

Holzner, Mario

Research Report

Policy Options for Competitiveness and Economic Development in the Western Balkans: the Case for Infrastructure Investment

Policy Notes and Reports, No. 16

Provided in Cooperation with:

The Vienna Institute for International Economic Studies (wiiw) - Wiener Institut für Internationale Wirtschaftsvergleiche (wiiw)

Suggested Citation: Holzner, Mario (2016) : Policy Options for Competitiveness and Economic Development in the Western Balkans: the Case for Infrastructure Investment, Policy Notes and Reports, No. 16, The Vienna Institute for International Economic Studies (wiiw), Vienna

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JUNE 2016

Policy Notes and Reports 16

Policy Options for Competitiveness and Economic Development in the Western Balkans: the Case for Infrastructure Investment

Mario Holzner



Policy Options for Competitiveness and Economic Development in the Western Balkans: the Case for Infrastructure Investment

MARIO HOLZNER

Mario Holzner is Deputy Director of the Vienna Institute for International Economic Studies (wiiw).

Executive Summary

- › The Western Balkans are a region with a substantial economic catch-up potential. Compared to other European economies these countries are either poor or very poor.
- › Structural underdevelopment and low competitiveness impede the catch-up process. Mass unemployment and a huge trade deficit indicate heavy internal and external imbalances.
- › Short-run policy measures should focus on fiscal devaluation and NPL resolution to foster cost competitiveness and private investment.
- › A 'Big Push' in infrastructure investment is imperative for long-term prosperity. An investment volume of EUR 7.7 billion as envisaged in the 'Berlin Process' has the potential for an additional GNP growth impulse of about 1% p.a. and a positive employment effect of up to 200,000 people in the region.

Keywords: Macroeconomic Policy, Investment, Infrastructure, Fiscal devaluation, Competitiveness, Western Balkans, Berlin Process

JEL classification: E27, E60, F21, H54, O24

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Policy Options for Competitiveness and Economic Development in the Western Balkans: the Case for Infrastructure Investment

INTRODUCTION

The Western Balkan states are among the poorest countries in Europe. Their societies expect security and prosperity to be achieved with the help of their integration into the European Union. However, their integration process is taking very long and has been cumbersome. In his inaugural speech at the European Parliament, **Jean-Claude Juncker**, the President of the European Commission, made it clear:

In the next five years, no new members will be joining us in the European Union. As things now stand, it is inconceivable that any of the candidate countries with whom we are now negotiating will be able to meet all the membership criteria down to every detail by 2019. However, the negotiations will be continued and other European nations and European countries need a credible and honest European perspective. This applies especially to the Western Balkans. This tragic European region needs a European perspective. Otherwise the old demons of the past will reawaken.

(Strasbourg, 15 July 2014)

A more supportive stance was taken by Germany with its intergovernmental cooperation initiative, the so-called 'Berlin Process'. A hundred years after the outbreak of the First World War, the heads of government, foreign ministers and economics ministers of the Western Balkans, as well as representatives of the European Commission, the next host Austria, and France, met in Berlin for the first Conference on the Western Balkans. There, German Chancellor **Angela Merkel** emphasised:

All states in the Western Balkans should have the opportunity to join the European Union if they fulfil the accession requirements.

(Berlin, 28 August 2014)

The goals of the **Berlin Process** were set as follows: (i) to support the Western Balkans on their path to European Union membership; (ii) to intensify regional cooperation; (iii) to strengthen good governance; and (iv) to increase prosperity via sustainable economic growth. The last point is expected to be achieved via improved market access, reinforced competitiveness, strengthened transport and energy infrastructure, better education especially in vocational training as well as a more efficient use of EU pre-accession funds. The 2014 Conference in Berlin was followed by the 2015 **Summit in Vienna**. Here the participants from the Western Balkans have agreed on a list of specific regional transport and energy priority projects to be constructed in the years to come.

Important infrastructure investments will be supported by funds from the EU's Instrument for Pre-Accession Assistance (IPA). However, the 2015-2020 **IPA II funds for co-financing** are rather modest and in the order of EUR 1 billion. By comparison, the EU Member State Romania has a similar

population size as the Western Balkans but has earmarked six times more EU co-funding for transport and energy infrastructure in the EU's current Multiannual Financial Framework for the period 2014-2020.

In the wider preparations of the Berlin Process, the Vienna Institute for International Economic Studies (wiiw) has conducted two studies. One on 'Improving Competitiveness in the Western Balkans' for the Federal Ministry of Finance of Germany and another one on 'Infrastructure Investment in the Western Balkans' for the Federal Ministry of Science, Research and Economy of Austria. The latter was even mentioned in the Final Declaration by the Chair of the Vienna Western Balkans Summit of 27 August 2015. The present note summarises the main conclusions and policy recommendations of both studies.

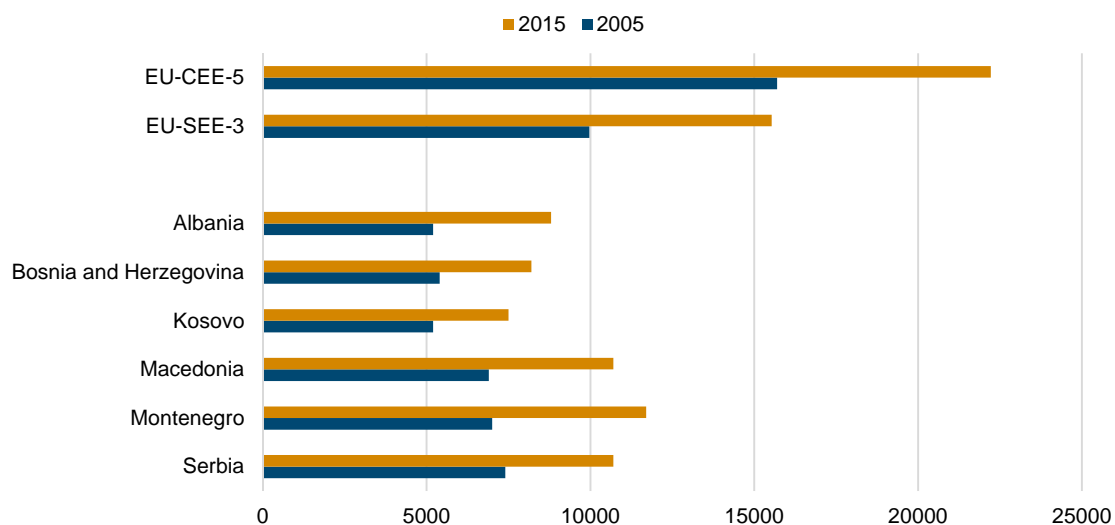
ANALYSIS OF THE ECONOMIC SITUATION

The Western Balkans is the poorest region in Europe. Their average 2015 GDP per capita level (Figure 1) is at less than 10,000 euro at Purchasing Power Parities (PPP). This is about 60% of the level of the three Southeast European EU Member States Bulgaria, Croatia and Romania (EU-SEE-3) and around 40% of the income level of the five Central and East European EU Member States the Czech Republic, Hungary, Poland, Slovakia and Slovenia (EU-CEE-5).

In terms of economic development, the region is split into a group of poor countries at 11,000 euro at PPP (Macedonia, Montenegro, Serbia) and very poor states at somewhat more than an average 8,000 euro at PPP (Albania, Bosnia and Herzegovina, Kosovo). When compared to a decade earlier, real income increased in the Western Balkans by an annual rate of about 5% to 6%, which however was not much more than the growth of its northern and eastern peers. Hence, there has been no substantial catching-up process measurable since 2005.

LOW OR VERY LOW LEVEL OF ECONOMIC DEVELOPMENT IN THE WESTERN BALKANS

Figure 1 / Gross domestic product per capita, in EUR (at PPP)

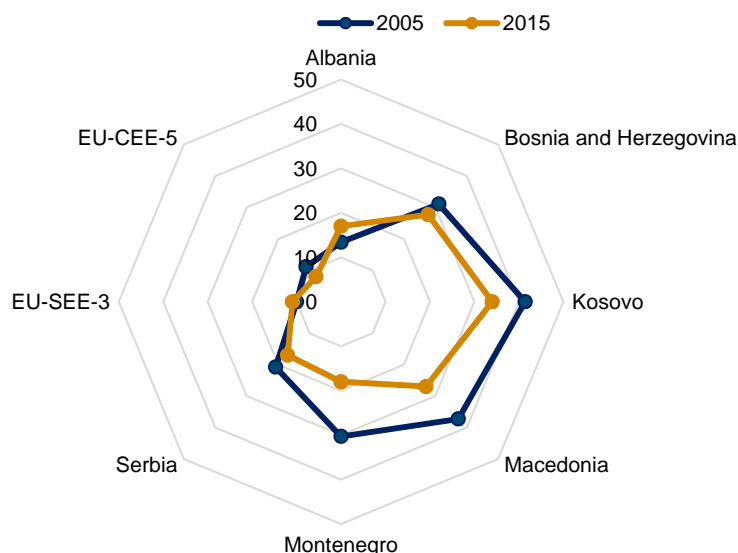


Note: PPP – Purchasing Power Parity; EU-CEE-5 includes the Czech Republic, Hungary, Poland, Slovakia and Slovenia; EU SEE-3 includes Bulgaria, Croatia and Romania.

Source: wiiw Annual Database.

STRUCTURAL MASS UNEMPLOYMENT

Figure 2 / Unemployment rate LFS, total in %, annual average



Note: LFS – Labour Force Survey. For Albania and Bosnia and Herzegovina: no data available for 2005; instead data for 2007 and 2006 were used.

Source: wiiw Annual Database.

Correspondingly there is also structural mass unemployment in all the Western Balkan economies (Figure 2). Unemployment rates are in the double-digit per cent range. This is in stark contrast to most of the peer group countries in the EU-SEE-3 and EU-CEE-5 which have unemployment rates in the one-digit per cent range. The worst-performing countries in the region are Bosnia and Herzegovina, Kosovo and Macedonia with about 30% of their labour force without employment. Youth unemployment is a particular problem. In Macedonia and Serbia it is at around 50% and in Kosovo and Bosnia and Herzegovina it is even at about 60%.

Hence the situation is still extremely worrisome despite a marked reduction of the unemployment rates by several percentage points compared to a decade earlier. However, this is not necessarily due to a strong increase in employment but to a large extent due to mass migration. For the population in the Western Balkans, the labour market is the whole world. Major destination countries for Western Balkan migrants are Germany, Switzerland, Italy and Austria but also the United States, Canada and Australia.

One of the reasons for the weak economic development in the Western Balkans is the lack of competitiveness. The trade balance is a good indicator for this (Figure 3). The countries of the region are not able to cover their imports by exports from their own production. This is very different from the northern and eastern peer group economies which register either balanced trade or even strong surpluses. Still, the situation in the region has improved quite a bit over the last decade. However, this was to a large extent due to massive import contraction in the wake of a deep slump in domestic demand related to the global financial crisis and not necessarily due to substantial export expansion.

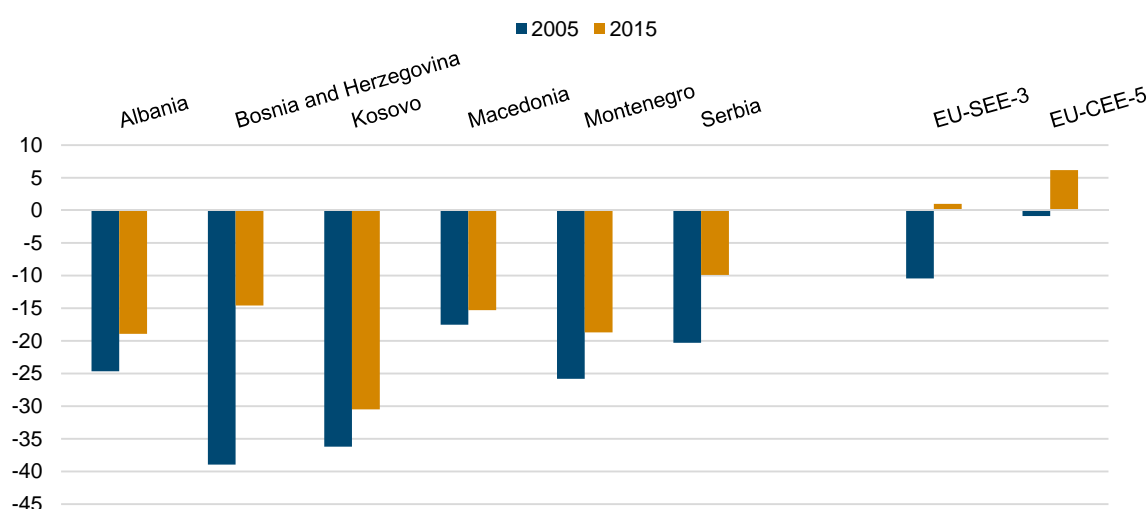
Nevertheless, it has to be noted that in recent years a number of ‘green shoots’ of export industries (especially in the automotive sector) have started to operate in the region and contribute to the improvement of the trade balance. Still, the situation is unsustainable as the economies are unduly dependent on foreign capital inflows which are mostly used for consumption and not investment. Periods of rising global interest rates cause at regular intervals sudden stop crises which hamper a smooth long-term development and full employment.

An important explanatory factor for this lack of competitiveness is the fact that the Western Balkans, with the exception of Macedonia, have only a small share of manufacturing exports in GDP. Especially Kosovo, Montenegro and Albania have hardly any manufacturing base. Countries of Europe’s manufacturing core such as, for instance, Hungary and Slovenia, have manufacturing export shares of more than 60% of GDP. This is related to high productivity, high wages and hence a high GDP per capita at PPP. Moreover, the Western Balkans are not integrated in the global industrial value added chains. This becomes particularly visible when looking at the countries’ export share of medium- to higher-tech industries from the group of mechanical engineering and car manufacturing in total goods exports (Figure 4).

Only Serbia and Macedonia are equally integrated into the global value chains of the machinery and automotive sector as for instance the EU-SEE-3 with an export share of about 20% to 30% in 2015 in this category. A decade earlier they had much lower levels of less than 10%, comparable to most of the other countries in the region. This is to a large extent due to foreign direct investments by British emission control catalyst producer Johnson Matthey near Skopje, Macedonia, and Italo-American car manufacturer Fiat Chrysler in Kragujevac, Serbia. However, even today’s higher shares are a far cry from the EU-CEE-5 which have half of their exports in the machinery and automotive sector.

HUGE TRADE DEFICIT INDICATES LACK OF COMPETITIVENESS

Figure 3 / Balance on goods and services, in % of GDP, BOP 6th edition

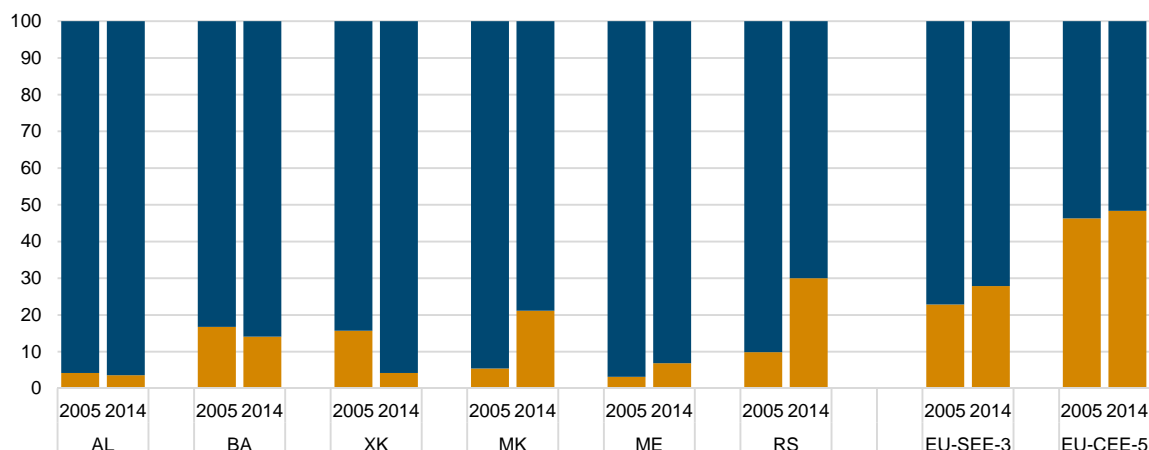


Note: GDP – Gross Domestic Product; BOP – Balance of Payments. Year 2015 data not available for Albania and Croatia – instead 2014 data were employed. Year 2005 data from the BOP 6th edition not available for Albania, Bosnia and Herzegovina, Bulgaria, Montenegro, Serbia and Slovakia – instead BOP 5th edition data were used.

Source: wiiw Annual Database.

WESTERN BALKANS NOT PART OF THE CENTRAL EUROPEAN MECHANICAL ENGINEERING AND AUTOMOTIVE CLUSTER

Figure 4 / Exports of SITC group 7, in % of total goods exports



Note: SITC – Standard International Trade Classification; SITC group 7 – Machinery and transport equipment.

Source: wiiw Annual Database.

SHORT-RUN MEASURES TO IMPROVE COMPETITIVENESS

What are the measures to attract more foreign as well as domestic investment? How can the export sector be supported and trade balanced? And what can be done in the short run without burdening ailing public finances too much? These were some of the questions raised in the wiiw study on 'Improving Competitiveness in the Western Balkans' for the Federal Ministry of Finance of Germany. In the following we present two short-run policy recommendations that try to react to the above questions.

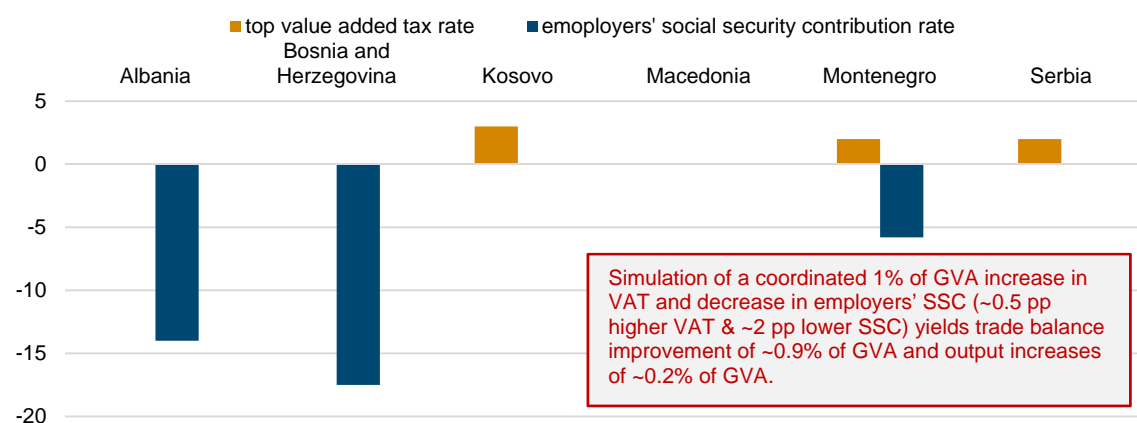
As most countries in the region have chosen a fixed peg to the euro or even adopted the euro unilaterally, the short-term option of a substantial nominal depreciation to improve competitiveness is not available in any country of the region. In addition, the high degree of euroisation of loans to private 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 have engaged – more or less deliberately – in fiscal depreciation over recent years (Figure 5). Most countries in the region increased for instance value added tax (VAT) rates while reducing employers' social security contributions (SSC). The former measure is a substitute for tariff increase and the latter for a production subsidy. Overall, the tax modifications of recent years may have helped to promote import substitution and exports.

We have simulated with the help of a partial equilibrium model a coordinated budget neutral 1% of gross value added (GVA) increase in VAT and a simultaneous decrease in employers' SSC. For the average Western Balkan country this is approximately equivalent to an about 0.5 pp higher statutory VAT rate and 2 pp lower statutory SSC rate. This very modest fiscal devaluation yields a trade balance improvement of some 0.9% of GVA and output increases of about 0.2% of GVA. Applying a factor of 10 to the tax rate changes would thus (at least in the short run) cause a substantial reduction in the trade balance deficit and a moderate expansion of production. However, in order to prevent political resistance

due to potentially strong regressive effects of these tax changes, a well-designed fiscal devaluation has to anticipate the distributional effects.

SHORT-RUN PRICE COMPETITIVENESS SUPPORT: FISCAL DEVALUATION

Figure 5 / Change in statutory VAT and social security rates, 2005-2016, in pp

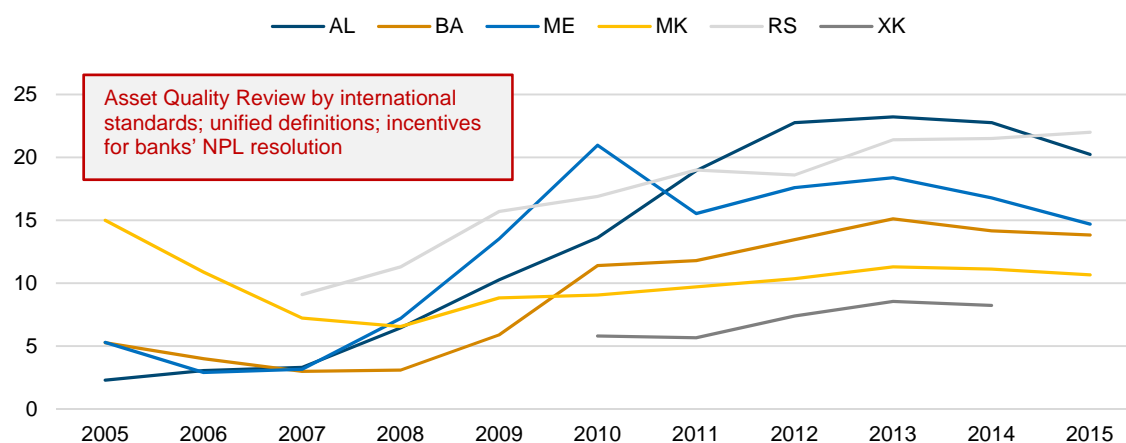


Note: VAT – Value Added Tax; GVA – Gross Value Added; SSC – Social Security Contribution.

Source: EC, UNMIK, FIPA, SIEPA, KPMG, PWC, Deloitte.

SHORT-RUN PRIVATE INVESTMENT SUPPORT: NPL RESOLUTION

Figure 6 / Bank non-performing loans to total gross loans, in %



Note: NPL – Non-Performing Loans; in most cases loans more than 90 days overdue. NPLs are negatively correlated with non-financial private loans growth.

Source: National Central Banks, The World Bank.

A widely considered major constraint on more domestic investment is the high share of non-performing loans (NPL) in the region (Figure 6). Even though NPL shares have stabilised in recent years, their levels are still very high in Serbia and Albania (above 20%) and high in Montenegro and Bosnia and Herzegovina (around 15%). Although at around 10%, also the NPL shares in Macedonia and Kosovo

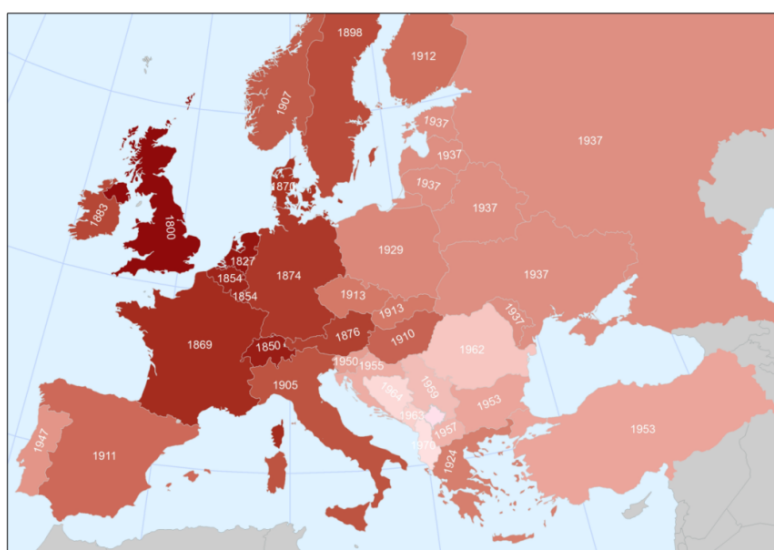
need to be reduced in order to free fresh credit capacities for firms willing to invest. Regulatory and supervisory authorities in the financial sector have so far been rather indulgent towards the banks, thus raising their bailout expectations. More resolute action to eliminate options for passive behaviour 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, employing also unified definitions. For some countries the establishment of a bad bank to deal with non-performing loans should be considered, following an effective AQR and independent stress tests. More generally the incentives for banks' NPL resolution have to be stepped up.

LONG-RUN MEASURES FOR ECONOMIC DEVELOPMENT

However, short-run measures will mostly fix only short-run problems. In this respect it is worth taking a closer look also at the very long run. The industrial revolution came very late to the Western Balkans. The United Kingdom was the first country in Europe that surpassed the benchmark of 2000 USD GDP per capita in 1800 (at prices of 1990, Figure 7). This level of income also reached the continent, albeit rather slowly, via the Netherlands (1827) and Belgium (1854). Germany surpassed the benchmark in 1874 and Austria in 1876. Most countries in the Western Balkan region reached this level only in the second half of the 20th century and Kosovo probably only in 2002, almost 200 years later than the motherland of the industrial revolution.

INDUSTRIAL REVOLUTION'S SLOW TRICKLE DOWN

Figure 7 / Year of surpassing 2000 USD in GDP per capita (1990 Int.\$ at PPP)



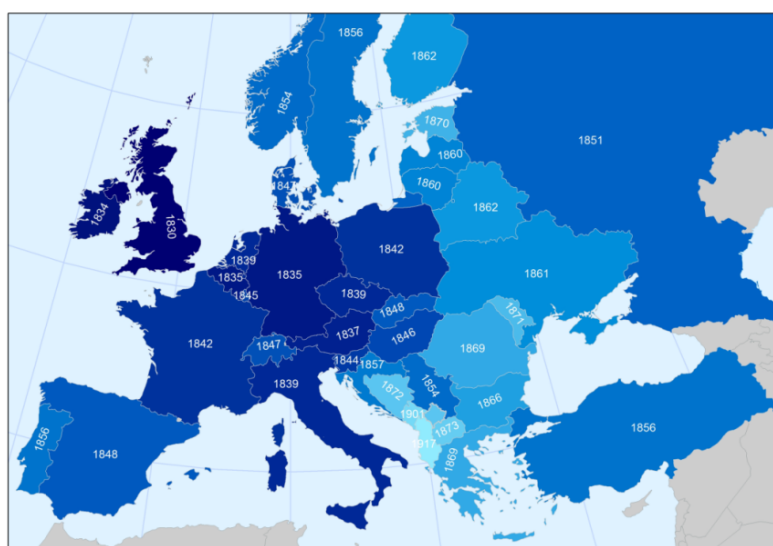
Note: Interpolation for Ireland; extrapolation for Slovenia; Kosovo 2002 estimate based on wiiw data; Czechoslovak observation for Czech and Slovak Republic; Belgian observation for Luxembourg, Soviet observation for Russia, Estonia, Latvia, Lithuania, Belarus, Ukraine and Moldova.

Source: The Maddison Project, wiiw, own estimates.

The development of basic infrastructure, such as rail, followed the geographic dispersion of the industrial revolution (Figure 8). The first rail line was built in the United Kingdom in 1830; on the continent, Belgium and Germany (1835) as well as Austria (1837) followed. The last European country to build a railway line was Albania in 1917. It is, of course, difficult to come up with a statistical proof of causality between economic development and the construction of railway lines. However, there are good reasons to assume that the construction of infrastructure creates economic expansion even in the short term. In the long term it is more likely to contribute to the industrialisation of large parts of the economy, because production costs decrease and access to markets improves considerably. This leads to a more efficient allocation of capital and labour.

LATE INTRODUCTION OF RAILWAY TIME IN THE WESTERN BALKANS

Figure 8 / Year of construction of first railway line



Note: Kosovo 1874.

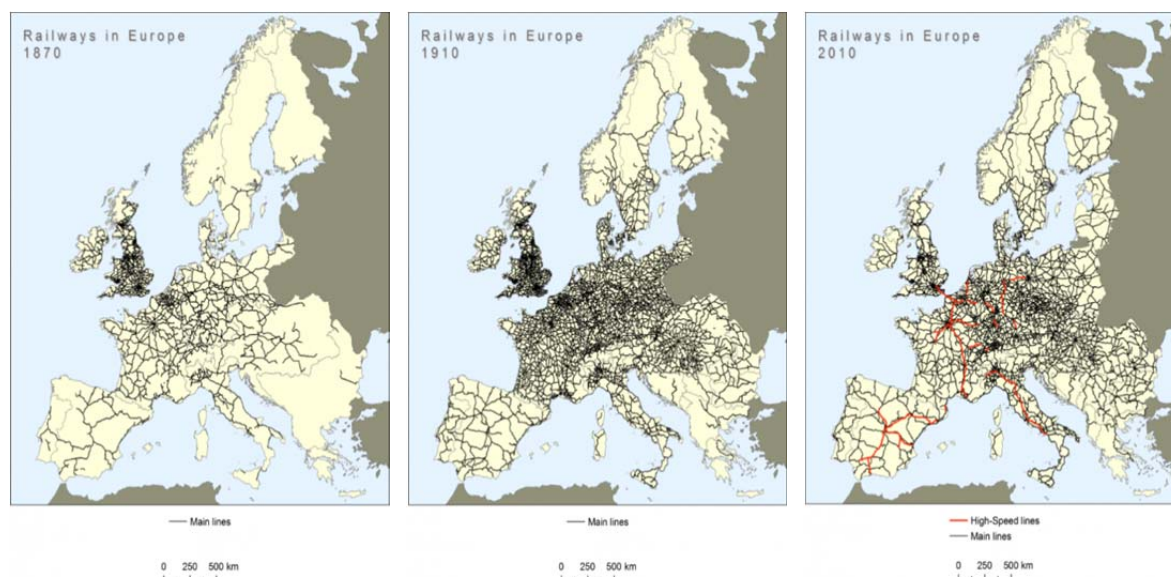
Source: Wikipedia, Wikimedia, FDV.

Not only did infrastructure start late, but there was also very weak development of networks. The density of the railway network, for example, has not increased much in large parts of the region during the last 100 years (Figure 9). The late start of the railway network could be explained by the fact that the Western Balkan countries were part of the Ottoman Empire in the 19th century, an empire that had experienced stagnation from as early as the 17th century. The slow development in the later phases is probably due to a pronounced political fragmentation of the region. There was a short period of industrialisation during the Tito years in Yugoslavia; but infrastructure development during that period was rather low and did not have a sustained economic impact. Rising interest rates in the course of the second oil crisis in 1979 led to a period of economic decline and this was finally followed by the bloody disintegration of the country into small states that partly show further potential for fragmentation. The process of European integration may at last provide the region with the stable political framework necessary for a coordinated infrastructure policy as well as with the financing required for implementation. This may eventually lead to stable social and economic development.

The current initiative of the 'Core Network and Priority Projects' in the context of the 'Berlin Process' includes, according to the South East Europe Transport Observatory (SEETO), some 221 km of mature new priority road building projects (EUR 2.9 billion), 189 km of mature new priority rail building projects (EUR 1.1 billion), several mature priority rail renovation projects (EUR 1.6 billion) as well as substantial strategic gas projects (EUR 2.3 billion). The European Commission has estimated an investment volume of EUR 7.7 billion for transport infrastructure in the region. Based on this figure, the wiiw study on 'Infrastructure Investment in the Western Balkans' for the Federal Ministry of Science, Research and Economy of Austria estimates, over a period of 15 years, an additional Gross National Product growth impulse of about 1% p.a. for the Western Balkans. The estimated positive employment effects account for up to 200,000 people. This is about 4% of the Western Balkan workforce.

LOW DENSITY OF RAILWAY NETWORK IN THE WESTERN BALKANS

Figure 9 / Core railway network in Europe, 1870, 1910 and 2010



Source: HGISE Railways Historical Database.

CONCLUSIONS

The Western Balkans are the poorest region in Europe. The average GDP per capita at PPP is only about half of that of the Central, East and Southeast European EU Member States. Unemployment is widespread, especially among the young. The countries of the region lack competitiveness as indicated by their substantial and persistent trade deficits. The region cannot cover its imports by own production exports and is hence dependent on foreign capital inflows. Periods of increasing global interest rates regularly cause substantial economic disruptions detrimental to a balanced development. One of the major causes of low competitiveness is the thin industrial base. The economies of the Western Balkans are not integrated in the international value added chains. This is particularly visible in the very low share of medium- to higher-tech exports of the machinery and automotive industry in total exports of the region.

Short-run measures need to encompass policies that can be implemented quickly and do not burden the ailing public finances and at the same time have the potential to improve foreign and domestic investments as well as competitiveness. These measures include for instance fiscal devaluations as substitutes for nominal exchange rate devaluations, given that all the countries of the region are massively euroised and do not have the option of a nominal currency devaluation. An increase in the VAT rate and a reduction in the employers' social security contributions have the potential to support import substitution and export expansion while being budget neutral. Regulatory incentives for banks to reduce the high share of non-performing loans are imperative for an increase of much-needed foreign and domestic investment in productive capacities. These include also asset quality reviews by international standards and the enhancement of the quality of new loans.

Long-run measures need to tackle especially the countries' infrastructure in order to make broad industrialisation more likely. Although a certain amount of catching-up in the Western Balkans has been recorded in the construction of transport infrastructure in recent years, railway density remains low and motorway density is even lower. Also, the deficiency in energy infrastructure is substantial. The good news is that some countries in the Western Balkans certainly still have some fiscal room to manoeuvre which could be used to (co-)finance infrastructure projects. Bosnia and Herzegovina, Macedonia and Montenegro are partially still well below the public debt level of 60% of GDP. Public debt in Kosovo is even only 10% of GDP. Only Albania and Serbia have reached the 70% mark. Compared to the eurozone average of over 94%, public debt in these two countries is also rather low.

In the framework of the 'Berlin Process' a list of priority infrastructure projects was defined. The European Commission has estimated a total transport infrastructure investment volume of EUR 7.7 billion. According to wiiw estimates, over a period of 15 years, this would cause an additional GNP growth impulse of about 1% p.a. and a positive employment effect of up to 200,000 people or about 4% of the workforce.

Since the Berlin Process is an intergovernmental process and not initiated by the European Union, it naturally has certain limitations. The task over the next few years will be to sensitise the other EU Member States to the continuation of the enlargement process. This should also take place for geopolitical reasons. Regional powers such as Turkey and major powers such as Russia and China have been trying to gain influence in the Western Balkans for a long time. China has designed a variety of infrastructure plans for the region, such as the establishment of a high-speed railway line between Belgrade and Budapest. So far, only a few of these projects have actually been implemented. However, a section of motorway between the Serbian border and the Montenegrin harbour, Bar, is already being built.

The definite connection of the Western Balkans to the West should be an important objective for the EU, not least to ensure and expand the connectivity and cohesion between the current Member States in the centre of the Union and those on the periphery (Greece, Bulgaria and Romania). But the development of physical and human infrastructure alone will not create modern societies and EU candidate countries in the Western Balkans ready for EU accession. The expansion of democratically legitimated, functioning institutions, as repeatedly called for in the progress reports of the European Commission for the Western Balkan countries, is an important precondition for a sustainable, European development of the region.

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hardcopy: EUR 80.00 (PDF: EUR 65.00)

IMPRESSUM

Herausgeber, Verleger, Eigentümer und Hersteller:

Verein „Wiener Institut für Internationale Wirtschaftsvergleiche“ (wiiw),
Wien 6, Rahlgasse 3

ZVR-Zahl: 329995655

Postanschrift: A 1060 Wien, Rahlgasse 3, Tel: [+431] 533 66 10, Telefax: [+431] 533 66 10 50
Internet Homepage: www.wiiw.ac.at

Nachdruck nur auszugsweise und mit genauer Quellenangabe gestattet.

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