SWP Comments

Stiftung
Wissenschaft und
Politik

German Institute
for International and
Security Affairs

The EU and the Western Balkans: So Near and Yet So Far

Why the Region Needs Fast-Track Socio-Economic Convergence with the EU

Matteo Bonomi and Dušan Reljić

The European Commission will unveil its new EU Enlargement Strategy on February 6th, 2018. Since relations with Turkey have deteriorated markedly, only the Western Balkan states remain candidates for EU membership. The EU High Representative for Foreign Affairs and Security Policy, Federica Mogherini, has stated the European Commission's intention to ensure that the Western Balkan countries are on an "irreversible" track to membership in the Union before the end of its mandate in 2019. Unless the new Enlargement Strategy offers a realistic plan to tackle the lack of economic growth and social progress in the region, it will be another futile institutional exercise because democracy, the rule of law and other basic distinctions of "Europeanness" cannot make lasting inroads into the enduring poverty in the Western Balkans.

In the past two decades, the Western Balkan countries have largely enacted the fundamental economic reforms requested by the European Union (EU), the World Bank and the International Monetary Fund (IMF) under the so-called "Washington consensus", following the matrix previously created for Central-Eastern Europe (CEE). They have opened their markets to the EU, privatised and liberalised their economies, and imposed austerity policies during the post-crisis period. The idea behind the "Washington consensus" was for the reforms, in combination with the progressive adoption of EU laws, principles and activities in the framework of the EU's enlargement policy, to create functioning market economies, foster democratic institutions and pave the way for EU membership. Things have turned out differently from the transition blueprint that was envisaged for the Western Balkans, however. The expectations that these countries would gradually converge towards EU economic standards and become consolidated democracies have not been met.

Without doubt, the transition in CEE has not been a complete success story either. Leaving aside political considerations about the state of democracy in some CEE countries, and in purely economic terms, it is evident that only those in the CEE region that started from better economic conditions, notably the Czech Republic and

Dušan Reljić is Head of Brussels office of SWP.
Matteo Bonomi was visiting scholar at the Brussels office of SWP in 2017

Slovenia, have come close to reaching the living standards of the poorer countries of Western Europe. The economic performance of the Western Balkans has been particularly disappointing, even when compared to the relatively modest results in CEE.

Western Balkan states such as Bosnia and Herzegovina and Serbia are in the group of countries that are worst off in terms of income inequality and recovery of their pre-transition GDP. These two countries, together with Montenegro, have not yet reached their real 1989 GDP level. If we look at the average GDP per capita in Purchasing Power Parities (PPP) in 2016, the six Western Balkan countries had not reached 28 per cent of the level in the old EU member states (the so-called EU15), while CEE was at around 60 per cent of the EU15 average.

The Western Balkans' inability to beneficially integrate with the EU economy can be illustrated by their limited overall exports, particularly of manufactured goods. Exports of goods and services as a share of GDP represent a low 30 percent on average in the Western Balkans. This is far below the 80 percent averaged by similar-sized transition economies now in the EU. Moreover, manufacturing exports of the Western Balkans are less sophisticated, since the region still confines itself to labour and resource-intensive products. Whereas in CEE, the early arrival of foreign direct investments has favoured the transfer of capital, know-how and modern technology, thereby also facilitating re-industrialisation, in the Western Balkans, most countries have experienced almost three decades of continuous deindustrialisation.

Closer Economic Ties to the EU, but with Negative Results

Faced with these sobering results, the IMF, World Bank and other international organisations usually point to "reform fatigue" and vested interests within the Western Balkans to explain the poor economic performance and loss of reform momentum. Yet such a narrow focus is not entirely adequate, since it does not take into account the long-term causes of the current economic, social and political situation. When in the early 2000s the international strategies towards the Western Balkans region changed dramatically, the overall political and economic conditions in the region were far worse than in CEE in 1989. The legacy of a disintegrating Yugoslavia and the ensuing wars in the 1990s meant that potential EU candidates in the Balkans adopted the EU integration path, with rapid market opening and economic integration with the EU. This path was embarked upon despite devastated industrial capacities, thriving shadow economies, extremely weak states marked by dysfunctional public administrations, widespread corruption and unsatisfactory education and health systems and other socio-economic flaws.

While economic performance did improve, the strong growth during 2001-08 was primarily based on the inflow of foreign capital without leading to profound economic restructuring and modernisation. The institutions that governments tried to put in place to regulate the markets and safeguard competition were inefficient, often leaving tycoon capitalists a free hand to exercise quasi-monopolistic power. At the same time, foreign investors mainly targeted the non-tradable sectors, contributing to deindustrialisation, insufficient job creation and widening trade deficits.

The unsustainability of the growth model in the Western Balkans became fully apparent when the global financial and economic crisis in 2008/2009 hit the region badly. The Balkan countries were particularly affected by the crisis due to their already strong integration with the EU. As a result, the growth of the last ten years has been nullified, while during the same period these countries accumulated a trade deficit with the EU of 97 billion euro (2005-16) paralleled by increasing foreign debt. Whereas a substantial part of the Western

Balkans' GDP is transferred yearly to core EU countries such as Germany and Italy through trade deficits and the repayment of loans to Western banks, Western Balkan countries, unlike the new EU members, do not qualify for the EU structural funds or other grants that would alleviate the impact of the economic crises and foster growth. Funds from the EU's Instrument for Pre-accession Assistance range from around 40 million euro a year for Montenegro to 200 million euro for Serbia and are directed almost entirely to supporting administrative and other institutional reforms, without sufficiently taking account of the enormous development gap between the Western Balkans and the EU.

All in all, almost two decades of EU-Balkan economic integration have led to a pronounced dependency on the EU. Today, from a socio-economic perspective, the pre-accession countries in the Balkans already appear to be part of the European club – but with many disadvantages and no voting rights. The Western Balkans have 73% of their total goods trade with the EU within an almost completely liberalised trade regime. Between 75-90% of their banking systems are foreign-owned (mainly by German, Italian, French, Austrian and Greek banks). Almost all countries have adopted fixed exchange-rate regimes, formally or *de facto* linking their currencies to the euro or using the euro (Kosovo, Montenegro). However, close economic ties with the EU have not helped economic modernisation to take hold or the Western Balkans' capacity to develop. Despite being so close to the EU, the region remains a long way from achieving stability and prosperity and thus firmly embarking on the road to successful European integration.

Precarious Decades Lie Ahead

Today, just as economic recovery in Europe is starting to take root, timing is critical to consolidate growth and establish a sustainable development path. Securing the political support of the population for the further reforms required by the EU accession process depends on it. Yet the challenges facing the Western Balkans are complex and formidable. To date, even under the most optimistic economic forecasts, the expected average Western Balkans' GDP growth rate of around 3 percent is insufficient to accelerate the process of catching-up and convergence. A recent estimation by the World Bank indicates that at current growth rates, it would take about six decades for average per capita Western Balkan income to converge with the EU average. With faster growth of 5 to 6 percent, convergence could be achieved by the end of the 2030s.

This means that by then, broad sections of the population would have spent over half a century in poverty and precarious socio-economic conditions. It should therefore come as no surprise that the "EU model" is being questioned by a considerable part of the populace, who are less and less convinced that this model is the universal remedy for all political and economic troubles. This view is at odds with the dominant political discourse, both in the region and among external Western actors. This disparity opens inroads for other political and economic concepts that, as a rule, tend to be populist and authoritarian.

The current political and economic debate focuses on the need for a new growth model for the Western Balkans and insists on the need to reform domestic institutions. However, it is far from clear what this means in terms of concrete policies. International organisations such as the World Bank and the IMF have advocated a further reduction in the size and role of the state, usually pointing to the need for the Western Balkans to improve the business environment as one of the key elements to attract more foreign investment and drive economic development. The position adopted by the EU is slightly different in that it has embraced a broader notion of what reforming domestic institutions entails. Since 2014-15, especially, with the EU's new approach to economic governance towards the enlargement countries and the launch of the Berlin process, more emphasis is being placed on improving in the quality of state apparatus and the entire policy cycle, together with longer-term structural reforms.

After over fifteen years of experimentation with neo-liberal economic prescriptions, strengthening economic governance in the Western Balkans seems to be one of the key factors to accelerate economic growth and development. Infrastructure projects should be supplemented by additional investments in health, social services, education and research and development, which in turn could facilitate the development of smarter and more knowledge-based economies, together with better access to resources for small and medium-sized enterprises.

The EU's "Soft Belly" Needs Attention

A glance at the map of Europe shows that the region is not the EU's south-eastern courtyard but rather its overlooked soft belly – surrounded by EU and NATO member states. Also, all essential political outcomes in the region over the last three decades were masterminded and micromanaged by the EU and the Western allies. Only recognition from Brussels and other EU capitals of the Balkans for what they genuinely are – namely an integral part of core Europe and the European integration project – can offer a way forward. In this respect, a more flexible and differentiated approach towards the Balkans is required to improve the current enlargement policy. This approach could pragmatically advance sectoral integration and provide the missing link between present conditions and their eventual date of entry into the EU.

In concrete policy terms, the EU should:

- (1) mobilise resources for the Western Balkans that are proportional to their level of market integration, with the EU considering ways to open structural funds even before accession, or provide similar amounts of funds through regional or similar projects. These would also be beneficial to the ring of EU countries around the Western Balkans (primarily targeting infrastructure, transport, energy and environment protection);
- (2) extend the use of EU financial stability mechanisms to the region, taking into consideration that the local banking system is largely owned by banks from the EU;
- (3) include the Western Balkans in the EU digital market and free roaming to facilitate business contacts and other trans-border initiatives;
- (4) expand cooperation in education and research and innovation policies (Horizon2020, Erasmus) with a focus on the developmental needs of the region;
- (5) enable a stronger integration for their labour markets to favour circular migration and the return of economic migrants;
- (6) explore ways to include the Western Balkans in EU policies and actions in the field of justice and home affairs.

Given the small size of the Balkan countries (merely 3.6% of EU's population), measures in this direction would have a limited overall impact on EU member states, but they could go a long way towards restoring the credibility of EU policies in the region. It is in the EU's own economic interests to make the region more attractive for trade and investment, and to link the transport, energy and digital networks of the entire south-eastern Europe area. This would also lessen migration pressures. The potential political gains are obvious too: strengthening security in south-eastern Europe would boost the EU's standing in a new era of geopolitics, when China, Russia, Turkey and certain Islamic states also vie for influence in the region. The next EU institutional cycle, starting in 2019 with the election of the new European Parliament, a new Commission and the adoption of the new EU budget, should also bring about a reformed enlargement policy.

SWP
Stiftung Wissenschaft und Politik
German Institute for International and Security Affairs

Ludwigkirchplatz 3–4
10719 Berlin
Telephone +49 30 880 07-0
Fax +49 30 880 07-100
www.swp-berlin.org
swp@swp-berlin.org

ISSN 1861-1761