Building a Better BALKANS

By DR. VALBONA ZENELI, Marshall Center faculty

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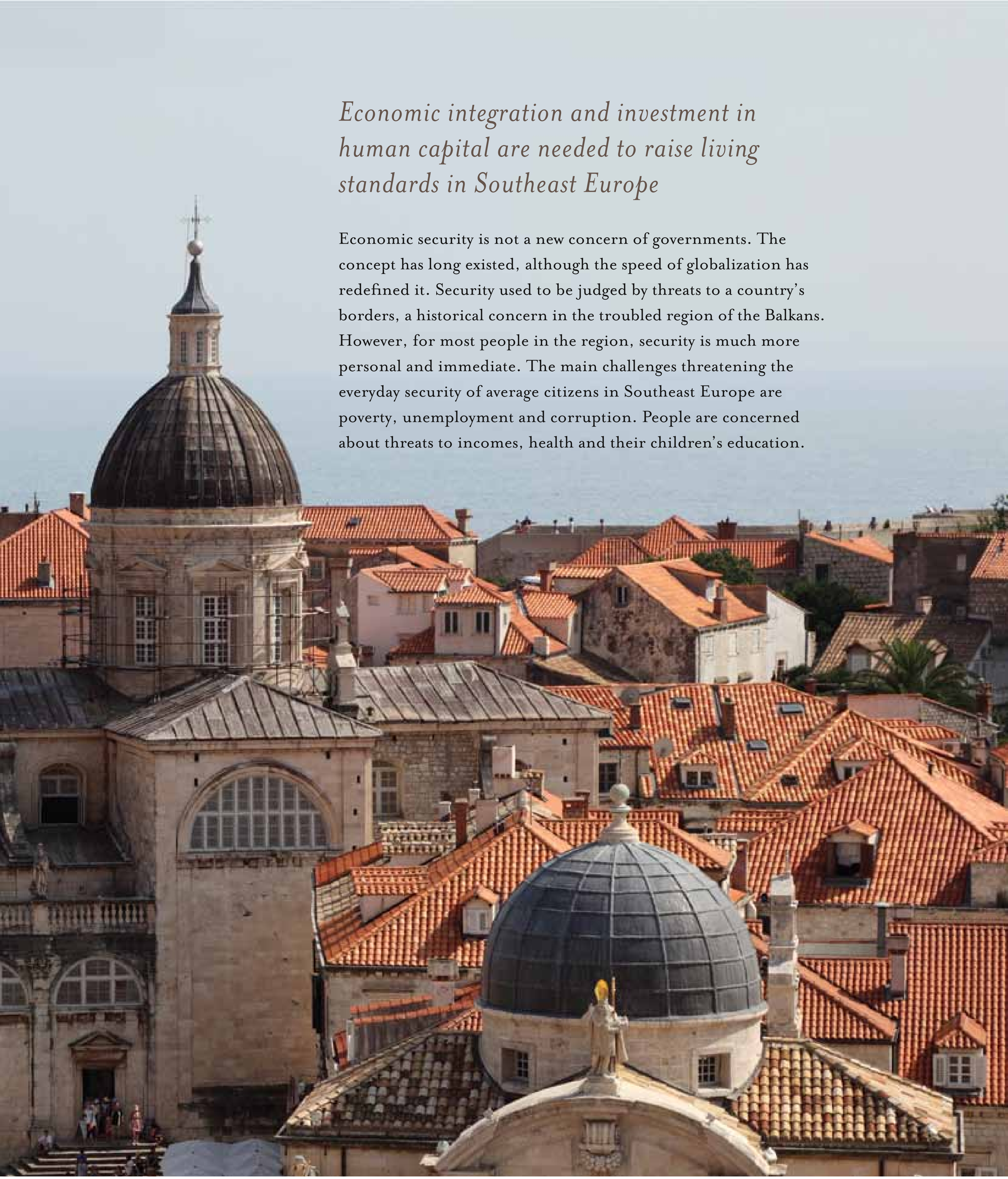
Economic integration and investment in human capital are needed to raise living standards in Southeast Europe

Economic security is not a new concern of governments. The concept has long existed, although the speed of globalization has redefined it. Security used to be judged by threats to a country's borders, a historical concern in the troubled region of the Balkans. However, for most people in the region, security is much more personal and immediate. The main challenges threatening the everyday security of average citizens in Southeast Europe are poverty, unemployment and corruption. People are concerned about threats to incomes, health and their children's education.



Southeast Europe economies lag behind developed Western economies. Living standards and incomes are relatively low, with average per capita GDP only 36 percent of the European Union average in 2010. The region reports the highest unemployment rates in Europe, averaging 24 percent in 2012, and in some countries exceeding 30 percent.

The past two decades have been especially challenging for people in Southeast Europe. The fall of the Iron Curtain resulted in drastic policy and economic change for former communist countries. Since the beginning of the transition process, the countries of Southeast Europe have made great strides in their transformation. The common objective has been integration into the EU and inclusion into the global economy. However, the transition to efficient market economies remains unfinished, and despite the indisputable achievements of the past two decades, challenges remain formidable.

Many have studied the successful transformation strategies and the EU enlargement process in Eastern and Central Europe and tried to replicate it. Although a broad consensus for change exists within society, Southeast Europe has been beset by problems. Its industrial base was obsolete, and governments failed to develop comprehensive strategies for reforming their economies and societies. Neo-liberal reforms and the privatization process have been largely short-term and ineffective; favoring insiders and shadowed by corruption. These problems kept serious foreign investors away from the region.

Regional disputes, including the wars of the 1990s, have distracted governments from reforms, destroyed industrial capacity and disrupted trade, worsening the economic and welfare situation. Economic growth in the region only resurged during the 2000s and brought with it rising economic and social welfare. During the past decade, average gross domestic product (GDP) growth in the region was 3.4 percent, and some countries managed growth rates higher than 7 percent. This economic expansion resulted in an increase of 40 percent in aggregate regional GDP, helping residents of the Balkans to narrow their income gap with the EU.

ECONOMIC RECESSION IN SOUTHEAST EUROPE

But after a decade of macroeconomic growth, the boom came to an abrupt end in 2009. Southeast Europe suffered from a lagged reaction to the eurozone economic crisis through declining trade, investment, finance and remittances. Real GDP contracted 5.9 percent in 2009 and, following a double-dip recession in 2012, shrunk another 1.2 percent. The consumer and investment markets registered even deeper declines.

The most significant of the contagion channels in Southeast Europe has been a 30 percent drop in foreign direct investment (FDI), the worst decline experienced in any other emerging market. Another important negative spillover effect that harmed the region's balance of payments was a decline in trade with the EU, especially with neighboring Italy and Greece.

The decrease of remittances from EU countries had dire consequences for these small economies, exacerbating social tensions and suppressing consumption among people who relied on the financial support of expatriate workers.

The ongoing Greek crisis has hurt the regional economy. Greece had been a major strategic partner and big investor in Southeast Europe, and Athens' troubles have delayed EU integration with the Western Balkans. As late as the Thessaloniki summit in 2003, Greece had pledged to integrate the region into the EU. One of the main consequences of the eurozone crisis is a credit crunch that has deprived businesses of money needed for operations and investment, impeding economic growth.

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STRUCTURAL DEFICIENCIES

The crisis has exposed regional vulnerabilities. Southeast Europe faces challenges and opportunities that are common to Europe as a whole, as well as challenges that are specific to itself. The global crisis is an important explanation for the stagnation of Southeast Europe economies, but that explanation only goes so far. More importantly, the underperformance is a direct result of structural problems in the Balkan economies. Some are a consequence of decades of conflict, and others stem from a still-unfulfilled reform agenda meant to transform planned economies into democratic market economies.

Many regional problems are chronic and reflect suboptimal patterns of growth, creating significant imbalances, both macroeconomic and structural. The high growth of the last decade was made possible by domestic-led demand nourished by large inflows of foreign capital. Reliance on this consumption-led growth has resulted in widespread unsustainable deficits with rising foreign debt.

Worsening this picture, credit capital inflows were misallocated and neglected productive investment in favor of consumption. Southeast Europe suffers a serious lack of competitiveness and productivity, reducing the region's appeal to foreign investors.

The stall of GDP growth in the region is alarming for these weak emerging economies. Brief growth spurts followed by stagnation simply lower average growth and prolong the process of catching up to advanced economies.

SUSTAINABLE GROWTH MODEL

The old economic model in Southeast Europe is challenged. That development was driven by the accumulation of physical and financial capital that has fueled sovereign debt rather than build human resources. With global liquidity shrinking, the region needs to change gears. Regaining one's economic stride is more complicated when structural changes must occur in a time of financial austerity.

So future economic development should rely on increased regional cooperation and deeper integration with the EU. This is the first and best option for the small but not yet competitive economies of Southeast Europe.

A worker cleans the facade of the Bank of Greece in Athens. Greece once served as a model and patron for nations of the Western Balkans aspiring to EU membership, but financial woes have weakened that role. GETTY IMAGES

Fiscal and economic security cannot be guaranteed unless there is a clear, long-term strategy for growth and development aimed at the well-being of society. A new growth model is needed to accelerate socioeconomic reform and modernize and reindustrialize the economy. That will create more jobs and deliver better living standards to the population.

Economic remodeling should be done by changing the drivers of growth toward greater exports and foreign investment. That will require a focus on stimulating innovation, acquiring skills and integrating regional trade. This is also in line with the EU 2020 growth strategy that talks about smart growth built on knowledge, education and innovation.

Sustainable growth and wealth creation is built on people, human capital and knowledge for a continuous structural change in an economy. Governance is crucially important. Open markets are necessary but not sufficient. Innovation and technological progress — the main sources and factors of growth and job creation in this century — increase productivity. But that progress is founded on human capital and institutions that create the necessary conditions for the market system to function freely and properly.

ATTRACTING INVESTMENT

The countries of Southeast Europe are not considered to be innovation-driven economies, ranking very poorly in the World Economic Forum's Global Competitiveness Report 2013, especially when it comes to innovation and business sophistication.

One of the easiest ways to acquire innovation and knowledge in Southeast Europe is through interaction with the global economy and the attraction of FDI. But to achieve this, countries should have the necessary absorptive capacity to take the greatest advantage of the positive spillovers of FDI. Foreign investors are still reluctant to invest in the region — most of the actual investments relate mainly to the privatization process — for various political and economic concerns. They include weak growth rates, relatively small markets, pervasive corruption, insufficient labor skills and weak institutions. The poor performance of institutions and high levels of corruption are what worry most foreign investors.

FDI is an important indicator of economic health in a country and a strong channel for direct growth, employment and increased income. It provides the main source of untainted private capital, a vehicle of modernization and a driving force for sustainable development.

The establishment of a competitive economic environment in the whole region is a key precondition for attracting FDI. The region should realize that its individual nations are too small and noncompetitive in the global market. Each lacks resources and the capacity to compete and generate sufficient scale to attract quality investment.

Regional cooperation and interoperability are imperative for the economic future of Southeast Europe. Further integration in the global economy can be achieved only by improving competitiveness. Regional integrated growth can only be achieved through complete liberalization of trade and investment and harmonization of regulations, procedures and institutions. Creating a regional strategy will be vital for promoting a friendly business environment for the "pooled" attraction of FDI toward sectors that augment domestic investment and improve productivity.

The Central European Free Trade Agreement (CEFTA) is a regional cooperation agreement strongly supported by the EU. It has been instrumental in fostering open and accessible regional markets, leading to complete trade liberalization. CEFTA is a good framework for cooperation, but the challenge lies in its effective implementation and the removal of burdensome nontariff barriers. A better framework of cooperation would increase the very low intra-trade levels between members and lead to higher productivity.

JOB CREATION

High unemployment is putting a significant strain on fiscal balances and on all forms of social and economic security. Work-related security has several dimensions related to incomes, representation, labor opportunities and productive employment. One of the main problems in the region is the mismatch between the aspirations of people to find decent jobs and their ability to obtain them.

Key to reducing unemployment will be more robust growth. To achieve this, countries need to continue their fiscal adjustments and improve their investment climate and competitiveness. More aggressive policies are needed to foster entrepreneurship and small business development, invest in skills and remove barriers to mobility. That would help the region escape the vicious cycle of low growth and high unemployment.

International development institutions argue that policymakers should focus not just on economic growth but on human development, making people both the means and the ends of this process. The success of a government should be measured in terms of human development, a process of enlarging people's choices and expanding their capabilities.

Human and economic security should also be the foundation of reconciliation and development in the region. The role of the government is to create an environment where private sector investment is profitable. The principal investments that are needed to support growth are education and infrastructure. Both positively impact growth by raising returns in the private sector, domestic and foreign.

National institutions will continue to be the essential providers of economic security to their citizens. However, under the conditions of globalization, these institutions must evolve. The recent crises have boosted the role of the govern-

James Hogan, right, president and CEO of Abu Dhabi-based Etihad Airways, Serbian Deputy Prime Minister Aleksandar Vučić, center, and Dane Kondić, general manager of Air Serbia, celebrate Etihad's purchase of 49 percent of the Serbian national airline. Balkan businesses have struggled to find well-heeled foreign partners. GETTY IMAGES

ment in the economy. An effective public sector is a prerequisite for overall productivity gains. The establishment of a transparent and effective environment free of corruption would radically improve the business and investment climate.

A REGIONAL VISION

Some time ago, many people in Southeast Europe viewed regional integration more as a risk than an opportunity. This provincial mentality has definitely changed. The regional reconstruction vision, with its roots in the Marshall Plan after World War II, sees underdevelopment and economic instability as major sources of regional instability. The way to achieve stability is to transform economic conditions. This would make disputes and conflicts extremely expensive for everyone.

The enticement of a common future under the EU motivates countries to develop. However, regional cooperation is a precondition for EU integration. It is extremely important that people in the region have linked their future to the EU. They regard Europeanization as a desirable and modernizing change, even though the road to EU integration has been bumpy for some of the countries, with corruption and organized crime as the main impediments. But working with the EU through the accession process has been crucial to building institutional capacity in these countries.

Economic security and prosperity are critical for bridging barriers between states and easing mistrust among neighbors. Cooperation stimulates economic prosperity and decreases the chances for conflict. Regional leaders should be visionary in recognizing the advantages of economic cooperation. Trade and investment interdependence has the power to reduce and eliminate nationalistic confrontation.

Better regional cooperation would reduce instability in Southeast Europe, one of the main concerns of foreign investors. Strong political will is needed to meet challenges. Rebuilding the region on a strong and sustainable foundation will require, above all, investment in education and knowledge as a gateway to economic development and regional integration. To do otherwise would be to squander a valuable opportunity. □