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ECONOMY OPENNESS AS AN IMPORTANT FACTOR TO OVERCOME SLOW ECONOMIC GROWTH IN THE WESTERN BALKAN COUNTRIES

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Abstract

This paper aims to contribute to the current policy discussion on measures for achieving sustainable growth and the steady convergence of Western Balkan economies. A significant fall in demand and a strengthening of competitive pressures characterize the latest trends on the international markets. Western Balkan countries (WBC), whose economic growth models have been challenged in recent years, are faced with the challenge of more active inclusion in the international integration process, and one of the key factors in this path is the improvement in trade patterns and export competitiveness. The changes of export structure towards higher value added products are a precondition of a growth and export competitiveness. In this context, the ability of adjusting to new market circumstances and the development of economic cooperation are especially important for the achievement of continued growth in production and in exports. The paper attempts to identify factors that can contribute to these results, such as export performance, level of opening of the economies of these countries, foreign direct investment, domestic prices and costs and institutional and structural indicators. We conclude by summarizing measures and instruments for achieving export-driven economic development and by formulating policy recommendations such as: intensifying trade, greater focus on exports, focusing on FDI attraction policy, institution building and improvement of the overall business environment.

Keywords: Western Balkan countries, external competitiveness, economic growth, foreign direct investment, structural characteristics

INTRODUCTION

The Western Balkan countries (Albania, Bosnia and Herzegovina, Kosovo, Macedonia, Montenegro, Croatia[1] and Serbia) witnessed strong economic growth in the pre-crisis period, but the growth was based on high domestic consumption linked to fast credit growth. The

[1] In this study, we present data before 1 July 2013, the period when Croatia becomes the 28th Member State of the European Union

growth was accompanied by a widening budget deficits and increased public and foreign debts. WBC growth models were based on (1) cheap international capital and loans extended and indexed to international currencies, and (2) the liberalization of foreign trade and financial markets (Penev, 2012). This situation particularly deteriorated in the period of financial crisis when investment inflow ceased and the current account deficit was exposed to unforced adoption, exacerbated by low export income, significant import demand (Nuti, 2009), a credit crunch, a decline in remittances, and a decline in foreign direct investment.

When considering the countries in the Western Balkan region must have in mind that they are highly interconnected and interdependent and are small economies and not very large markets (Jeleva, 2012). The small size of most of their economies[2] implies the critical importance of an export-led growth. The crisis has highlighted internal structural weaknesses and exposed a lack of progress in reforms that would release public resources for investments in growth sustaining infrastructure. Weaknesses are identified in the political and regulatory environments. The climate for foreign and domestic investments needs significant improvement in the region. Moreover, the constraints on private sector development restrain the dynamics of Western Balkan economies and undermine expectations of a quick recovery.

At the same time, the overall export performance has improved to some extent, as these countries have opened up to trade and increased their world export market shares, albeit to a lesser degree than other emerging countries in Europe. All WBC countries increased their export and trade openness over the past period (Orszaghova *et al.*, 2013). The growing trade of WBC, both in terms of volume and in terms of value, could be related to the transition and integration process, by means of which these countries have integrated (or reintegrated) with global and European markets through trade liberalization, trade-related reforms and the signing of trade agreements (Di Mauro & Forster, 2008).

The paper has considered the different studies in view of economic development of the Western Balkan countries by using statistical macroeconomic analysis. Secondary analysis of previous quantitative data and published studies, combined with an own qualitative study in the field, has provided a reliable and convincing basis for analysis. The paper is organised as follows: first, we provide a concise overview of trade dynamics and export growth developments across the WB countries. This is followed by a discussion of the price and cost related aspects of competitiveness. Our analysis is completed by a discussion of the two main factors behind export performance: foreign direct investment and institutional and structural issues.

[2] Statistics on population size are highly doubtful, due to the lack of recent census in some of the countries, we are discussing, but in any case, the region's common market encompasses little more than 20 million people.

MACROECONOMIC OUTLOOK OF WB COUNTRIES IN 2013

The Western Balkan economies were among the hardest hit by the financial and economic crisis. In 2012, the region entered into a double-dip recession (making Western Balkans the most crisis-stricken developing region globally), with weighted average GDP falling by 0.8% per year. GDP growth for 2013 is average 1.5%, partly resulting from the recent downgrades of the EU growth projections that are likely to affect the growth projections for the Western Balkans as well (WBIF, 2013a).

The reasons for such weak recent economic performance of the Western Balkans include external vulnerabilities to the euro zone. The Western Balkan countries are especially vulnerable to the effects of the euro zone crisis because of the high degree of 'euroization' (Bartlett & Uvalic, 2013). Almost 60% of the region's exports go to the EU, while the banking sector relies heavily on euro zone finance. For the Western Balkans, integration proved to be a double-edged sword: in good times, the European core exported its prosperity towards its south-eastern periphery; but now, at a time of crisis, it is exporting instability (Bechev, 2012). However, internal structural weaknesses of the economies in the Western Balkans have undoubtedly also contributed to the economic stall. These include labour market mismatches and rigidities, business environment complexities, lack of competitiveness, lack of demand on the world markets for their local products, reduced trade in general, limited access to funding, reduced direct foreign investment, decreased amount of remittances flowing back into the region from migrant workers (Gallup Balkan Monitor, 2010), as well as weak political and economic governance and public sector management.

The common features of WBC include high unemployment, government deficits, still relatively high government share in the economy, lack of domestic capital, inherited and newly created indebtedness. In general, they lack competitiveness, which has resulted in perpetuating trade deficits. Their relatively poor performance on international markets is a direct consequence of the slow implementations of the reforms on domestic product markets.

Looking at the sub-balances of the current account, all WB countries have reported persistent merchandise trade deficits. The widening of regional budget deficits is the result of the negative spillovers of the global economic crisis (Čaušević, 2012). To some extent, large transfers of remittances and a positive service balance have offset these. The weighted average figure for current account deficit of -9% of GDP for 2013, hides the enormous discrepancies existing among Western Balkan countries: from -0.1% for Croatia and -3.9% for Macedonia, to between -9.6% and -10.9% for Albania, BiH and Serbia, or -17.6% and -20.4% for Kosovo and Montenegro.

Apart from an increase in exports to EU countries, trade among the Western Balkan countries has also grown significantly. The countries re-integrated their (once common) markets, most notably Serbia, Macedonia, Montenegro and Bosnia and Herzegovina. Furthermore, since 2007, all Western Balkan countries have been part of the Central European Free Trade Agreement, and have thus replaced a matrix of bilateral free trade agreements (Orszaghova, *et al*., 2013). The accession and participation on the common EU market bring additional challenges to these rather non-competitive economies. What comes into perspective when having in mind the integration prospects is the evolution of trade between these countries and EU (Botrić, 2012). Foreign imbalances, which were clearly unsustainable for some Western Balkan countries in the last decade, have generally improved, but all countries are far from exhibiting surpluses of net exports that would indicate their international competitiveness.

In general, recovery is difficult here. As evident from the analysis below, economic growth and recovery in general are mainly driven by external demand. Exports from the Western Balkans continue to consist mainly in low-value added products, including commodities that are subject to price volatility and strong competition from emerging markets (Jeleva, 2012). These countries also suffered from a collapse in domestic demand and the subsequent contraction of demand from within the EU. Countries with a high degree of integration experienced the crisis sooner; those with a lower degree of integration experienced a larger decrease in production (Bartlett, 2010).

Table 1 shows macroeconomic stability, including adequate price stability, sustainable public finances and external accounts in Western Balkan countries in 2013.

Table 1: Achieved level of macroeconomic stability in Western Balkan countries, 2013

WB COUNTRIES	**Ec. Growth % GDP**	**Unemployment rate %**	**Gen. Gov. Debt % GDP**	**Inflation %**	**Current account deficit % GDP**
Albania	1,8	12,8	61,8	2,1	-9,6
BiH	0,5	28	42,1	1,7	-8,5
Croatia	-0,2	19,1	59,5	3,4	0.8
Kosovo	2,9	35,1	17,4	2,5	-18.2
Macedonia	2	30,5	34,3	2,8	-3,6
Montenegro	1,2	19,3	52,9	2,7	-15,2
Serbia	2	24	64,7	8,5	-8,5
WBC average	**1,5**	**24,1**	**47,5**	**3,4**	**-9**

Sources: WBIF (2013)

As said, the real growth rate for the region as a whole has dramatically fallen during the financial and economic crisis, and it is only slowly recovering according to forecasts. The average annual growth rate of about 2,5%, as expected for 2014 is insufficient to stimulate socio-economic development and sustain the build-up of growth-enhancing infrastructure *(WIBF, 2013)*.

WBC TRADE POLICY AND GROWTH

The issue of an extent to which WB countries trade policy can contribute to their economic growth remains directly linked with relation between liberalization of an external trade and growth stimulation. To avoid a slow-down in exports as an engine to growth, the region will therefore need to make efforts in addition to dismantling tariff barriers: surmounting non-tariff obstacles to trade and improving the institutional environment (Snoy, 2011).

Over decades, the export-led growth pattern delivered convincing arguments to be followed. It generated high growth rates, created new jobs, led to higher labour productivity, introduced new organizational and managerial methods of production, ensured relevant inflows of capital and technology, substantially increased export revenues, diminished the traditional trade deficit, improved the current account balance and as a result contributed to higher financial stability of the given economy. It should not be ignored that cooperation with foreign (transnational and small & medium - sized) firms many times opens up external markets for domestic production and fosters the export-led growth pattern (Buturac, *et al,* 2010).

Therefore, the EU accession process rapidly brings benefits in terms of trade integration due to the abolition of import tariffs and the more efficient use of resources. An expanding of trade, through improvements in competition policy and specialization, has become a priority for the current ascending Western Balkan economies that are traditionally less opened in comparison to Emerging EU economies.

One of the most important factors, that can overtake the international economics developments in to a specific country, is of course the level of integration of this country related to world economy. Economic integration of a country with the world economy is analyzed generally through export - import volume of this country related to the rest of the world. Of course, in a large view, we can include here also the foreign investment, remittances, etc., but we will focus on commercial relation. For showing openness of the WBC economies to the euro zone, we present data of export to EU as % in total exports of the country (*Table 2).*

Table 2: Export to EU as % in total exports

WBC	**Alb.**	**BiH**	**Croa.**	**Kos.**	**Mac.**	**Mont.**	**Serb.**
%	75	58	58	39	58	29	58

Source: WBIF (2013)

Data shows that Albania, Serbia, Croatia and Macedonia have a higher openness index, even higher than some West European Countries. In the observed period, index of openness is only 53,57% average for the Western Balkan economies. The average level of openness for Emerging European economies is 92.89%, even though the two largest economies in the sample - Poland with only 56.05%, and Romania with 60.76% - considerably decrease the average openness index in Emerging European economies. Without intensifying trade relations, these economies might step further away from the sound economic recovery path.

TOP EXPORTS & IMPORTS PARTNERS IN WESTERN BALKANS

Trade plays an important role in the EU's efforts to promote peace, stability, freedom and economic prosperity in the Western Balkans. As small, open economies - more than one fifth of economic output and employment is based on exports - the Western Balkan countries were especially vulnerable to the effects of the world crisis, especially the fall in global growth and trade**.** WB countries with a high degree of trade integration experienced the crisis sooner; those with a lower degree of integration experienced a larger decrease in production (Jovičić, 2010).

- The EU is the Western Balkans' largest trading partner (Grupe and Kušić, 2005), accounting for about two thirds of the region's total trade. As a whole the region's share of overall EU trade was 1,4% in 2012, however individual countries' shares were very low - Croatia 0,5%, Serbia 0,4%, Macedonia 0,2%, Bosnia and Herzegovina 0,2%, Albania 0,1%, Montenegro 0,0% and Kosovo 0,0%.
- In 2012, the EU's main imports from Western Balkans were manufactured goods classified chiefly by materials (21.7%), manufactured articles (20.9%), and machinery and transport equipment (20.7%). The EU's exports to the Western Balkans were mainly machinery and transport equipment (25.3%), manufactured goods classified mainly by material (21.2%), chemicals (15.1%), and mineral fuels (14.8%) (European Commission, 2013)

The euro area countries are the main trading partners for the region, accounting for about half of all exports on average - slightly more in the case of Albania and BiH, and slightly less for Serbia, which has relatively strong trade links with Russia and other emerging European economies. Within the euro area, Italy is generally the most important export market for the region, especially for Albania, while Greece is the most important export market for Montenegro. Trade linkages with the rest of the euro area are mostly dominated by Germany, with countries such as Austria, Slovenia, France, Spain, Belgium, the Netherlands and the UK also being on the list (IRIS, 2010). Experiences with CEFTA and existing trade and specialization patterns suggest low level of potential intra-regional trade, especially given the small size of the regional market and similar competitive (Grupe and Kušić, 2005).

Since the EU member states constitute the most important trade partners for WB countries, the deteriorating conditions in the EU, had a particularly detrimental effect on exports to traditional markets and cross border trade relations. For example, due to reduced foreign demand, Macedonia's metallurgical industries were operating on 50% of their capacities, leading to a large fall in production as well as massive layoffs. Croatia, whose tourism industry is a major source of income and is mostly powered by citizens of EU countries, also lost important revenue as the economic downturn led to a dramatic fall in tourism.

Trade of the countries with the EU is quite low, the share of intra-industry trade is also relatively low, and the structure of products traded is relatively unfavourable and not improving. The simple continuance of current trends would most likely lead to nominal stagnation, and real divergence from the main European trading routes.

However, there is room for improvement. Intensifying trade, and possibly intensifying trade with more demanding markets, might be of crucial importance for the future developments of Western Balkan countries (Botrić, 2012). This could be achieved by exploring new export patterns and identifying additional priority areas. Some studies point out the need for deeper regional integration between Western Balkan countries to increase the region's attractiveness for investors and foreign direct investment (FDI) inflows. Further efforts are required to intensify the development of domestic human capital, to improve productivity and help overcome the predominance of low-skill content in exports.

PRICE LEVEL

Over the pre crisis period, all WBC experienced a loss in price and cost competitiveness. In the context of an economic catching up process, it seems natural that unit labour costs and real effective exchange rates have increased. Yet, labour productivity has not grown in line with the increased cost of labour and prices have risen faster than the level of convergence, which has thus affected competitiveness and contributed to increasing trade deficits. The higher prices extend their negative impact in other countries as well, making imports for these countries more expensive and increasing their costs of production. However, it depends of course from the structure of the imports.

The lack of adjustment in price and cost indicators, particularly in Croatia and Montenegro, continues to weigh on the external competitiveness of these countries. Most WB countries have diversified their exports, both in terms of the number of trading partners and the number of products exported, thereby enhancing their resilience to economic shocks. All of these countries have increased their exports to the EU. Some, in particular Croatia and

Montenegro, rely heavily on exports to EU periphery countries, which have experienced an important economic slowdown. This can partly explain their short-term vulnerability in terms of export performance (together with their loss of price and cost competitiveness), and an adjustment in their export orientation strategy may be needed in the near future.

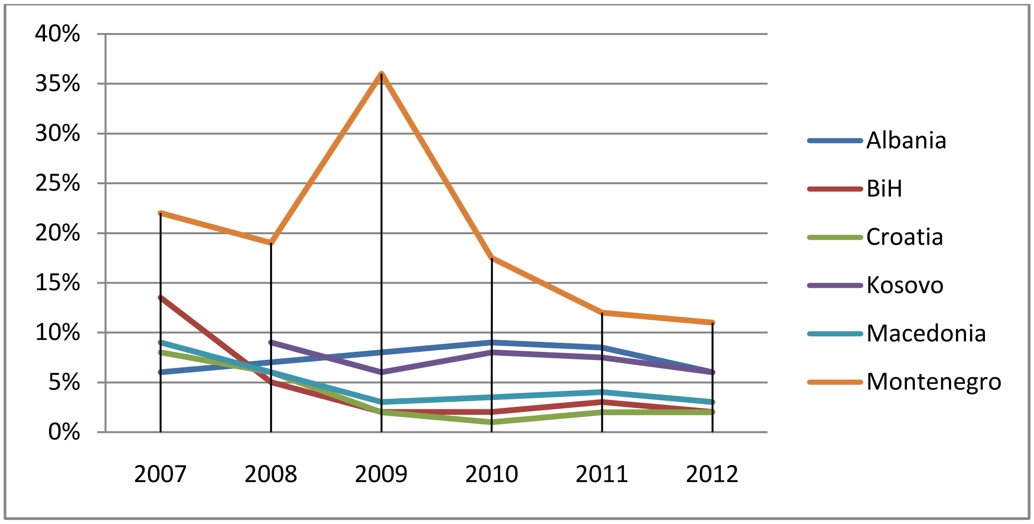
As mentioned above, WB countries have also improved their exports in terms of the number of products exported, but most of them and esspecially Montenegro remains dependent on a small number of raw materials for their exports. Moreover, several countries have not yet managed to climb up the quality ladder and their exports are concentrated in stagnant sectors, such as agriculture and textiles. The outlook for export growth is rather uncertain for these countries, as they are vulnerable to competition from other emerging markets.

FOREGIN DIRECT INVESTMENTS (FDI)

All WB countries have attracted considerable FDI over the past decade, which largely has helped in covering their current account deficits. However, the level of FDI per capita has differed substantially across the countries, with Croatia and Montenegro having been the most successful of the WB countries in attracting FDI during this period. Meanwhile, the FDI inflows per capita of the Macedonia and Serbia have been among the lowest, and these have mostly been directed towards the tradable sectors. Consequently, the sharp decline in foreign direct investment after 2008 – caused mainly by the economic downturn in the investing countries – has had a seriously detrimental effect on the national economies in the region (Kekic, 2009).

FDI in WB countries has not been flowing consistently into the main export sectors. This has arguably reduced the degree of pass-through from FDI inflows to export growth. In fact, the non-tradable sectors (*e.g.* financial services, telecommunications, electricity provision and tourism) of several countries, in particular Croatia and Montenegro, have attracted the major share of foreign capital, with this partly neglecting the major manufacturing export sectors (such as the shipbuilding industry in Croatia and aluminium smelters in Montenegro). In contrast, Macedonia and Serbia have successfully attracted sizeable investments in their manufacturing industries, such as those related to metal and machinery production (e.g. the automobile industry). In addition, Serbia's food industry has also received a considerable proportion of the country's FDI inflows. The companies from transition countries must consider more lively trade exchange with countries in the region and the EU markets (Žugić, 2010).

Figure 1: Foreign Direct Investment, 2007-2013 (in % of GDP)



Source: WBIF (2013a)

In the pre-crisis years some of the countries in the region (especially Montenegro and Croatia) were among the front-runners in FDI as a share of *GDP (see Figure 4).* After the crisis began, the FDI flows diminished as the result, more or less, of a chain reaction: the FDI in the Western Balkans was mainly obtained from the developed countries, where the crisis started in 2007 and was in full swing in 2008, with the 2010-2012 average investment in absolute terms representing only half of the 2006-2008 average value.

While part of this fall in FDI can be attributed to negative economic developments in the investors' home markets, it is also likely to indicate a lack of confidence in the political, economic, institutional and regulatory environment of the beneficiary countries in the Western Balkans. Poor institutional and physical infrastructure, relatively low market and labour efficiency, as well as limited innovation and sophistication potential of the region are serious limitations to the competitiveness of the region.

When investigating the relationship between FDI and trade performances, one can expect a natural lag of several years between the time an investment is made and the moment from which it starts to pay off in terms of output. However, establishing a strong link is very difficult when relying on descriptive statistics only, particularly given the fact that most FDI has not flowed into the tradable sectors (Orszaghova *et al.,* 2013).

With regard to structural and institutional factors, some major improvements have been made enhancing the competitiveness of their business environment and increasing their attractiveness to foreign investors. However, important reforms have lagged behind. Moreover, when compared with other European economies, the WBC countries perform quite poorly in respect of several structural indicators, especially corruption.

STRUCTURAL AND INSTIUTIONAL ENVIRONMENT OF WESTERN BALKANS

A favorable business environment is one of the key preconditions for the economic recovery and growth of the Western Balkans region, as many elements of a sound business environment, such as efficient and predictable government institutions, an educated labour force, a good physical infrastructure, and access to finance, have direct effects to the economic growth. The recent economic crisis has underscored the importance of a competitiveness-supporting economic environment for better enabling national economies to absorb shocks and ensure solid economic performance (Penev, 2012).

A number of international surveys and datasets attempt to measure the various components of the business environment. According to them, the Western Balkan countries are lagging behind the EU‑27 in a range of competitiveness, business and investment environment and institutional reform indicators. Business environment indicators have shown improvement in WB countries, especially in areas such as starting a business, dealing with construction permits and ease of paying taxes (Bogetić, 2012).

According to the Doing Business 2013 ranking list, Macedonia was ranked 23rd and it is followed by Montenegro, which is 51st, due to intensive reforms in several reform areas. Macedonia has managed to improve many dimensions of its business environment, showing that it can be done in other countries in the region, too. Albania worsened its position in 2013 and was ranked 85th. Serbia improved its position and was ranked 86th, while Bosnia and Herzegovina worsened its positions for one spot, due to the reduced intensity of reforms. In 2012, Kosovo was ranked far below the regional average (117th), while in 2013 Doing Business it ranked 98th, improving its position 19 spots (World Bank and International Finance Corporation, 2013).

The *Global Competitiveness Index* looks at different areas related to institutional/administrative obstacles to competitiveness. Areas that exhibit particular flaws in the region are business sophistication, market size, and labour market efficiency. The rankings for institutions range from 72th place for Macedonia and Serbia, to 95 place for Montenegro, out of the 144 countries ranked (WEF, 2013).

Table 3: Ranking WBC according “Doing Business” and “Global Competitiveness Index”

WB COUNTRIES	DOING BUSINESS		GLOBAL COMPETITIVENES INDEX	
	Overall rank	**WBC rank**	**Overall rank**	**WBC rank**
Albania	85 out of 185	4 out of 7	89 out of 144	5 out of 6
BiH	126 out of 185	7 out of 7	88 out of 144	4 out of 6
Croatia	84 out of 185	3 out of 7	81 out of 144	3 out of 6
Kosovo	98 out of 185	6 out of 7		
Macedonia	23 out of 185	1 out of 7	72 out of 144	2 out of 6
Montenegro	86 out of 185	5 out of 7	95 out of 144	6 out of 6
Serbia	51 out of 185	5 out of 7	72 out of 144	1 out of 6

Source: http://www.weforum.org/reports/global-competitiveness-report-2013-2014

Considering previous indicators presented, it is obvious that the investment climate in the Western Balkans still exhibits significant shortcomings. Skills, technology absorption, capacity, institution building and the overall business environment will become more important (Snoy, 2011). A closer look at the key aspects affecting the investment climate, in particular the frail institutional and administrative framework (Kostovicova, *et al.,* 2013), clearly indicates that there is substantial room for improving the overall business climate to boost investments and other economic activities, notably for involving the private sector in infrastructure developments.

CONCLUSIONS AND RECOMENDATIONS

The growing awareness of the WBC that the efficiency of the foreign trade policy affect economic growth has led to their strategic approach and to the adoption of comprehensive regulatory reform strategies, such as:

- Encouraging trade and improvement of the Western Balkan countries’ potential for exports and imports, especially through appropriate infrastructural links, which can make them, combined, and the region as a whole, more attractive for investment than any Western Balkan country taken separately;
- The focus must be on maintaining price competitiveness, stabilising labour costs and improving productivity, all of which require extensive and difficult reforms.
- Further encouraging the fragile economic recovery and supporting economic growth, consolidating fiscal policy, balancing national budgets, solving liquidity problems and problems connected with national currency fluctuations.
- Intensifying trade with more demanding markets, might be of crucial importance for the future developments of Western Balkan countries;

- Further supporting the modernisation efforts of the countries in the region, including structural reforms in all the respective areas, but also strengthening the main domains of democratic development, such as the rule of law, good governance, political consolidation and ethnic tolerance;
- Removing obstacles to regional cooperation and stability;
- Further efforts on the part of WB countries to improve their business environment by implementing effective legislation and reducing bureaucratic hindrance and corruption could help draw the interest of foreign investors. Under current circumstances, it will be quite a challenge to attract foreign investment. This only serves to underline that the management of FDI and its diffusion to tradable sectors, particularly manufacturing, is also of great importance.
- There are other aspects of investment climate and business practices that can be important for investment and growth, for example, the quality of infrastructure and inequities in the tax treatment of formal and informal firms can be significant obstacles to domestic and foreign investment;
- WB countries should interchange best practices in legal and regulatory environment, as well as other aspects of the investment climate, so that ranking improvements can be comprehensive and faster. This is important not only to attract foreign investors, but also to serve as a benchmark for reforms and promote economic growth.

LIMITATIONS & FUTURE RESEARCH

The paper features certain limitations, related to the availability of trusted and comparable data (especially BiH and Kosovo, due lack of statistics). However, with the selected approach we tried to provide more than a momentary snapshot of the situation and at the same time attempt to capture trends, which might be useful for the explanations and most of all for the elicit projections for the future that may be used for policy recommendations. The analysis above has suggested a variety of starting points and diagnostics to tackle the shortcomings and constraints to future growth in WBC**.** It has also concluded that, on an individual basis, available competitiveness and business environment indicators have limited value for policy-makers, but that taken together they can provide a valuable instrument.

In the future it will be interesting to research the effects of different obstacles for trade in the Western Balkans region, such as non-tariff barriers (particularly technical and administrative barriers). Research related to the factors that attract FDI in the transition economies is particularly interesting. An extension of this research would be to examine how these factors influence overall imports and exports and to compare them among countries.

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