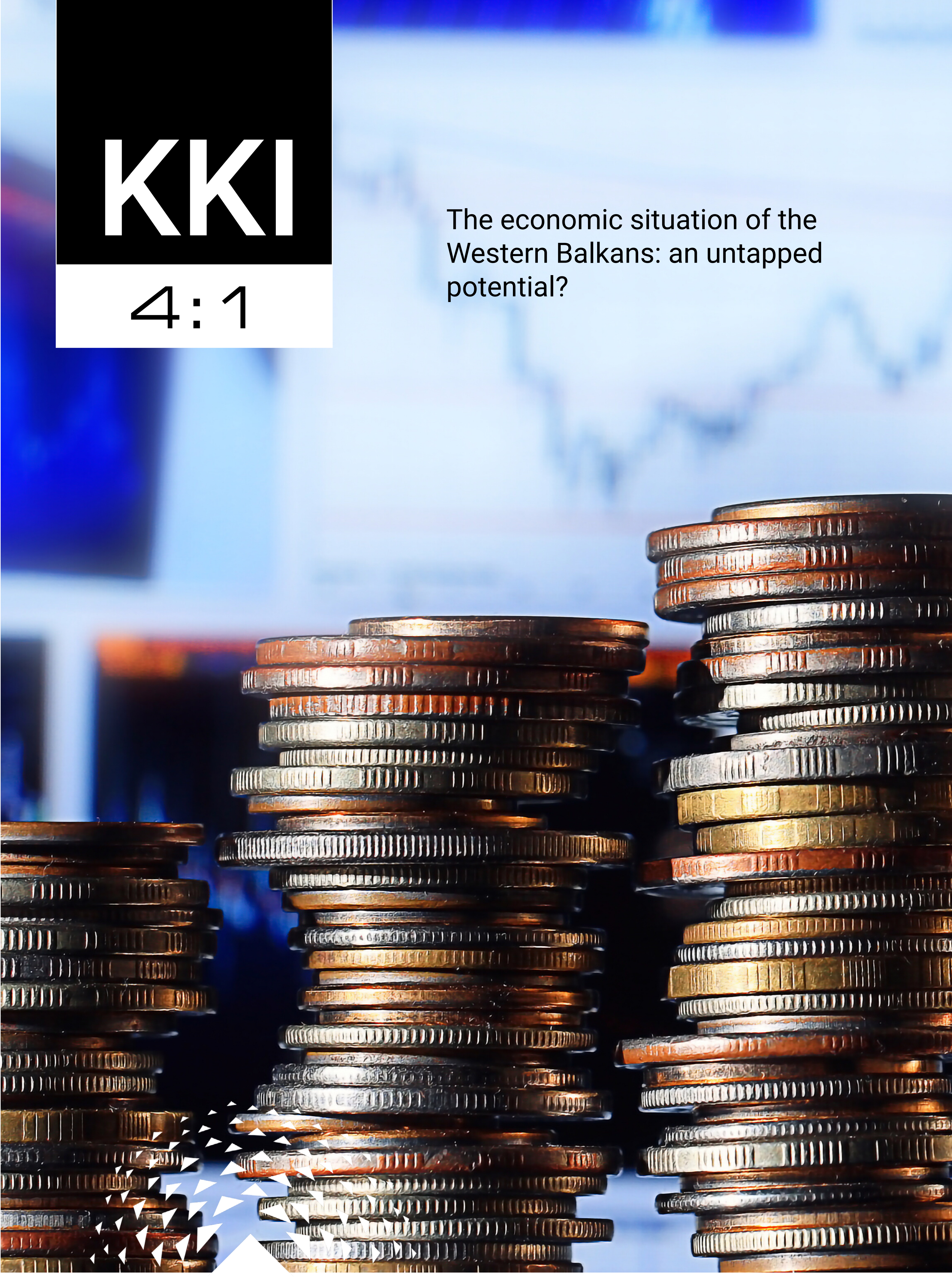
KKI 4:1

The economic situation of the Western Balkans: an untapped potential?



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In the 4:1 series of the Institute for Foreign Affairs and Trade, four experts give a short answer to the same question concerning international politics and economics. Our aim is to launch scientific debates in and beyond Hungary and promote dialogue among experts. In this issue our topic is *"The economic situation of the Western Balkans: an untapped potential?"*

Viktória Endrődi-Kovács

In economic terms, the Western Balkan countries are small countries with limited economic resources and potential. Their markets, population, and income are relatively low compared to most European Union (EU) member states. In spite of this, the economic role of the region has appreciated in light of the prospect of EU accession, as it had done in previous accession rounds. In addition, these countries still have untapped economic potential for investors in terms of economic growth and development.

The proximity of the region to the European Union, its higher economic growth potential and lower labour costs create opportunities to attract more Inward Foreign Direct Investments (IFDI). Although Serbia stands out in the Western Balkans in terms of attracting FDI, the received IFDI (both in flows and stocks) still lags behind the Central and Eastern European (CEE) average before EU accession. The IFDI trends show that before CEE countries' accession rounds in 2004, 2007, and 2013, these countries started to attract more IFDI, which increased significantly after the accession. We can also expect this in the case of Western Balkan countries, since there are several attractive opportunities for investors, such as the car industry and transportation (e.g. BMW in Bosnia and Herzegovina, vanHool in North Macedonia, or Hyundai in Albania), food/beverage processing, or the leather and shoe sector in Albania. The Western Balkans still have economic potential for further investment and for strengthening their embeddedness in the global value chains. Local availability of raw materials, improving the investment climate through strong government commitment, competitive fiscal and incentive regimes compared to CEE member states, or the first-mover advantage to enter these markets can give a competitive advantage to the region in attracting foreign direct investment. Euroization in Montenegro and Kosovo or the other fixed exchange rate regimes used in Bosnia and Herzegovina or North Macedonia ensure stable prices for investors.

On the other hand, these countries have weaker institutions, higher corruption levels, and less developed (but developing) infrastructure and logistic performance than other CEE or European countries, which makes the Western Balkan region more risky for investors. Furthermore, some believe that these countries offer generous incentive packages to foreign investors (from total to partial profit tax breaks, tax-holidays for employee benefits, subsidised salaries, investment grants, custom tax reliefs, and 'special' treatments in provision of public services), which is disadvantageous for the economic development of these countries, since it results in a race to the bottom (when countries give more subsidies and incentives than they receive as a result of IFDI). These generous investment packages and state aid must be reconsidered in the future to be in line with the EU rules. Finally, since the Western Balkan countries are relatively small, the trends in the world economy shape the economic performance of the region. Due to the pandemic, FDI flows have started to drop, and this trend can also be observed in FDI flows to this region. Future FDI flows also depend on how fast the global economy and global value chains will recover or be restructured. The latter can provide an advantage for the region due to nearshoring and the appreciation of regionalism.

Beside the FDI trends, trade can be highlighted as an economic potential. Trade relations with the EU will probably intensify as these countries join the EU, since there will be more investments when the region abolishes the remaining tariffs on goods imported from the EU. The Open Balkan initiative (previously called 'mini-Schengen') also brings more trade facilitation and opportunity for economic growth for the countries that join it. Serbia's trade agreement with the Eurasian Economic Union (EAEU) also carries further economic potential.

Since the economic development of these countries is lower than the EU average, there is potential for higher economic growth. However, the Western Balkans are not only facing Covid-19 but also structural weaknesses such as relatively low firm-level productivity, limited market competition, weak institutions, a grey economy, and relatively high unemployment rates (mainly among young people and women), which can hinder their future economic growth and convergence.

Other aspects that must be mentioned about untapped potentials include energy security (e.g. the role of Balkan Stream as an extension of Turkish Stream) and transport routes (e.g. the Budapest–Belgrade railway). Although these topics are controversial in the media and also raise geopolitical concerns, they (will) have a significant economic impact and can create further economic potential in this region. For instance, the Budapest–Belgrade railway can facilitate transportation from Serbia to Budapest and onward to other European countries, reducing time and cost. In addition, the role of the Balkan Stream can appreciate in an environment where international gas prices are rising, and a European gas shortage is a real threat, since it can diversify energy routes and bring higher competition to the natural gas market.

Attila Galambos

An untapped potential? Yes and no. But to whom and from what point of view?

The Western Balkan region has become a popular topic again, attracting the attention of political decision-makers and economic experts, as well as academia.

But who cares about the Western Balkans? The great powers and the large global and regional players see it primarily as a geopolitical playing field, a testing ground for conflict generation and management. However, the investments that fit into the global system do not affect the region. As the region is part of Europe, first and foremost we need to interpret its economic position within the continent. In terms of economic relations, developed European countries have already built their bridgeheads in the past, although this does not mean their continued economic presence.

Sufficient economic dependence has been created through the political floating of the European Union (EU) membership and the provision of pre-accession funds. The low-level utilization of the Instrument for Pre-Accession Assistance (IPA) over the years is not primarily a failure of the host states but a tactic of the EU to keep the region under control, thus preventing the creation of an integrated, strong European economic centre in global economy. Instead, the EU member states that have undergone similar historical, political, and economic developments and have geographical proximity to the area are interested in cooperation with the Western Balkan region.

Hungary as a neighbouring country recognized the advantageous situation of the region through the announcement of the Western Balkans Strategy in 2013. Following the political declarations, it has also allocated financial and economic devices for the implementation of the strategy, through various areas, institutions, and programs, especially in recent years. The prerequisite of lasting success is the continuous coordination of these programs and economic development instruments, as well as the creation of an interactive dialogue with the companies implementing the programs. It is important to know the local markets and the development strategies of all the Western Balkan countries, as is filtering and preparing Hungarian companies intending to enter foreign markets in the medium and long term. No matter how fast the circumstances change, appearance and lasting presence in foreign markets requires gradual adherence.

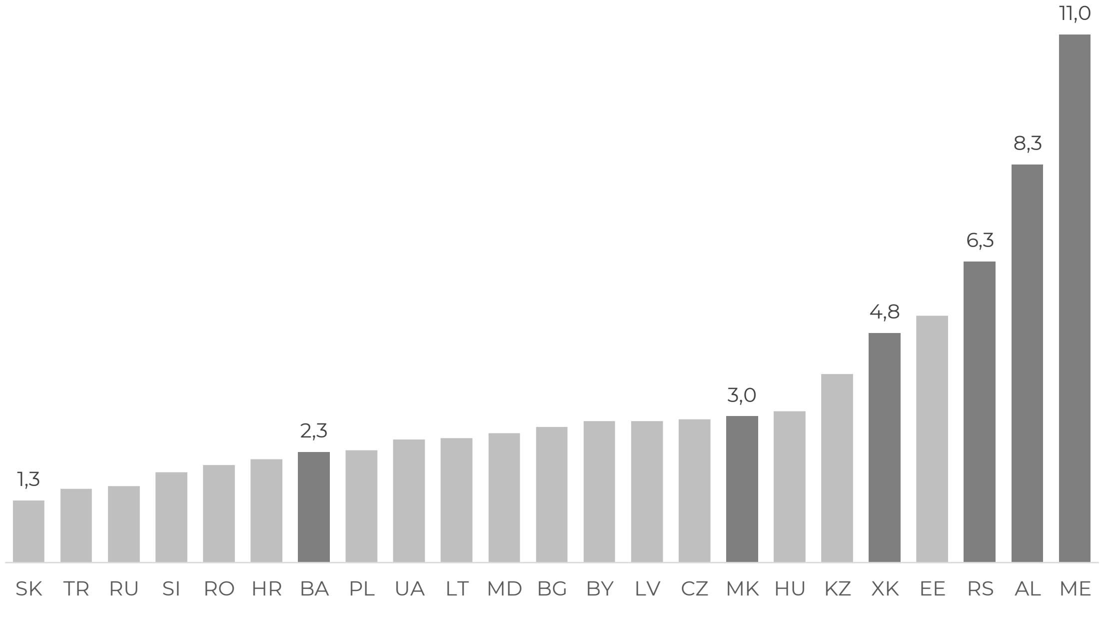
The changes of recent years, especially the economic shock and inability to act caused by the pandemic, have highlighted the strong negative effects of globalization and global value chains, with a focus on regionalism and the revival of former rational economic activities. The retention of the labour force within the country is a priority, and it is not possible to follow the practice of extracting labour force within Europe.

At this historic moment Hungary is about to use the experience it has accumulated and its knowledge of the region in combination with company-level opportunities to be successful in the Western Balkans.

Branimir Jovanović

For as long as I can remember, FDI has been a sacred word in the Western Balkans. Economists have been constantly repeating that you need to attract foreign investors in your country, in that way you bring capital and technology, you employ people, and you ensure economic growth and development. Politicians have similarly always placed FDI high on their agenda, doing all kinds of things to lure in foreign investors, bragging about each new company that would come to their country. And it seems that Western Balkans did quite well in this sense during the past decade (2011-2020) – FDI inflows in the region were solid, much better than in any other Eastern European region (Figure 1). Montenegro, Albania, and Serbia were on top, attracting more FDI than any other country from the region relative to their size, Kosovo and North Macedonia also did quite well, only Bosnia and Herzegovina did not impress.

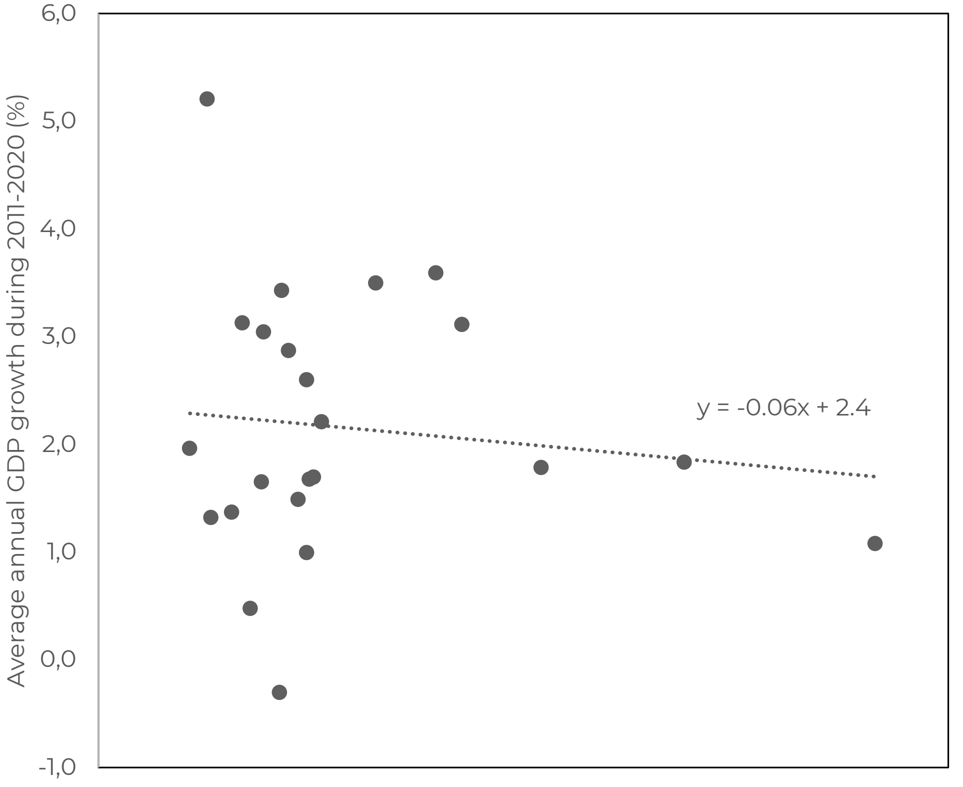
Figure 1.
Average annual FDI inflows in Eastern European economies during 2011-2020 (% of GDP)



Source: wiiw FDI database

However, despite the strong FDI inflows, economic growth remained low, poverty remained high, and the Western Balkan economies continued to lag well behind the EU countries in every sense. FDI has simply failed to bring robust economic growth. In fact, the association between FDI inflows and GDP growth in Eastern Europe is negative during 2011-2020 – the countries that had stronger FDI inflows had on average lower GDP growth during these years (Figure 2).

Figure 2.
Association between FDI inflows and GDP growth in Eastern European economies during 2011-2020



Source: wiiw FDI database and wiiw Annual database

How can this paradox be explained? It is actually fairly simple – the FDI that the Western Balkans was attracting was mostly low-tech, low value-added, and low-wage. The prototype has been an assembly line employing several thousand people, paying wages close to the national minimum, importing virtually all of its inputs, with few connections to the rest of the economy. Such FDI may help reduce unemployment, but it does not necessarily reduce poverty and inequality, it does not bring new technologies to the country, nor does it help domestic companies.

Every crisis is an opportunity, the old adage goes, and the COVID-19 pandemic, as the biggest crisis of the last several decades, is a crisis that must not be wasted.

Two years after the emergence of the pandemic, global supply chains are still upside down due to the numerous disruptions to production and transportation from far-away destinations. According to one recent survey of 3,000 German companies with international operations, 54% of the companies are facing problems with their supply chains, 72% of which are looking for new suppliers, and

15% are thinking of relocating production. This offers a huge opportunity for the Western Balkan economies, who are the natural first choice for the German and European companies that want to bring production closer to their countries due to their geographic proximity, availability of labour, and relatively low wages.

However, as we have found in our recent study Getting Stronger After COVID-19: Nearshoring Potential in the Western Balkans, for the Western Balkan economies to really benefit from these near-shoring trends in the post-pandemic world, they would have to go beyond low labour costs, which was their main story for attracting investors in the previous decade. They would have to focus on skilled labour, investment in education and training, and improving infrastructure and governance, as these factors are even more important for foreign investors than low wages.

Simply put, Western Balkan economies should change their story. Instead of promoting themselves as low-cost countries, they should promote themselves as high-quality countries. Instead of only attracting FDI, they should try to attract good FDI, for example, in hi-tech, which has higher value added, pays higher wages, can have positive technological spill-over to the rest of the economy, and it can integrate domestic companies into their value chains.

The COVID-19 pandemic provides the Western Balkan economies with a huge opportunity to change their economies, to make them better, stronger, fairer. Whether they will take this opportunity only depends on them.

Dženita Šiljak

The Western Balkan countries, namely Albania, Bosnia and Herzegovina, Kosovo, Montenegro, North Macedonia, and Serbia, seemingly have all the prerequisites of success. They are transition economies that can follow the path of the Central and Eastern European (CEE) countries, with which they share a similar, socialist past. Therefore, the transition process should be easy and fast. Looking at the positive side, it can be concluded that these countries have a lot to offer to foreign investors. These diversified economies are characterized by macroeconomic stability, low taxes, a cheap and educated labour force, they are candidates and potential candidates for European Union (EU) membership, and they are positioned close to the EU, which is the main trade partner of the region. However, looking closely, it can be concluded that although the Western Balkan region performs well quantitatively, it does not do so qualitatively. The Western Balkan economies are growing, but at a lower rate compared to the CEE countries; they converge towards the EU, but at a lower rate than they could and should; they offer low tax rates, but the process of preparing and paying for taxes is too long and complicated; the labour force is cheap, but its productivity is only around 40% of the EU average; the unemployment rate has decreased, but due to migration; they are diversified economies, but they also rely on the production of services even though their technology is obsolete, and they are not competitive, especially in the EU market.

Even though the countries can offer a lot of advantages to foreign investors, without whom the transformation from a centrally planned to a market economy is not possible, the region is not their favourite destination. There are two reasons for this: inefficient institutions and political instability. While during socialism the state controlled all aspects of the economy, and there were no independent institutions, this must change during the transition process, and the state is expected to create a healthy and stable business environment with efficient public administration. In the Western Balkans, the level of corruption is much higher than the EU average, property rights are not protected enough, and the judiciary system is not independent, which discourages foreign investors from coming to the region and hampers economic growth and development.

The Western Balkan countries have consistently had difficulties moving forward on their own, without external prodding. The EU has helped significantly through financial aid (with the help of the Instruments for Pre-Accession Assistance), as well as through guidance on the necessary and expected reform measures. Ultimately, it is up to the countries to find the political will to change. They are not functioning market economies that can compete in the EU market because the quality of their products is not sufficient enough to meet EU standards. This situation can be improved with FDI inflow, but companies are reluctant to invest in a country where governments cannot last from one election to another and where threatening with war is an everyday topic.

In the end, what can be done? Now it is up to policymakers in institutions to start changing the situation. The Western Balkan countries must complete the transition process, which has already lasted thirty years, they have to open their economies to more trade and investment, decrease the level of corruption, and make the business environment less complicated. Taking quantity into consideration, the region looks favourable. However, it is the quality that matters and what is lacking in the Western Balkans.