integration process and has been an official candidate member of the European Union since 2005, thus reducing the risks for foreign investors wanting to invest in Macedonian production capacities.

External threats also exist

Macedonia's landlocked position is a geographical disadvantage. Moreover, the country has been largely segregated along ethnic lines especially since the armed conflict with the large Albanian minority in 2001 and the ensuing Ohrid Framework Agreement, which has not been fully implemented to date. In addition, the grotesque dispute with Greece over the country's name poses a threat to its European integration. Macedonia's lack of internal and external sovereignty makes the country's political arrangements seem provisional. Furthermore, Macedonia is surrounded by politically unstable states. These include, in particular, Kosovo, which still has not gained full sovereignty.

Cost-benefit analysis of efficient measures for Macedonia

Low-cost, high-benefit measures – imperative

Efficient measures include the reform of the land registry and the private bankruptcy law. Their implementation, however, would take some time and the benefits would only materialise in the distant future. Promoting circular migration by cutting red tape would be beneficial as well. Improving the absorption capacity of EU funds by implementing relevant administrative reforms seems to be a particularly important aspect. Public administrations must have the ability to identify and co-finance beneficial projects.

Short-term efficient measures include, for example, widening the exchange rate band in order to fend off the adverse effects of capital inflows on the real exchange rate. Measures to control capital inflows including, for example, selected minimum reserves and tax rates for capital inflows could achieve a similar effect.

Another important measure that could be implemented quickly by creating corresponding incentives for the banking sector is the reduction of the level of non-performing loans, which, although not high, is not insignificant either. In principal, a depreciation of the nominal exchange rate within the band would also be possible. As this would hardly be effective with regard to the real exchange rate, however, given the increasing euroisation in Macedonia and its external debt, fiscal devaluation policies could be imposed as an alternative even at short notice. However, political opposition to a tax reform that could have regressive effects on income distribution might be quite strong.

Interest groups might also try to prevent a reduction of non-tariff barriers to trade, especially since some of these barriers are designed to protect vested interests. However, reducing these barriers, in particular for the export sector, would be an efficient way to increase Macedonia's competitiveness over the short term. In Macedonia, these barriers include poorly developed information and notice mechanisms, the inadequate adoption of technical EU rules and of European sanitary and phytosanitary measures as well as administrative burdens associated with customs documents and customs automation.

High-cost, high-benefit measures – advisable

Costly measures that would, however, yield high benefits over the long term include the final resolution of the country's naming issue (as well as full implementation of the Ohrid Framework Agreement), even against the strong opposition of policy makers, in order to finally begin EU accession negotiations as well as public investments in transport infrastructure, which is a little more realistic and less controversial. These are likely to reduce domestic production costs and to encourage industrialisation in many sectors. In this context, it is not only necessary to improve the local transport infrastructure but also to ensure the connectivity of transport networks across regions. Macedonia has already made some investments in its motorways but it should now step up its efforts. In addition, it should also channel larger investments into the railroad infrastructure in order to facilitate the emergence of larger companies relying on this infrastructure. These investments would stimulate growth over a short period of time, which could lead to long-term self-financing using the resulting additional tax revenues. The same applies to the energy infrastructure.

The introduction of a dual system of education would be just as costly and it would take a long time for the benefits to materialise. The combination of in-company training and teaching theoretical knowledge in vocational schools produces skilled workers for the further transition from a low- to a medium-tech industrial base, which is already taking place in Macedonia as well, albeit too slowly. This process should be accompanied by an even more active industrial policy and promotion of exports for the manufacturing sector and the export-oriented services sector. Implementing a wage policy based on cooperation between social partners aimed at achieving full employment while maintaining a low inflation rate would be another measure with beneficial effects over the long term. A more complex inter-regional structural policy would certainly be desirable but seems difficult to implement at the political level given the large number of different interests. Incentives from and coordination by the EU could probably help overcome these obstacles.

A costly measure that could be implemented relatively quickly is to increase support for foreign direct investment (FDI), for example through additional solutions for business taxation aimed at attracting companies or tailored infrastructure investments, which would lead to a rapid transfer of technology driven by said FDI. Introducing an active labour market policy would be costly but could be implemented immediately, including through targeted measures to promote labour mobility and to increase transparency of the labour market or through hiring incentives, especially for adolescents.

Low-cost, low-benefit measures – advisable where possible

The group of policy recommendations which are low-cost but will yield only limited benefits in macroeconomic terms includes long-term measures such as a professional country branding or short-term measures like hosting regional economic forums or exchanging good practices in different areas that are important for promoting competitiveness. These measures however would take away already limited public resources from more promising projects.

High-cost, low-benefit measures – to be avoided

High-cost measures whose benefits cannot be foreseen or will likely be very low in the current environment are to be avoided. Thus, for the time being, a country like Macedonia, where no major research institutions or larger companies implementing those research results exist, should refrain from costly public investments in research and development. These include support for start-up companies aimed at financing innovations or the establishment of support funds for outstanding research.

Top five measures providing the maximum benefits

1. Resolution of the country's naming issue (expensive, long-term, politically charged)
2. Investments in a dual system of vocational training (expensive, long-term)
3. Improve absorption capacity of EU funds (inexpensive, long-term)
4. Fiscal devaluation (inexpensive, short-term, politically charged)
5. Widening of the exchange rate band (inexpensive, short-term)

Appendix 1

Appendix Table 8.5.1 / Selected indicators of competitiveness – Macedonia, 2013

	MK	WB-7	NMS-5	DE
Current account balance, in % of GDP	-1,9	-6,1	1,7	7,5
Exports of goods, in % of GDP	41,7	22,0	67,9	42,7
Exports of machinery and vehicles, in % of GDP (SITC 7)	5,6	3,9	35,9	18,8
Exports of chemical products, in % of GDP (SITC 5)	8,2	2,3	6,8	6,3
Property rights, '7' = clearly defined and well protected by law	4,5	3,7	4,0	5,8
Judiciary independence, '7' = entirely independent	3,2	3,1	3,5	6,0
Motorways in km per 100 km ² land area	1,0	0,8	1,5	3,6
Power outages per firm per month	1,2	3,2	0,4	.
Researchers per 1 million inhabitants, in full-time equivalents	461	728	2789	3950
Enrolment rate in upper secondary technical and vocational education, in %	45,5	50,3	54,0	51,4
Unemployment rate in %, LFS	29,0	23,1	10,1	5,3
Employees in % of total employed	19,1	19,8	14,7	10,6
Automated teller machines per 100,000 adults	49,9	54,6	62,9	118,8
Non-performing loans in % of total loans	11,3	17,2	11,9	2,7

Note: Data refer to the year 2013 (in most cases), or to the latest available year. WB-7 = average of the seven West Balkan countries; NMS-5 = average of the five Central European new Member States.

Source: wiiw Database, Eurostat, IMF, WEF, UNESCO, WDI, national statistics.

Appendix 2

Appendix Figure 8.5.1 / SWOT analysis matrix – Macedonia

		Internal analysis	
		Strengths	Weaknesses
External analysis	Opportunities	<p>#long tradition in #lake tourism and #cultural tourism and first steps towards integration in international #transport networks and #production networks</p>	<p>#EU integration process and #production networks may help to strengthen #industry sector, #services sector, #institutions, #labour markets, #human capital, #social partners, #entrepreneurship and #macroeconomic framework</p>
	Threats	<p>#survivability in a regional political #provisional arrangement und #landlockedness</p>	<p>Credible ex ante commitment in a regional political #provisional arrangement regarding #institutional, #economic and #infrastructure issues is possible</p>

Note: The SWOT analysis focuses on the target state of a competitive economy; it describes states of things and not concrete measures.

Appendix Figure 8.5.2 / Cost-benefit matrix – Macedonia

Costs			Benefits
	<p>#start-up support for innovation, #support fund for outstanding research</p>	<p><i>Final #resolution of the political status, investment in #transport infrastructure, #FDI promotion, #incomes policy, investment in #dual education system, active #export promotion, #industrial policy, <i>interregional #structural policy</i>, active #labour market policy</i></p>	
	<p>#country branding, regional #economic fora, #good practice exchange</p>	<p>absorption of #EU funds, #NPL resolution, #fiscal devaluation, #widening the exchange rate band, #management of capital inflows, <i>reduction of #non-tariff trade barriers</i>, #cadastre reform, #private bankruptcy, support of #circular migration</p>	

Note: Measures ranked according to benefit. Measures that can be realised in the short term are shown in bold type. Measures likely to encounter social or political resistance are shown in italics.

8.6. ANALYSIS BY COUNTRY - MONTENEGRO

Assessment of Montenegro's competitiveness

Montenegro is one of the poorer countries in Europe. Its income level is only a little more than one-third that of Germany, measured as gross domestic product (GDP) per capita in purchasing power parities (PPP). With a population of 620,000, Montenegro is also one of the smallest countries in Europe. Nonetheless, the country is home to a wide range of ethnic groups. Only about 45% are Montenegrins, 29% identify as Serbs and the remainder as Bosniaks, Albanians, Roma or Croats. Supported by the parties of the smaller minorities, the established party around Prime Minister Milo Djukanovic has ruled the country since the first elections in 1991 and also after the country gained independence from Serbia in 2006. Thus, for the time being, Montenegro's political system is stable. However, critics also point to corruption at the highest political levels.

The economy's lack of competitiveness is reflected by a persistent double-digit current account deficit as a share of GDP. Structurally, the country is not yet able to finance the import of goods and services by its own exports, thus running the risk of accumulating external debt that will be unsustainable over the long term. Added to this, in contrast to the other Western Balkan countries, goods exports as a share of GDP have dropped by nearly 50% since 2005. At 12%, they are well below the average of the Western Balkan countries and thus even further below the recent rates of the new EU Member States from Central Europe of almost 70%. The collapse of exports is mainly a result of the bankruptcy of Montenegro's largest exporter, the Aluminium Plant Podgorica.

Other goods exported by Montenegro are low-tech and mainly consist of electricity, metals and food products. Montenegro hardly exports higher-quality goods such as machinery, vehicles or chemical products. Moreover, due to the sharp increase in unit labour costs, Montenegro has seen a further drop in the already low market share for goods exports into the European Union suggesting, inter alia, an increasingly overvalued real exchange rate. Since Montenegro has unilaterally adopted the euro as its official currency, a nominal depreciation to respond to negative developments at home and abroad is not an option. Non-tariff barriers to trade also impose a significant burden on the export industry. These include the inadequate adoption of EU standards.

Another deficit is the lack of integration into international production networks. Intra-industry trade is extremely weak and primarily takes place in the low-tech sector. Overall, Montenegro imports more intermediate goods than it exports. These goods are mainly required for maintaining machinery and vehicles. A smaller part is used for manufacturing final goods for export. The overall export performance of Montenegro's manufacturing sector is weak. Key export markets are the other countries in the region: Serbia, Croatia, Slovenia, Kosovo and Bosnia and Herzegovina.

Tourism plays an extremely important role in Montenegro's tradable services sector. The majority of tourists come from Russia, Serbia, Bosnia and Herzegovina and Ukraine. In recent years, many of them have purchased real estate property in Montenegro. Consequently, net services exports contribute significantly to improving Montenegro's current account balance.

Surveys on the quality of public institutions consistently rank Montenegro higher than other Western Balkan countries – a region that, as a whole, is not performing well compared to the new EU Member States from Central Europe. Protection of property rights is comparatively high and the independence of the judiciary is likely to have improved as well over the recent years. To a certain extent, this can be attributed to Montenegro's active participation in the EU integration process although the European Commission still has some serious concerns about the judiciary. Montenegro was granted candidate status in 2010 and accession negotiations began in 2012. 16 out of 35 negotiating chapters have now been opened for negotiation, of which two have already been provisionally closed.

Montenegro is currently the only country of the Western Balkans without motorways. The railroad network is poorly developed as well and requires considerable modernisation, which is already underway to some extent. The government of Montenegro has recently commissioned a Chinese construction company to build the first motorway from the port in the city of Bar to the border with Serbia. The project is being financed through a Chinese investment bank. Montenegro's power generation capabilities (in particular in the area of hydroelectric power) still have the capacity to expand. Despite an outdated electric grid, power outages are rare.

Montenegro only ranks average on a number of education and innovation indicators in a region that is not known for its high educational standards. This is illustrated, for example, by average ranks in terms of expenditures on research and development and the number of researchers as a share of the population. However, the PISA test results of Montenegrin students were comparatively low. The high share of adolescents enrolled in technical apprenticeships or higher vocational secondary education will contribute to an expansion of local production capacities over the long term.

At nearly 20%, the unemployment rate is average for the region. In addition, the poor capacity of the labour market to absorb job-seekers is reflected by a high rate of migration. An over-regulated labour market is not to blame as the labour law is extremely flexible when it comes to hiring and termination regulations. The average gross salary is EUR 730 and thus relatively high for the Western Balkans. Moreover, productivity gains have not kept up with wage increases since Montenegro's independence in 2006. The few industrial companies in Montenegro seem to have rather poor cooperative relations between employees and employers, and wage-setting in the individual companies is relatively uncoordinated.

At about 90%, equity market capitalisation is the highest in the region and even exceeds the average rate for the European monetary union. In contrast, lending suffers from the low level of financial intermediation just like in the other Western Balkan countries. About 90% of the banks in Montenegro are foreign-owned and the number of automatic cash dispensers is quite high. Yet, like in most Western Balkan countries, lending has dropped dramatically in recent years and interest rates in real terms are very high. On the supply side, the high share of non-performing loans in total receivables of banks (more than one-sixth) presents a major obstacle to expansive credit financing by much needed private investors. Recently, the share of non-performing loans in the corporate sector amounted to more than 30%.

Assessment of Montenegro's policies to date

The political climate in Montenegro can be described as 'extremely stable'. Despite regular elections, the ruling elite remains in power. A major reason for this might be the insistence on following an independent Euro-Atlantic path separate from Serbia. The most important opposition parties mainly consist of members from the rather large Serbian minority. Today, the aim of joining the European Union is largely undisputed. Thus, the EU integration process is seen as crucial for Montenegro's democratic development towards a functioning state governed by the rule of law.

Just like Kosovo, Montenegro first unilaterally adopted the Deutsche Mark and then the euro as official currency. Naturally, foreign currency loans account for 100% of all loans. Thus, the central bank is left with extremely limited scope for monetary and exchange rate policy action, as credit supply solely depends on the inflows of foreign currency and the – currently reluctant – lending behaviour of banks.

The total amount of gross external debt is unknown. The central government's gross external debt of more than 40% of GDP is rather high. Montenegro's recent fiscal measures have been characterised by an overall crisis-related drop in revenues from direct and indirect taxes and an increase in social spending. Spending on fixed asset investments was cut back. Declining public revenues can also be attributed to the reduction of the top income tax rate and the employers' social contributions (at the same time, the VAT rate and the employees' social contributions have been raised). Since the nominal exchange rate cannot be depreciated, fiscal devaluation policies have been implemented. In the last few years, these have more than likely reduced the upward pressure and have not led to a further deterioration of Montenegro's competitiveness. In contrast to other countries in the region, Montenegro has in recent years implemented active labour market policies aimed at establishing a modern labour market. The share of public expenditures on active labour market policies in GDP is on par with that of Central Europe.

The strategic promotion of investments by the state is poorly developed. The already low government expenditures on subsidies have been further eliminated over the last few years. In contrast to other Western Balkan countries, the government of Montenegro provides virtually no investment incentives. The only true incentive is a flat tax rate of 9% on corporate profits. In addition, start-up as well as small and medium-sized companies can receive loans from the investment and development fund at more favourable terms than they could obtain on the market. While the share of foreign direct investment has increased in recent years, it is primarily made up of real estate purchases by Russian citizens. Montenegro's regulatory policy is essentially determined by the EU integration process. In this respect, the European Union is an anchor of institutional stability.

Like other Western Balkan countries, Montenegro is actively seeking international cooperation in the area of transport and energy infrastructure. In this context, projects aimed at improving the road link to Croatia, Bosnia and Herzegovina and Albania were given priority. Moreover, there are specific plans to build several long-distance electricity transmission lines and a gas pipeline.

Swot analysis - Montenegro

Internal strengths few and far between

Montenegro's strengths are rooted in past experience and long-standing practices. Thus, a few long-standing traditions can be identified which the country can fall back on in the future. The country has a decades-long history of tourism in the coastal and mountain areas, energy production and mining. Montenegro is practicing a cooperative approach to foreign policy which has a stabilising effect on the region.

Internal weaknesses abound

The list of Montenegro's internal weaknesses is very long. The country's main weakness is the barely existent and technologically backward industrial sector, where wages are obviously too high compared to the low productivity rates. Moreover, there is virtually no business- and export-oriented services sector (apart from tourism) or it is only inadequately developed. The quality of public institutions is relatively satisfactory but there is still room for improvement. The public infrastructure is of poor quality. The absorptive capacity of Montenegro's labour market is modest and the quality of human capital is only average. Cooperation between social partners could also be strengthened. Moreover, the country lacks entrepreneurial traditions other than in retail trade and the macroeconomic policy framework could be improved as well.

External opportunities definitely exist

Montenegro has access to the sea as well as breathtaking coastal and mountain sections providing favourable conditions for sea trade and tourism. Moreover, natural resources and water are in abundance. Aside from bauxite and lignite, oil and natural gas reserves are believed to exist off the Montenegrin coast. Large quantities of annual rainfall feed into a number of rivers with steep slopes so that the dependency on energy imports could be reduced. The country was given the opportunity to participate in the EU integration process and has already started accession negotiations as an official candidate member of the European Union, thus reducing the risks for foreign investors wanting to invest in Montenegrin production capacities.

External risks also exist

Not least due to its geographical location far away from international transit routes and Europe's industrial centres, Montenegro is excluded from international transport and production networks. In addition, Montenegro is surrounded by politically unstable states. These include in particular Bosnia and Herzegovina and Kosovo, which are still going through political transition and have not yet managed to gain full sovereignty.

Cost-benefit analysis of efficient measures for Montenegro

Low-cost, high-benefit measures – imperative

Efficient measures include the reform of the land registry and the private bankruptcy law. Their implementation, however, would take some time and the benefits would only materialise in the distant future. Promoting circular migration by cutting red tape would be beneficial as well. Improving the absorption capacity of EU funds by implementing relevant administrative reforms seems to be an extremely important aspect. Public administrations must have the ability to identify and co-finance beneficial projects.

Efficient and short-term measures include for example implementing defensive mechanisms against destabilising capital flows through measures to control capital inflows in the areas of minimum reserve policies and selective taxation of capital imports. Solving the problem of non-performing loans is another important measure that could be implemented quickly and that would bring back investors. Even more so than in other Western Balkan countries, the high level of non-performing loans requires coordinated action of the government, the central bank and foreign owners of banks and international institutions. The banking sector can no longer solve this problem on its own as Montenegrin banks have the lowest amount of capital reserves of all Western Balkan countries. To this end, the creation of a special purpose entity (bad bank) to reduce the high share of non-performing loans in the household sector should be taken into consideration. Other countries have achieved good results with such an instrument. However, this would require an assessment of the banks' claims according to international standards in order to reduce the potential fiscal risks to an acceptable level. Otherwise, political opposition must be expected given the potential rise in government debt.

As an alternative to the impossibility of depreciating the nominal exchange rate, Montenegro could continue imposing fiscal devaluation policies. However, political opposition to a tax reform that could have regressive effects on income distribution might be quite strong.

Policy makers might also try to prevent a reduction of non-tariff barriers to trade, especially since some of these barriers are designed to protect vested interests. Reducing these barriers, however, in particular for the export sector, is an efficient way to increase Montenegro's competitiveness in the relative short term. These non-tariff barriers to trade include poorly developed information and notice mechanisms, the inadequate adoption of technical EU rules and of European sanitary and phytosanitary measures as well as administrative burdens in the area of customs.

High-cost, high-benefit measures – advisable

Costly measures that would yield high benefits over the long term include public investments in transport infrastructure. These are likely to reduce domestic production costs and to encourage industrialisation in many sectors. In this context, it is not only necessary to improve the local transport infrastructure but also to ensure the connectivity of transport networks across regions. So far, Montenegro has not made any investments in its motorways but has recently initiated specific measures in this regard. The country should now channel its investments into the railroad infrastructure and port facilities in order to promote the emergence of new mediums-sized and larger companies relying on this infrastructure. Moreover, these investments would stimulate growth over a short period of time, which could lead to long-term self-

financing using the resulting additional tax revenues. The same is true for the expansion of hydropower generation and the energy infrastructure.

The introduction of a dual system of education would be just as costly and it would take a long time for the benefits to materialise. The combination of in-company training and teaching theoretical knowledge in vocational schools produces skilled workers for the gradual transition from a low- to a medium-tech industrial base, which is also taking place in Montenegro, albeit far too slowly. This process should be accompanied by an active industrial policy and a promotion of exports for the manufacturing sector and the export-oriented services sector. Specific measures in this context could include the establishment of modern industrial zones in the vicinity of ports.

Implementing a wage policy based on cooperation between social partners that is aimed at linking real wage growth to productivity gains would be another measure with beneficial effects over the long term. A more complex inter-regional structural policy would certainly be desirable but seems difficult to implement at the political level given the large number of different interests. Incentives from and coordination by the EU could probably help overcome these obstacles.

A costly measure that could be implemented relatively quickly is to increase support for foreign direct investment (FDI), for example through solutions for business taxation aimed at attracting companies or tailored infrastructure investments, which would lead to a rapid transfer of technology driven by said FDI. Intensified active labour market policies would be costly but could be implemented immediately, including through targeted measures to promote labour mobility and increase transparency of the labour market or through hiring incentives, especially for adolescents.

Low-cost, low-benefit measures – advisable where possible

The group of policy recommendations which are low-cost but would only yield limited benefits includes long-term measures such as a professional country branding or short-term measures like hosting regional economic forums or exchanging good practices in different areas that are important for promoting competitiveness. However, these measures would take away already limited public resources from more promising projects.

High-cost, low-benefit measures – to be avoided

High-cost measures whose benefits cannot be foreseen or will likely be very low in the current environment are to be avoided. Thus, for the time being, a country like Montenegro, where no major research institutions or larger companies implementing those research results exist (or no longer exist), should refrain from costly public investments in research and development. These include support for start-up companies aimed at financing innovations or the establishment of support funds for outstanding research.

Top five measures providing the maximum benefits

1. Investments in transport infrastructure (expensive, long-term)
2. Increase support for foreign direct investment (expensive, short-term)
3. Improve absorption capacity of EU funds (inexpensive, long-term)
4. Reduce share of non-performing loans (inexpensive, short-term)
5. Fiscal devaluation (inexpensive, short-term, politically charged)

Appendix 1

Appendix Table 8.6.1 / Selected indicators of competitiveness – Montenegro, 2013

	ME	WB-7	NMS-5	DE
Current account balance, in % of GDP	-14.6	-6.1	1.7	7.5
Exports of goods, in % of GDP	12.1	22.0	67.9	42.7
Exports of machinery and vehicles, in % of GDP (SITC 7)	0.8	3.9	35.9	18.8
Exports of chemical products, in % of GDP (SITC 5)	0.3	2.3	6.8	6.3
Property rights, '7' = clearly defined and well protected by law	4.2	3.7	4.0	5.8
Judiciary independence, '7' = entirely independent	3.6	3.1	3.5	6.0
Motorways in km per 100 km ² land area	0.0	0.8	1.5	3.6
Power outages per firm per month	2.5	3.2	0.4	.
Researchers per 1 million inhabitants, in full-time equivalents	763	728	2789	3950
Enrolment rate in upper secondary technical and vocational education, in %	60.0	50.3	54.0	51.4
Unemployment rate in %, LFS	19.7	23.1	10.1	5.3
Employees in % of total employed	13.7	19.8	14.7	10.6
Automated teller machines per 100,000 adults	69.6	54.6	62.9	118.8
Non-performing loans in % of total loans	17.4	17.2	11.9	2.7

Note: Data refer to the year 2013 (in most cases), or to the latest available year. WB-7 = average of the seven West Balkan countries; NMS-5 = average of the five Central European new Member States.

Source: wiiw Database, Eurostat, IMF, WEF, UNESCO, WDI, national statistics.

Appendix 2

Appendix Figure 8.6.1 / SWOT analysis matrix – Montenegro

		Internal analysis	
		Strengths	Weaknesses
External analysis	Opportunities	#long tradition in #coastal tourism and #mountain tourism as well as #energy generation and #mining	#EU integration process may help to strengthen #industry sector, #services sector, #institutions, #labour markets, #human capital, #social partners, #entrepreneurship and #macroeconomic framework
	Threats	#stabilising factor in a regional political #provisional arrangement and #transport- and #production-network-isolated home country	credible ex ante commitment in a regional political #provisional arrangement regarding #institutional, #economic and #infrastructure issues is possible

Note: The SWOT analysis focuses on the target state of a competitive economy; it describes states of things and not concrete measures.

Appendix Figure 8.6.2 / Cost-benefit matrix – Montenegro

Costs			Benefits
	#start-up support for innovation, #support fund for outstanding research	investment in #transport infrastructure, #FDI promotion , #incomes policy, investment in #dual education system, active #export promotion, #industrial policy, <i>interregional #structural policy</i> , active #labour market policy	
	#country branding, regional #economic fora , #good practice exchange	absorption of #EU funds, #NPL resolution , #bad bank , #fiscal devaluation , #management of capital inflows, reduction of #non-tariff trade barriers , #cadastre reform, #private bankruptcy, support for #circular migration	

Note: Measures ranked according to benefit. Measures that can be realised in the short term are shown in bold type. Measures likely to encounter social or political resistance are shown in italics.

8.7. ANALYSIS BY COUNTRY - SERBIA

Assessment of Serbia's competitiveness

Serbia is one of the poorer countries in Europe. Its income level is only about one-third that of Germany, measured as gross domestic product (GDP) per capita in purchasing power parities (PPP). However, there are great disparities between the regions. It has the highest industrial share in GDP among the Western Balkan countries. With a population of slightly more than seven million, Serbia is by far the most populous country in the Western Balkans. Approximately one-third of those living in the Western Balkans are from Serbia.

Like the other Western Balkan countries, Serbia, too, has a persistent current account deficit. Structurally, the country is not able to finance the import of goods and services by its own exports, so that the high levels of external debt, already amounting to 80% of GDP, run the risk of becoming an extreme burden on the economic policy in the medium term. However, its share of goods exports in GDP has increased by 70% since 2005. At more than 34%, it is above the average of the Western Balkan countries but yet well below the recent rates of the new EU Member States from Central Europe of almost 70%.

Technologically, goods exported by Serbia differ greatly and they consist mainly of machinery and vehicles, metals, food, textiles and shoes, and chemical products. In recent years, its main export products have included, inter alia, Fiat automobiles, electric cables, steel, copper and aluminium alloys, fruits and vegetables, corn, sugar, underwear, polyethylenes, and pharmaceuticals. Serbia therefore also exports some higher-quality products. By regional comparison, Serbia's share of machinery and vehicle exports in GDP is particularly high. Despite a slight increase in unit labour costs, Serbia was able to expand its market share for goods exports into the European Union slightly, suggesting, among other things, a higher quality of the range of goods available for export. The freely floating exchange rate (recently, it has become a rather 'managed float') allows a depreciation of the nominal rate in the event of external shocks. In the past, this has had a beneficial effect on export activities. Yet, some significant non-tariff barriers to trade impose a burden on the export industry. These include the inadequate adoption of EU standards.

Nonetheless, the country is making efforts to integrate its economy into international production networks. Intra-industry trade primarily takes place in the medium-tech sector. Overall, Serbia imports more intermediate goods than it exports. These goods are not only required for maintaining machinery and vehicles. A certain proportion is also used for manufacturing final goods for export. The overall export performance of its manufacturing sector is satisfactory compared with other Western Balkan countries. Its key export markets are, by a large margin, Italy and Germany. Other key export markets include Bosnia and Herzegovina, Russia, Montenegro and Romania. Numerous business-related services and the transport industry play an important role in Serbia's tradable services sector. Its tourism industry is comparatively underdeveloped and currently attracts mainly local and regional guests. All in all, net services exports hardly contribute to improving Serbia's current account balance.

Most surveys on the quality of public institutions rank Serbia behind the other Western Balkan countries – a region that, as a whole, is not performing particularly well compared to the new EU Member States

from Central Europe. In Serbia, protection of property rights is weak, the independence of the judiciary is limited and corruption is rampant. Although Serbia's public management and regulatory quality have improved in recent years, they are still at a low level. To a certain extent, this can be attributed to Serbia joining the EU integration process at relatively late stage. Serbia became a candidate member only in 2012, and accession negotiations started in early 2014.

A motorway runs along most of the main transit route between the Croatian and Hungarian border in the north, the capital Belgrade, and the Macedonian and Bulgarian border in the south. Some sections in the south, however, have not been completed yet. Off the main transit route in west-east direction, there is often no modern road infrastructure. Thanks to an electrified and partly double-track railway line along the main transit route, Serbia has a large railway network by regional comparison. The country's supply of electricity is guaranteed. Power outages are very rare. Serbia is a potential exporter of electricity.

Serbia ranks above average on a number of education and innovation indicators compared to other Western Balkan countries. There are researchers and engineers in Serbia, albeit not abundantly. The PISA test results of Serbian students were average. Gross domestic spending on research and development as well as public spending on education are comparatively high. Moreover, a large number of adolescents are enrolled in technical and vocational higher secondary training.

Serbia's unemployment rate of 22% is near the average of the Western Balkan countries. The poor absorptive capacity of the labour market is also reflected by the high rate of migration and the large number of self-employed individuals (an indicator of the shadow economy) and the fact that 20% of the population is still employed in the agricultural sector. Hiring and firing practices are extremely flexible. The average gross wage of an employee is only EUR 540. The industrial companies in Serbia seem to have confrontational relations between employees and employers, and wage setting in the individual companies is relatively uncoordinated.

Although the Serbian banking sector boasts the highest share of domestic bank owners, the majority of banks located in Serbia are still owned by foreign owners just like in other Western Balkan countries. The number of automatic cash dispensers is below average and the lending volume is low. Lending has dropped significantly in recent years and interest rates in real terms are very high. On top of this, 20% of the loans are non-performing. They present an obstacle to expansive credit financing by much needed private investors.

Assessment of Serbia's policies to date

Serbia's political scene is regularly influenced by individuals. Undisputedly, Prime Minister Aleksandar Vucic, member of the national conservative Serbian Progressive Party, is currently the country's leading power figure. He gained popularity with his large-scale 'anti-corruption campaign' in the course of which potential political opponents, too, were arrested. Promising to tackle bureaucracy and tidy up the nationalised sector, he won a landslide victory in the last elections. So far, however, only a few actions have followed. At the same time, he is trying to perform a balancing act in foreign policy. While the traditional Serbian-Russian friendship continues to be fostered, every effort is made to advance the EU accession process. This includes a cooperative position on Kosovo and Bosnia and Herzegovina. Although the EU is not held in particularly high regard in Serbia, the aim of joining the EU is largely

undisputed. Thus, the EU integration process is seen as crucial for Serbia's democratic development towards a functioning state governed by the rule of law.

The essentially free exchange rate acts as a buffer against external shocks like the one that occurred in 2009. Serbia's gross external debt of more than 80% of GDP is comparatively high. Its economy is highly euroised. The share of foreign currency loans in the banking system's outstanding claims amounts to over 70%. This leaves the central bank with little leeway for monetary policy measures. However, such measures are regularly taken.

Serbia's recent fiscal measures have been characterised by an overall crisis-related drop in revenues from direct and indirect taxes and an increase in social spending. Public spending on fixed asset investments was cut back. To date, Serbia has hardly implemented any targeted activation measures aimed at modernising the country's labour market policy. The share of public spending on active labour market policies is very low.

Serbia is pursuing structural policies that involve the strategic promotion of investments. The Serbia Investment and Export Promotion Agency (SIEPA) provides grants to domestic and foreign companies for investment projects in the manufacturing and tradable services sector as well as in tourism. In principle, the level of support depends on the eligible investment costs or the gross wage costs for newly created jobs and amounts to between 50% for costs up to EUR 50 million and 17% for costs up to EUR 100 million. Subsidies are also available to export-oriented companies. Also, incentives are offered to companies settling in one of the 13 free economic zones. In particular, these may include exemptions from VAT and customs duties for certain materials or machines that are used in the production process. Apart from SIEPA, there are other institutions in Serbia which also provide incentives to promote investments and employment. For example, measures taken by the National Employment Service include the exemption from social security contributions for certain groups of workers (e.g. people under the age of 30 or older than 45 years) or subsidies for newly created jobs. The National Bank of Serbia administers a fund that provides subsidised loans to small and medium-sized companies. In recent years, state subsidies have stagnated at a high level. At approximately 3% of GDP, they are the second highest in the region. By regional comparison, FDI inflows in the manufacturing sector as a share of GDP have been relatively high in recent years as well. Notably, the highly subsidised Fiat automotive construction plant in central Serbia has contributed to this. However, a substantial proportion of the subsidies is used to support loss-making companies that are still predominantly state-owned. Serbia's regulatory policy is essentially determined by the EU integration process. In this respect, the European Union is an anchor of institutional stability.

Like other Western Balkan countries, Serbia is actively seeking international cooperation in the area of transport and energy infrastructure. In this context, road construction projects aimed at improving the north-south link between Hungary in the north and Montenegro, Macedonia and Bulgaria in the south were given priority. Moreover, there are specific plans for a high-speed railway connection between Belgrade and Budapest under Chinese patronage.

Swot analysis - Serbia

Internal strengths exist to some extent

Serbia's strengths include a century-long history of agriculture, forestry, energy production and mining. Especially the northern part of Serbia has always been one of the most fertile agricultural areas in Europe. The history of transit traffic along the Danube by land and by sea is at least as long. Another strength involves the largely stabilising effect of Serbia's more recent foreign policy with respect to the region.

Internal weaknesses abound

The list of Serbia's internal weaknesses is long. Quantitatively and technologically, there is room for improvement in the export-oriented industrial sector. The business- and export-oriented services sector is inadequately developed. Public institutions are of poor quality. The quality of public infrastructure needs improvement, too. The absorptive capacity of Serbia's labour market is limited. The quality of human capital is rather low. Cooperation between social partners is inadequate. Also, the country lacks entrepreneurial traditions other than in retail trade. The macroeconomic policy framework could be improved as well.

External opportunities exist

Serbia has been endowed generously by nature with agricultural areas and forests. Serbia's central location in Southeast Europe along the Danube river is another advantage, facilitating the country's integration into international transport networks. The mechanical engineering and automotive construction industry, in particular, are beginning to be integrated into international production networks. The country was given the opportunity to participate in the EU integration process and has been an official candidate member of the European Union since 2012, thus reducing the risks for foreign investors wanting to invest in Serbian production capacities.

External threats also exist

A geographic disadvantage is that Serbia is a landlocked country. In addition, Serbia is surrounded by politically unstable states. These include in particular Bosnia and Herzegovina and Kosovo, which still have not gained full sovereignty. Serbia, which is burdened by the armed conflicts of the past, has now taken on a new constructive role and can make an important contribution to resolving the sovereignty issue.

Cost-benefit analysis of efficient measures for Serbia

Low-cost, high-benefit measures – imperative

Efficient measures include the reform of the land registry and the private bankruptcy law. Their implementation, however, would take some time and the benefits would only materialise in the distant future. Promoting circular migration by cutting red tape would be beneficial as well. Improving the absorption capacity of EU funds by implementing relevant administrative reforms seems to be a

particularly important aspect. Public administrations must have the ability to identify and co-finance beneficial projects.

Short-term efficient measures include for example the adoption of an intermediate exchange rate system with a fluctuation band against the euro, which would offer more certainty for exporters and serve as shield against destabilising capital inflows at the same time. Measures to control capital inflows, such as minimum reserve policies and the taxation of selected capital inflows, could have a similar effect. Since the banking sector is equipped with sufficient reserves it should bear the primary responsibility for solving the issue of non-performing loans, which have achieved a high level.

As an alternative to a depreciation of the nominal exchange rate induced by monetary policy, which would hardly be effective given the increasing euroisation in Serbia and its external debt, fiscal devaluation policies could be imposed even at short notice. However, political opposition to a tax reform that could have regressive effects on income distribution might be quite strong.

Policy makers might also try to prevent a reduction of non-tariff barriers to trade, especially since some of these barriers are designed to protect vested interests. Reducing these barriers however, in particular for the export sector, is an efficient way to increase Serbia's competitiveness. In Serbia, these barriers include poorly developed information and notice mechanisms, the inadequate adoption of European sanitary and phytosanitary measures as well as administrative burdens associated with customs procedures.

High-cost, high-benefit measures – advisable

Costly measures that would yield high benefits over the long term include public investments in transport infrastructure. These are likely to reduce domestic production costs and to encourage industrialisation in many sectors. In this context, it is not only necessary to improve the local transport infrastructure but also to ensure the connectivity of transport networks across regions. Serbia has already invested heavily in its motorways but it should now step up its efforts and also channel larger investments into the railroad infrastructure. These investments would stimulate growth over a short period of time, which could lead to long-term self-financing using the resulting additional tax revenues. The same applies to the energy infrastructure.

The introduction of a dual system of education would be just as expensive and it would take a long time for the benefits to materialise. The combination of in-company training and teaching theoretical knowledge in vocational schools produces skilled workers for the further transition from a low- to a medium-tech industrial base, which is taking place in Serbia, albeit too slowly. This process should also be supported by an even more active industrial policy and promotion of exports for the manufacturing sector and the export-oriented services sector. Implementing a wage policy based on cooperation between social partners aimed at achieving full employment while maintaining a low inflation rate would be another measure with beneficial effects over the long term. A more complex inter-regional structural policy would certainly be desirable but seems difficult to implement at the political level given the large number of different interests. Incentives from and coordination by the EU could probably help overcome these obstacles.

A costly measure that could be implemented relatively quickly is to increase support for foreign direct investment (FDI), for example through additional solutions for business taxation aimed at attracting companies or tailored infrastructure investments, which would lead to a rapid transfer of technology driven by said FDI. Introducing an active labour market policy would be costly but could be implemented immediately, including through targeted measures to promote labour mobility and to increase transparency of the labour market or through hiring incentives, especially for adolescents.

Low-cost, low-benefit measures – advisable where possible

The group of policy recommendations which are low-cost but would only yield limited benefits includes long-term measures such as a professional country branding or short-term measures like hosting regional economic forums or exchanging good practices in different areas that are important for promoting competitiveness. These measures however would take away already limited public resources from more promising projects.

High-cost, low-benefit measures – to be avoided

High-cost measures whose benefits cannot be foreseen or will likely be very low in the current environment are to be avoided. Thus, for the time being, a country like Serbia, where only a few research institutions or larger companies implementing those research results exist, should refrain from costly public investments in research and development for now. These include support for start-up companies aimed at financing innovations or the establishment of support funds for outstanding research.

Top five measures providing the maximum benefits

1. Investments in transport infrastructure (expensive, long-term)
2. Investments in a dual system of vocational training (expensive, long-term)
3. Improve absorption capacity of EU funds (inexpensive, long-term)
4. Reduce share of non-performing loans (inexpensive, short-term)
5. Fiscal devaluation (inexpensive, short-term, politically charged)

Appendix 1

Appendix Table 8.7.1 / Selected indicators of competitiveness – Serbia, 2013

	RS	WB-7	NMS-5	DE
Current account balance, in % of GDP	-5.0	-6.1	1.7	7.5
Exports of goods, in % of GDP	34.3	22.0	67.9	42.7
Exports of machinery and vehicles, in % of GDP (SITC 7)	10.7	3.9	35.9	18.8
Exports of chemical products, in % of GDP (SITC 5)	2.9	2.3	6.8	6.3
Property rights, '7' = clearly defined and well protected by law	3.2	3.7	4.0	5.8
Judiciary independence, '7' = entirely independent	2.6	3.1	3.5	6.0
Motorways in km per 100 km ² land area	0.7	0.8	1.5	3.6
Power outages per firm per month	0.9	3.2	0.4	.
Researchers per 1 million inhabitants, in full-time equivalents	1221	728	2789	3950
Enrolment rate in upper secondary technical and vocational education, in %	65.5	50.3	54.0	51.4
Unemployment rate in %, LFS	22.1	23.1	10.1	5.3
Employees in % of total employed	22.6	19.8	14.7	10.6
Automated teller machines per 100,000 adults	46.0	54.6	62.9	118.8
Non-performing loans in % of total loans	19.9	17.2	11.9	2.7

Note: Data refer to the year 2013 (in most cases), or to the latest available year. WB-7 = average of the seven West Balkan countries; NMS-5 = average of the five Central European new Member States.

Source: wiiw Database, Eurostat, IMF, WEF, UNESCO, WDI, national statistics.

Appendix 2

Appendix Figure 8.7.1 / SWOT analysis matrix – Serbia

		Internal analysis	
		Strengths	Weaknesses
External analysis	Opportunities	<p>#long tradition in #agriculture, #forestry, #energy generation, #mining, #waterway transit and #road transit and first steps in integration in international #transport networks and #production networks</p>	<p>#EU integration process and transport networks and #production networks may help to strengthen #industry sector, #services sector, #institutions, #labour markets, #human capital, #social partners, #entrepreneurship and #macroeconomic framework</p>
	Threats	<p>#stabilising factor in a regional political #provisional arrangement; #landlockedness can be compensated by #long tradition in transit trade</p>	<p>credible ex ante commitment in a regional political #provisional arrangement regarding #institutional, #economic and #infrastructure issues is possible</p>

Note: The SWOT analysis focuses on the target state of a competitive economy; it describes states of things and not concrete measures.

Appendix Figure 8.7.2 / Cost-benefit matrix – Serbia

Costs			Benefits
	<p>#start-up support for innovation, #support fund for outstanding research</p>	<p>investment in #transport infrastructure, #FDI promotion, #incomes policy, investment in #dual education system, active #export promotion, #industrial policy, <i>interregional #structural policy</i>, active #labour market policy</p>	
	<p>#country branding, regional #economic fora, #good practice exchange</p>	<p>absorption of #EU funds, #NPL resolution, #fiscal devaluation, #crawling exchange rate band, #management of capital inflows, reduction of #non-tariff trade barriers, #cadastre reform, #private bankruptcy, support of #circular migration</p>	

Note: Measures ranked according to benefit. Measures that can be realised in the short term are shown in bold type. Measures likely to encounter social or political resistance are shown in italics.

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