EUROPEAN POLICY CENTRE

POLICY BRIEF

10 November 2016

Economic governance in the Balkans: Towards a more sustainable path of economic development?

Matteo Bonomi

BACKGROUND
Extending the EU Semester fomula to the Balkans

In 2013, the European Commission added economic governance to the fundamentals of the European Union's (EU) enlargement strategy. The new approach to economic governance was for the first time implemented in 2015 and became fully operational in early 2016. This is a welcome development, but, as always, the proof will be in the pudding.

This paper argues that the track record of the new approach is sobering. Although it is leading to some relevant developments in the Balkan governments' policy-making (in terms of a more strategic and longer-term stance towards economic reforms), its overall influence on the region's economies remains unclear since, so far, it has not had a strong impact on economic restructuring. This year's Commission Country reports, issued this week, confirm these results. It is thus important that the EU supports positive changes in the Balkans more resolutely, and that the governments of the region improve their analytical and institutional capacities, which would facilitate progress with economic reforms. In times of multiple uncertainties within the EU, a more pragmatic engagement with the Balkans is pivotal for strengthening the credibility and transformative power of the enlargement policy.

The Commission's new approach to economic governance comes in response to the Balkans' limited progress in economic reforms and catching up with the more developed parts of the EU. The Balkan countries aspiring to join the EU are still not functioning market economies and have persistent structural weaknesses. The strong growth in the region during the 2001-2008 period (on average close to or over 5%) was primarily based on domestic consumption financed by foreign, mainly European, capital (including official financial assistance, Foreign Direct Investment (FDI), foreign bank loans, and workers' remittances). The modernisation of the real economy has been rather limited, leading to insufficient job creation, continuous deindustrialisation, and the widening of trade deficits.

The EU financial and economic crisis has severely affected the region. The sharp fall in foreign capital inflows and reduced demand for exports in the aftermath of the crisis have led to several recessions between 2009 and 2014. Despite over fifteen years of EU support facilitating EU-Balkans interdependence and fostering capital and trade integration (almost 80% of the region's trade is with the EU, while 75-95% of its banking system is foreign-owned), the countries in the region are not yet able to fulfil the Copenhagen economic criteria for accession.

To achieve a faster economic restructuring, the EU's approach to economic governance provides a new framework for economic policy-making in the enlargement countries. It reflects, to some extent, the process of strengthened economic policy monitoring and multilateral surveillance that was developed in the context of the EU's European Semester. It also seeks to develop institutional and analytical capacities, and help the aspirants to correct structural imbalances, stimulate long-term convergence, and foster competitiveness.

To this end, it establishes a strengthened economic dialogue between the EU and the enlargement countries. Governments are expected to prepare medium-term Economic Reform Programmes (ERPs), which outline national macroeconomic and fiscal stability frameworks, as well as priority structural reforms to boost competitiveness and long-term growth. Whereas the Commission assesses the ERPs, the Economic and Financial Council (ECOFIN) provides targeted guidelines to the aspirants.

Will the new approach to economic governance help achieve more sustainable economic development in the Balkans?

STATE OF PLAY
Progress, but results still limited

At first glance, the Commission's assessments of national ERPs for 2016-2018 are quite upbeat. According to the Brussels' executive, since 2015, when the new approach was launched as a pilot programme, almost all Balkan countries have presented ERPs, providing a sound basis for policy discussion. With the exception of Bosnia and Herzegovina and the former Yugoslav Republic of Macedonia (FYROM), where internal political problems have obstructed significant developments, all other Balkan countries have at least partially addressed the recommendations of the ECOFIN Council.

Fragile economic recovery

Yet, despite some encouraging signs highlighted in the ERPs for 2016-2018, economic recovery is still weak, while the Commission warns about the risks regarding the region's growth prospects.

According to national ERPs, growth prospects are improving due to strengthened domestic demand. A further acceleration of growth is expected, with the region's GDP forecasted to rise by 2.8% in 2016, 3.2% in 2017, and 3.9% in 2018. Governments foresee a new investment cycle supported by increased FDI, an improved business climate, and recently launched public infrastructure projects. They anticipate growth in private consumption also thanks to rising wages and remittances, along with low inflation.

In contrast, the Commission's assessments warn that growth prospects often reflect an optimistic bias and could easily be revised downwards. The fact that all countries except Serbia have already fallen short of previous GDP growth targets raises some concerns. The Commission's cautious evaluations are linked to difficult investment environments, delays in executing public investments, persistence of banks' non-performing loans, and overly positive assumptions about employment and wage growth.

A different assessment of the underlying structural weaknesses is also evident between the Balkans and the EU. While the former highlights the positive growth impact of increasing domestic demand, the latter stresses the need to tackle key structural problems, particularly external imbalances and poor labour market performance. In fact, according to the Commission, all countries are badly in need of directing more FDI to the tradable goods sector to increase exports. At the same time, the Balkan governments' expectations on the rise in employment and wages do not sufficiently take into account the structural weaknesses of their labour markets, characterised by weak public employment services, lack of active labour market policies, and a widespread mismatch between education provision and labour-market needs. This could seriously jeopardise the pace of domestic consumption in driving growth.

Weak fiscal consolidation

The recessions that the region has experienced since late 2008 have led to a fast increase in public debt in all countries. Consequently, one of the Commission's key priorities has been to upsurge fiscal sustainability. Mirroring the evolutions within the European Semester, the Commission has devoted greater attention to fiscal surveillance in the Balkans, aimed at reducing the overall government expenditure in parallel with fostering capital investments.

Despite some progress in fiscal consolidation (especially in Albania and Serbia, which have the highest public debt levels in the region, 72.2% and 76% of GDP in 2015 respectively), the Commission's assessment warns that debt stabilisation still has to be achieved by all Balkan countries, highlighting the need to increase the credibility of their fiscal strategies.

Moreover, the fact that the International Monetary Fund's (IMF) loans through Stand-By Arrangements (SBAs), rather than the EU's conditionality, still represent a major factor in bringing public finance under control in the region, is of concern. According to the Commission, the only two countries that are not relying on an IMF's SBA or similar[1] (that is, Montenegro and FYROM) have presented inadequate fiscal reform agendas. The programmes of both countries do not offer concrete solutions for rising public debts, thereby disregarding the Commission's expectations on fiscal consolidation.

Fragmented structural reforms

The most innovative part of the new approach is the introduction of a strengthened dialogue between the EU and the Balkans on structural reforms. In parallel to progress with reforms related to the Copenhagen political criteria, structural reforms are essential for improving the business climate and boosting competitiveness and long-term growth.

Under the new approach, governments have been asked to engage in a process of prioritisation of their national reform plans across eight different areas: public financial management; trade integration; infrastructure; sectoral development; business environment; innovation; labour market; and social inclusion. This has required a major effort of coordination among different ministries, pushing them to overcome political deadlocks and find consensus on key national strategic objectives.

As recognised by the Commission, this new exercise had some positive effects, as it has created the momentum for re-launching economic reform agendas across the region, giving new impetus to long-standing key pending issues, with respect, for example, to the management of public finance, infrastructure development or the restructuring of state-owned enterprises. At the same time, these processes are at an early stage. The ERPs appear rather fragmented, are not providing sufficient inter-linkages among the various priorities, and do not always envisage an adequate allocation of capital investments.

Problems are also evident in those areas that have seen significant progress, such as transport and energy, and which have received a very strong stimulus under the Connectivity Agenda within the so-called Berlin Process. The Connectivity Agenda has contributed to the process of prioritisation through the Balkan National Investment Committees, and infrastructure projects appear as the most advanced part of the ERPs. Nevertheless, the Commission cautions that in all Balkan countries, cost-benefit analyses are weak or missing, while budgetary allocations often do not provide a clear rationale.

For instance, while Serbia is under-allocating capital for maintaining and renewing its transport system, Montenegro is planning a major motorway investment costing as much as 20% of its GDP over the next four years. However, these large-scale infrastructure projects are not sufficiently accompanied by reforms to overcome structural weaknesses, including the liberalisation of the transport sector and energy markets. In particular, the Commission has pointed out delays in the implementation of obligations assumed under the Energy Community Treaty, as well as 'soft' measures regarding transport and energy, which are also part of the Connectivity Agenda. Both initiatives aim at a stronger regulatory integration of these sectors at the EU and Balkan level.

PROSPECTS

Now that economic recovery in the Balkans is gradually starting to take root, the timing is critical for establishing a different and more sustainable path of economic development. To ensure that all countries become functioning market economies, the new approach on economic governance has brought a significant change in the dialogue on economic policies between the EU and the Balkans, providing better communication, reporting and advice. At the same time, however, a number of shortcomings are evident:

- Important disagreements on the macroeconomic framework persist. While some progress has been made in aligning EU and Balkan expectations, important divergences remain in the overall judgements of the underlying structural weaknesses. These are clearly reflected in a different assessment of the potential sources of growth and should be swiftly ironed out by the Balkans and the EU. To this end, more concrete solutions on how to trigger different sources of growth should be made available to the Balkan countries.

- The EU lacks mechanisms to ensure fiscal discipline, which calls for more innovative thinking on the side of the Commission to engage the Balkan countries in this field. Despite the greater attention paid by the Commission to fiscal consolidation, the role of the EU in this area remains weak, consisting of monitoring and advice, while it is the IMF that sets strict rules for fiscal discipline, and only for those countries that have SBAs (or similar). Moreover, the threat to deny future membership is distant and not really credible, especially considering that even the most indebted countries, Albania and Serbia, stay significantly below the EU-28 and Euro area public debt averages (85.2% and 90.8% of GDP in 2015 respectively).

- Structural reforms have been launched, but remain at an early stage. Like in the framework of the European Semester, national economic reform agendas often appear only formally aligned with the long-term priorities highlighted by the EU. Still, for the first time, the ERPs impose on the Balkan governments the need to better coordinate different policy measures, which is essential for improving their dysfunctional public administrations. However, these organisational changes must be accompanied by adequate measures aimed at restructuring the Balkan economies.

In order to facilitate a more effective economic governance framework, more has to be done by both the Balkans and the EU. In fact, under the present scenario, even relying on optimistic growth forecasts, convergence perspectives for the Balkans remain uncertain and distant, risking to undermine progress also in other areas.

The Balkan countries should strengthen the ownership, ambition and credibility of their national ERPs. All countries of the region should improve the coherence of their economic reform strategies, providing stronger links between macroeconomic analysis, budgetary planning and structural reforms. It is thus crucial that the Balkan governments continue with the process of prioritisation of their structural reforms, providing better and more functional links between different areas. Moreover, this has to be grounded in a sound analysis of current structural weaknesses, and sustained by appropriate capital investments. Hence, it is also necessary that the Balkan countries develop a clearer assessment of their budgetary needs, providing a more efficient use of available government revenues.

The EU should provide more assistance in identifying the best-suited policy measures and support them through incentives, rather than (weak) rules. The EU should focus on specific projects, where a few priority measures ought to be clearly outlined and coherently backed by different EU bodies and member states, as well as incentivised through a (conditional) mobilisation of resources. From this angle, progress achieved with infrastructure projects under the Connectivity Agenda, despite delays, offers a good example of how a more concrete and concerted approach can advance national regulatory frameworks, while, at the same time, upgrading national capacities. Such an approach could be extended to other policy areas where fundamental changes are needed, such as industrial and competition policy, support for small- and medium-sized enterprises, or reforms in the areas of education, research and innovation.

To support such reform efforts, the EU should give due consideration to recent proposals made by some experts[2] to proceed towards a stronger integration of the Balkans in several EU policy areas even prior to EU accession. The merits of these ideas should be carefully assessed by the Commission in order to clarify whether it makes sense to grant Balkan countries access to European Structural Funds, extend the use of EU financial stability mechanisms to the region, or enable a stronger integration for their labour markets in order to favour the return of economic migrants (since today Balkan citizens working in EU member states are locked-in if they do not want to lose their working permits). While it might prove difficult to find consensus on implementing such proposals, they do offer a good basis for asserting new creative ways to bolster the support provided by the EU to the transformation of the region. Given the small size of the Balkan countries (3.6% of EU population), measures going in this direction would have a limited overall impact on the member states, but they could make a huge difference in restoring the credibility of EU policies in the region and positively affect progress in many other areas.

The hurdles faced by the Balkan countries are multiple and complex. The new strengthened economic dialogue between the EU and the Balkans represents a step forward in trying to identify common solutions for a more sustainable path of economic development, and in accelerating long-delayed economic reforms. However, finding specific policy measures that would ensure deeper restructuring of the Balkan economies, which is so fundamental for pursuing a more effective export-led growth strategy, is not a straightforward exercise, but one of the biggest challenges confronting both the EU and the Balkan aspirants. What is at stake for the EU is not only the possibility to significantly advance the enlargement process, but to prove that it is still capable of using economic relations as a driver for the diffusion of wealth and prosperity, which is ultimately also in the interest of the Union and its members.

Matteo Bonomi is a Programme Assistant for the European Politics and Institutions Programme at the EPC.

1 The SBA with Bosnia and Herzegovina expired on June 2015, but a new agreement (Extended Fund Facility) was negotiated and approved by the IMF on 7 September 2016.

2 See, for example, Reljic Dusan (2016), "Russia gives Serbia the choice: Satellite or bargaining chip" in Fischer, Sabine and Klein, Margarete (eds.), "Conceivable surprises. Eleven possible turns in Russia's foreign policy", SWP Research Paper, pp. 25-34.

European Policy Centre ■ 14-16 rue du Trône, 1000 Brussels, Belgium
Tel: +32 (0)2 231 03 40 ■ Fax: +32 (0)2 231 07 04 ■ Email: info@epc.eu ■ Twitter: @epc_eu ■ Website: www.epc.eu

Europe for Citizens Programme

With the support of the Europe for Citizens Programme of the European Union.