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ANALYSIS

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Towards A Sustainable Economic Growth and Development in the Western Balkans

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- Since the beginning of the transition to a market economy in 1989, the Western Balkan (WB) countries have faced particular difficulties in economic development, under the impact of the breakup of SFR Yugoslavia, military conflicts and international sanctions, thus delaying important economic and institutional reforms as well as integration with the European Union.

- During the 2001-2008 period there was a general improvement in macroeconomic performance of all Western Balkan countries, especially among those lagging behind witnessed: an acceleration in GDP growth, declining inflation, a fast rise in foreign trade, substantial FDI inflows and the implementation of many transition-related economic reforms.

- The global financial and economic crisis severely hit the WB countries through two main channels – a drop in export demand in foreign (mainly EU) markets and the abrupt reduction in foreign capital inflows (foreign loans, FDI, donors' assistance, workers' remittances). Thereafter, most WB countries experienced a deep recession or a notable GDP slowdown (Albania, Kosovo), followed by a period of prolonged stagnation or repeated recessions and a very gradual economic recovery.

- The multiple economic crises in the WBs after 2009 brought to the surface many structural problems: serious external imbalances deriving from high trade and current account deficits, essentially caused by insufficient competitiveness on foreign markets; mounting social problems, also due to the highly unsatisfactory situation on the labour markets; extreme deindustrialisation along with a fast expansion of services (banking, telecommunications, retail trade, real estate) that primarily serve the domestic market, thus contributing only indirectly to the development of the tradable goods sector and improved external competitiveness.

- The macroeconomic situation in the last few years has somewhat improved (gradual economic recovery, low inflation, some fiscal consolidation, lower current account deficits), but current economic policies are severely constrained – monetary policy by rigid exchange rate regimes and the high degree of euroisation of the WB economies, fiscal policies under strict EU surveillance.

- Moreover, the structural weaknesses of the WB economies have not been removed. In comparison with the Central East European and the Baltic (CEEB) countries, the WB countries are today less developed, less competitive and less integrated into the global economy; most countries still have extremely high unemployment rates and low employment rates; and they are more de-industrialised than even some of the older, and most of the newer, EU member states.

- The WB countries should aim at implementing a model of development that balances economic, social and ecological aspects. Key issues to be addressed in the future, through more efficient industrial policies and development strategies, include agriculture, energy, R&D (human capital) and public administration reform.

Introduction

Although the transition to a market economy and multiparty democracy in the Western Balkan (WB) region started in the late 1980s, in comparison with countries in Central and Eastern Europe and the Baltics (CEEB), most WB countries are today lagging behind in their level of economic development, economic and institutional reforms, and integration with the European Union (EU). The aim of this paper is to offer tentative answers to some fundamental questions regarding the WBs' economic development. Why have the WB economies performed worse than those in CEEB? Why are they still so underdeveloped? Why have similar policy prescriptions regarding the transition-related economic reforms had much more limited results in the WBs than in CEEB? The analysis of a quarter of century of transition should also point to possible remedies, namely more appropriate policy options for the WBs in the future.

We will consider the region in its narrow definition of the Western Balkan (WB) states— Albania, Bosnia and Herzegovina, former Yugoslav Republic (FYR) of Macedonia (hereafter Macedonia), Montenegro, Serbia and Kosovo. However, we will also add Croatia and refer to the whole group as the WBs.[1] Although Croatia became the 28th EU member state in July 2013 and therefore is no longer part of the WBs, it will be included in the analysis since its experience before joining the EU is very relevant for the economic problems of the other WB countries. In discussing the pre-1989 period, Slovenia will also be considered, since it was one of the republics of SFR Yugoslavia.[2]

1. There have been a number of statehood changes over the past 25 years. Five states were created immediately after the disintegration of the Socialist Federal Republic (SFR) of Yugoslavia in 1991: the Federal Republic (FR) of Yugoslavia, constituted in April 1992, consisting of Serbia with its two provinces, Vojvodina and Kosovo and Montenegro; Bosnia and Herzegovina; Croatia; Former Yugoslav Republic of Macedonia; and Slovenia. FR Yugoslavia changed its name into the State Union of Serbia and Montenegro on 4 February 2003; and after the May 2006 referendum on independence in Montenegro, Serbia and Montenegro became two independent states in mid-June 2006. Kosovo officially remained part of Serbia, according to the UN Security Council Resolution 1244 adopted in mid-1999, though effectively it was governed by UNMIK thereafter; in February 2008 Kosovo unilaterally declared its political independence. All statistics after 1999 on FR Yugoslavia/Serbia do not include data on Kosovo.

2. After its independence, Slovenia shared many features of the Central East European (CEE) countries and therefore has most frequently been considered as part of the CEE region.

In order to understand the starting conditions in the WB region, the paper will first give a short overview of the economic developments before 1989 (section 1). The main political and economic problems encountered by the WB countries after 1991 are then addressed, pointing to the main factors that have impeded a faster implementation of the transition during the 1990s (section 2). The principal achievements and failures of economic policies during the new millennium are then highlighted, both during the years of relative prosperity (2001 – 2008) (section 3) and the years after the global crisis (section 4). The main structural problems of the WB economies, that came to the surface after the 2008 economic crisis, are also discussed (section 5). The economic situation in the WB countries today is analysed in some detail, pointing to specific macroeconomic constraints (section 6). The key policy failures in a longer-term context are stressed, as well as some areas that need to be included in future strategies of economic development (section 7). The main conclusions and policy recommendations are given at the end (section 8).

1. The Western Balkans prior to 1989

On the eve of transition to multiparty democracy and a market economy, the general situation in the Western Balkan region was very different from what it is today. The region consisted of only two countries: the Socialist Federal Republic (SFR) of Yugoslavia with its six republics and Albania. SFR Yugoslavia was a much larger country in terms of territory and population, it had a much higher GDP per capita, it experienced various market-related economic reforms, developed a unique system of workers' self-management and implemented substantial decentralisation of its economy, particularly after 1974. Moreover, after the Tito-Stalin conflict in 1948 SFR Yugoslavia developed specific international relations which placed it somewhere between the East and the West,[3] enabling its increasing trade orientation primarily

3. SFR Yugoslavia did not join the Council of Mutual Economic Assistance (CMEA) in 1949 (though it participated after 1964 in some of its standing committees) nor was it part of the Warsaw Pact; together with Egypt and India it founded the non-aligned movement in the late 1950s. It was also a founding member of the International Monetary Fund and

towards the OECD countries (in 1990, 59,8 percent of its exports and 63,7 percent of its imports were to and from developed countries).[4] SFR Yugoslavia also had a more liberal political regime despite retaining a one-party system: the League of Communists was highly decentralised to facilitate political decision-making in its six republics, and its citizens had more individual freedoms than elsewhere in Eastern Europe.[5] By contrast, in 1989 Albania was the least developed country in Europe. After leaving the Council for Mutual Economic Assistance (CMEA), it pursued, for decades, a specific autarkic development strategy idealising national self-reliance as the main orientation of its economic policy. Consequently, in 1990, Albania was the most closed economy in Europe. At that time, it still had a rigorously centralised economy based on the traditional system of central planning (see Muco, 2001). In contrast to the Yugoslav successor states that in 1991 inherited elements of the market mechanism, Albania had no previous experience of a market economy. Albania also had one of the most authoritarian political regimes in Eastern Europe.

SFR Yugoslavia started its transition in the late 1980s with a burden of severe economic problems. Until 1979, the Yugoslav government implemented an ambitious economic growth strategy based on high investment rates and relying increasingly on external borrowing (Uvalic, 1992).[6] Structural weaknesses emerged due to insufficient investment in crucial sectors (energy, raw materials), parallel with excess capacity in other sectors and the duplication of plants across regions. After Yugoslavia was no longer able to service its external debt, a stand-by arrangement was concluded with the IMF in 1980 and the austerity packages implemented thereafter led the economy into a deep recession. The economic crisis persisted throughout the 1980s, culminating in hyperinflation in 1989 (Uvalic, 1992). The political crisis within the Yugoslav federation after Tito's death in 1980 brought the regional issues to the fore, which gradually drifted out of control by the end of the decade (Estrin and Uvalic, 2008).[7]

The first steps to fundamentally change the economic system in SFR Yugoslavia were taken in 1988 when Amendments to the Constitution raised the limits on private property and encouraged FDI. In December 1989, the Federal government launched a bold macroeconomic stabilisation programme based on "shock therapy".[8] These economic reforms were interrupted by a series of disputes between the republics for both economic and political reasons, which soon after led to Yugoslavia's break up. At the same time, the dissolution of the League of Communists of Yugoslavia in January 1990 led to the emergence of new political parties and the first free multiparty elections, which took place from April to December 1990 in all the Yugoslav republics.

Despite the complex situation prior to SFR Yugoslavia's break-up, there is no doubt that its successor states had better initial conditions than the centrally planned economies in Central and Eastern Europe (Uvalic, 1992). Kekic (1996: 5-22) calculated an index of initial conditions[9] in 26 communist countries in the late 1980s, showing that the index was lower for Bulgaria (13), Albania

the World Bank in 1944 and participated actively in the various rounds of the General Agreement on Tariffs and Trade (GATT). SFR Yugoslavia was an associate member of the OECD (the first OECD Economic Survey of SFRY was published in 1963) and it had a privileged relationship with the European Community - from the early 1970s through various trade agreements and benefiting from the Generalised System of Preferences; and since 1980 through a Cooperation Agreement which besides trade regulated other important fields of cooperation, including financial assistance, energy, transport and technology; see Uvalic (1992), p. 9.

4. In 1990, within the group of "developed countries", 45,8 percent of SFR Yugoslavia's exports went to the European Economic Community (EEC) and another 6,8 percent to the European Free Trade Association (EFTA) countries, while 44,3 percent of its imports were from the EEC and another 9,9 per cent from the EFTA countries; the rest was trade with the US and other developed countries; calculated from data of Savezni zavod za statistiku, 1991, p. 319.

5. For example, after 1965, Yugoslav citizens were free to travel abroad with passports that were issued for a period of five years (Uvalic, 1992). Moreover, visas were not required at that time to travel to any West European country.

6. Yugoslavia's external debt increased from less than US$ 2 billion in 1970 to US$ 14 billion in 1979 and, following the second oil shock, to US$ 18 billion in 1980 (based on official Yugoslav statistics, in Uvalic, 1992, p. 10-11).

7. For a very interesting empirical analysis of economic development in SFR Yugoslavia and its successor states throughout the 1952-2013 period, see Bicanic et al. (2016).

8. As a response to hyperinflation, the "shock therapy" was based on the pegging of the exchange rate to the German mark, the introduction of resident convertibility, freezing of money wages, strict monetary control, liberalisation of 75 per cent of prices (except for public utilities, some metals and pharmaceuticals) and liberalisation of 95 per cent of imports. A privatisation law was also adopted in December 1989 (Uvalic, 1992).

9. The index was calculated taking into account various indicators, including GDP per capita, dependence on CMEA trade, external debt, energy intensity, economic structure and general government expenditure.

(15) and Romania (15) than for the Yugoslav republics (19 for Serbia and Montenegro, 20 for Macedonia, 22 for Croatia and 24 for Slovenia). Within SFR Yugoslavia, there were major differences among its six republics regarding most economic indicators, but the institutional set-up was similar (Uvalic, 2010). All the Yugoslav successor states inherited some elements of the market mechanism and the system of self-management, but also features typical of the socialist economic system, well described by Janos Kornai (1980) (e.g. state paternalism, soft-budget constraints, an over-investment drive) (Uvalic, 1992).

After the break-up of the Yugoslav federation in mid-1991, the speed of the implementation of transition-related economic reforms varied considerably. One might have expected that the extent of market-oriented reforms undertaken in the past, which gave all the Yugoslav successor states some of the best initial conditions, would have facilitated the transition; but instead of being the leaders among transition countries, most of them have turned out to be laggards (Estrin and Uvalic, 2008). The rest of this paper will try to further highlight why this was so. In reality, Yugoslavia's successor states inherited from SFR Yugoslavia not only institutional advantages, but also important disadvantages, primarily very complex political problems that would lead to a whole decade of extreme political and economic instability.

2. Delayed transition in the Western Balkans during the 1990s

Three groups of inter-related factors explain the WB countries' delay in the transition to a market economy during the 1990s (Uvalic, 2012): (1) the political events of the early 1990s, which had profound economic consequences; (2) inappropriate economic policies, including the neglect of important transition-related economic reforms; and (3) limited EU measures to facilitate the transition in the WB countries, thus postponing their economic (and political) integration with the EU.

(1) In the early 1990s, the WB region was negatively affected by several institutional shocks: the break-up of the Yugoslav federation, the accompanying military conflicts and the transition to market economy. All the Yugoslav successor states were directly or indirectly involved in military conflicts – Slovenia (1991), Croatia (1991-95), Bosnia and Herzegovina (1992–95), FR Yugoslavia (1998–99) and Macedonia (2001). In addition, FR Yugoslavia was under severe UN/EU sanctions during most of the decade (in 1992–96 and again in 1998-99), while Macedonia was under the Greek embargo.

The highly unstable political conditions in the WB region had very profound economic consequences. As elsewhere in Eastern Europe, the early transition-related economic reforms also in the WBs brought high inflation, a substantial fall in real GDP, a rise in unemployment and the worsening of other social indicators, but in the successor states of former Yugoslavia these problems were much more pronounced than in Albania or the CEEB countries (Uvalic, 2012).

(2) These political events had a very negative impact on economic performance of most WB countries. Albania's stabilisation efforts were relatively successful after the implementation of its shock therapy stabilisation program in 1992, backed by an IMF stand-by arrangement. Despite the financial crisis in 1996-98 due to the crash of pyramid schemes that again provoked inflationary pressures, from 1999 on inflation has been low. On the contrary, the successor states of former Yugoslavia initially gave priority to the political agenda. Most countries faced extreme macroeconomic instability due to the break-up of the Yugoslav political, economic and monetary union, fuelled further by expansionary fiscal and monetary policies related to the military conflicts. Inflationary pressures were substantially reduced in Croatia and Macedonia already in 1994 and 1995, respectively, but in FR Yugoslavia only in 2001-02.[10] The Yugoslav successor states also went through a deeper and longer recession than the CEEB countries (or Albania); and all countries except Bosnia and Herzegovina again experienced negative growth in the second half of the 1990s. Due to a very poor growth record during the 1990s,

10. FR Yugoslavia experienced extreme monetary instability in the early 1990s: in 1993 it had the second highest and second longest hyperinflation ever recorded in economic history, of 116.5 trillion percent (Uvalic, 2010, p. 56).

the process of economic recovery of the pre-transition level of real GDP has been much slower in the WBs than in the CEEB countries (see below).

Yugoslavia's break-up had a disruptive effect on foreign trade, which remained unsatisfactory also in the second half of the 1990s. The WB countries attracted very limited Foreign Direct Investment (FDI), which mainly went into the services sector and prevalently into Croatia (Estrin and Uvalic, 2014). After 1995, the war-affected WB countries did receive substantial donors' assistance, but this caused an acute problem of "aid addiction" – transfers of large amounts of international resources without the creation of sound conditions for more permanent self-sustaining growth (see Kekic, 2001). Until 2000, the dominant part of foreign/EU aid in the Balkans was used not for investment, but for consumption - emergency programs, humanitarian assistance and food aid (Uvalic, 2010, p. 221).

The 1990s also brought increasing social problems to the WBs – high unemployment, the flourishing of the informal economy and substantial social differentiation. As in CEEB, rising income inequality was partly the consequence of transition-related reforms (e.g. privatisation), but in the WBs it was further aggravated by the particularly difficult economic conditions and isolation of countries that were under international sanctions. Instead of contributing to the achievement of the desired political goals, the sanctions in reality facilitated the enrichment of the privileged political and economic elites (Uvalic, 2010).

Progress with transition-related economic and institutional reforms in the WBs during the 1990s has been variable, though generally slower than in CEEB countries. Initially, Albania, Croatia and Macedonia implemented some reforms at a faster pace than the other countries and were therefore labelled as the "early reformers". The unfavourable political conditions in Bosnia and Herzegovina and FR Yugoslavia postponed more radical economic reforms until later, so they have been labelled as the "late reformers" (see Bartlett, 2008). These initial differences in transition-related economic reforms have become less accentuated after 2001 (see section 3 below).

(3) The WB countries have delayed their transition not only due to their internal political and economic problems, but partly also because of a hostile international environment. During the 1990s, EU policies towards the WB region were different than those applied towards the eight CEEB, or the two South East European (SEE) countries (Bulgaria, Romania). After the outbreak of war in SFR Yugoslavia in 1991, the EU did not elaborate a long-term strategy for the WBs. At that time, for the ten CEEB-SEE countries, it was sufficient to declare the desire to implement the transition to multiparty democracy and market economy in order to be offered substantial financial assistance (PHARE) and preferential trade access through Association Agreements with the EU, which were concluded with the ten countries already during 1993-1996. The WBs, in contrast, were offered similar measures of support of transition and integration with the EU only after the end of the Kosovo war in mid-1999. Moreover, EU conditionality towards the WB countries has become more stringent than it was for the CEEB-SEE countries, consisting of additional conditions[11] and longer procedures, thus postponing in most cases the conclusion of Stabilisation and Association Agreements with the EU.[12]

Therefore, the overall political and economic conditions in the 1990s were fundamentally different in the WBs than in the CEEB region, due to both internal and external factors. The 1990s were a decade marked by extreme political instability which had very profound and long-term economic consequences for all the WB countries. The 1990s had negative consequences for the entire WB region: although Albania and Macedonia were not caught by the military conflicts of the early 1990s, they have also been affected by the region's political instability, as suggested by the limited inflows of FDI or slow integration with the EU. The political tensions from the 1990s have left a heavy burden on most countries' political agendas, including the problems of borders, status, return

11. In addition to the so-called Copenhagen criteria defined in 1993 for all countries aspiring to join the EU, the WB countries also have to respect international treaties (Dayton Peace Accords, UN Resolution 1244, Ohrid Agreement etc.) and demonstrate willingness to implement regional cooperation.

12. Only Macedonia and Croatia were able to conclude Stabilisation and Association Agreements with the EU fairly early, in 2001. For the other WB countries the conclusion of these agreements was substantially delayed.

of refugees, property, minority rights, many of which have still not been resolved.

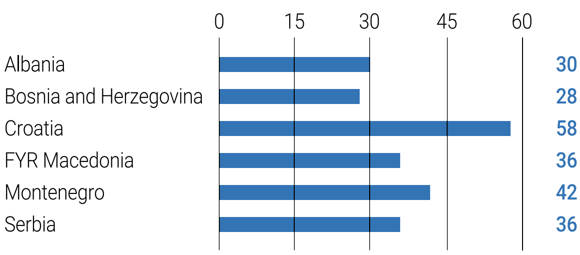
3. Economic performance of the Western Balkans in the new millennium

The new millennium brought many positive developments in all WB countries. Generally, in comparison with the previous decade, the WB countries until late 2008 experienced substantial improvements in most macroeconomic indicators. After 2001, many important economic and institutional reforms were also implemented even in countries that were previously lagging behind.

Since the early 2000s, the WB countries have registered relatively *rapid economic growth*. During 2004-2008, the WB countries registered high real GDP growth rates, on average for the five-year period ranging from 4 per cent in Croatia to 7 per cent in Montenegro. These high growth rates did facilitate some catching-up with the more developed countries in Europe, but GDP per capita in purchasing power standards (PPS) with respect to the EU average remains low (see figure 1).

Fast growth in the WBs during 2000-2008 was to a large extent sustained by the strong inflow of international finance. A boom in bank credits enabled increased domestic borrowing, as the foreign-owned domestic banks extended an enormous amount of loans to local clients, both firms and households. While government expenditure has also grown, in many countries it has been kept in check by the IMF and the EU (Bartlett and Prica, 2012).

Figure 1: GDP per capita in purchasing power standards (PPS) in percentage of EU28, 2015



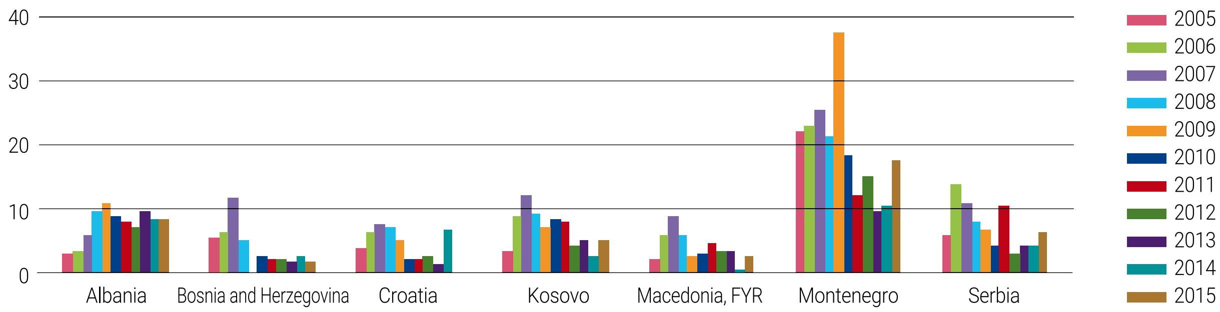
Source: Eurostat (2017a). Data for Kosovo is not available.

The WB countries have also achieved increasing *macroeconomic stability*, particularly important after many episodes of hyperinflation in the 1990s. Inflation rates have gradually been reduced to one-digit figures even in countries that earlier experienced extreme monetary instability (e.g. Serbia). Some fiscal consolidation has also taken place through cuts in public expenditure, reforms of the taxation system and stricter fiscal rules, particularly in recent years thanks to EU surveillance through the Economic Reform Programs. The level of public debt as late as 2011 was still below 60 per cent of GDP in all WB countries, thus lower than in a number of EU member states (Bonomi, 2016). Nevertheless, minor changes have taken place in the structure of public expenditure of WB countries, the dominant part still going into pensions and very little into public investment.

The process of *trade liberalisation* after 2001 – with the EU and with the other WB countries (the signing of bilateral free-trade agreements that in 2006 were transformed into the CEFTA-2006 agreement) – has contributed to a remarkable increase in the volume of foreign trade during 2001-08, in some cases by four or five times. Rapid growth spurred an increase in imports which was not accompanied by an equally fast increase in exports, given the relatively uncompetitive WB economies, leading to increasing trade and current account deficits (Bartlett and Prica, 2012). By late 2008, current account deficits reached alarming levels (particularly in Montenegro), being above 10 percent of respective GDPs in all countries except Croatia.

The WB countries have attracted *increasing FDI* after 2001 (see figure 2), prevalently from EU countries, but also from Russia, Turkey, Norway and Canada. FDI inflows were prompted by the reduced political risk, the massive privatisation of enterprises and banks, relatively low wages and improved prospects of EU accession (Estrin and Uvalic, 2014). However, important disadvantages for foreign investors remain, including the fragmentation of the region, the small size of the WB economies, the lack of economies of scale, and poor infrastructure. The structure of FDI has also not been favourable: until 2010, around 2/3 of FDI has gone into non-tradable services (banking, telecommunications, retail trade, real estate) which serve primarily the domestic market, rather than into manufacturing, so FDI has only marginally

Figure 2: FDI net inflows in percent of GDP, 2005 - 2015



Source: World Bank (2017).

contributed to industrial restructuring and to export-led growth (Estrin and Uvalic, 2014). After 2007, most WB countries have registered a decline of FDI by some 40-60 percent, which by 2016 has still not fully recovered to its pre-crisis level.

Since the early 2000s, the WB countries have implemented many *economic and institutional reforms* envisaged by the "ideal" model of a market economy, including price and trade liberalisation, the privatisation of small-scale enterprises and the massive privatisation of state-owned banks. These good results are suggested by the recent transition indicators of the European Bank for Reconstruction and Development (EBRD).[13] Croatia achieved the best results relatively early on, but the other WB countries have caught up in most areas of reform. Today, there are no longer large differences in various areas of economic reforms between the "early" and the "late" reformers, as was the case in 2001. Reforms in the area of price liberalisation, trade and foreign exchange systems and small-scale privatisation have been practically completed in all WB countries. Enterprise privatisation has contributed to the gradual expansion of the private sector, also in countries that were lagging behind (Bosnia and Herzegovina, Montenegro, Serbia), which today accounts for 65–75 percent of the WB countries' GDP.

Still, the private sector in most WB countries remains relatively undersized, which raises doubts about the effective outcome of recent reforms. Privatisation has often not led to improved corporate governance or to deeper enterprise restructuring, since the new owners often lacked the resources and skills to successfully modernise their firms. Competition policy is often ineffective. Many bureaucratic procedures for doing business have been abolished, but with large cross-country differences: in the World Bank's (2017b) update of the Doing Business Report that ranks 190 countries, Macedonia occupies the best position among WB countries (10th), while Bosnia and Herzegovina the worst (81st). The privatisation of the WB countries' banking sector has greatly contributed to strong financial and capital markets integration with the EU, given that the dominant part of the banking sector was bought by foreign (mostly EU) banks. In 2011, foreign ownership (defined as banks with assets in foreign ownership exceeding 50 percent) was still relatively low only in Serbia (74.5 percent), while in all the other countries it was close to or over 90 percent (EBRD Banking Survey).[14] The foreign ownership of banks, though a welcome feature in the initial process of bank restructuring, was also an important channel for contagion by the global financial crisis.

These positive developments in the WBs were sustained by the EU Stabilisation and Association Process (SAP) that offered these countries trade preferences,[15] financial assistance (CARDS, IPA, IPAII), contractual relations through Stabilisation and Association Agreements (SAA) and prospects of EU membership, which was reconfirmed at the 2003 EU–Balkan Summit in Thessaloniki. The new course was

13. The EBRD transition indicators estimate progress in various areas of economic reform in all country members (prevalently countries in transition), on the basis of scores which go from 1 (no or limited reform) to 4+ (comparable to a developed market economy).

14. Foreign ownership of banks (in 2011) was 89,7% in Montenegro, 90,3% in Albania, 90,6% in Croatia, 92,4% in Macedonia and 94,5% in Bosnia and Herzegovina (in 2009); see EBRD Banking Survey.

15. A privileged access to EU markets was offered already in 2000 through EU autonomous trade measures that established a uniform system of trade preferences for all WB countries (FR Yugoslavia was included somewhat later, on 1 Nov. 2000).

also facilitated by political changes in the early 2000s, which brought an end to the one-party domination and authoritarian tendencies in two key WB countries – Croatia (after the death of president Tuđman) and FR Yugoslavia (after the victory of the Democratic Opposition of Serbia over President Milošević in October 2000).

The described positive trends were interrupted by the global financial and economic crisis that severely hit the WB economies from late 2008 onwards. The global economic crisis has generally slowed down economic and institutional reforms in the WBs (though also more generally, in the whole transition region; see EBRD, 2013). The strong effects of the global economic crisis raised the question whether the economic strategy pursued in the WBs had been the best among the feasible policy options.

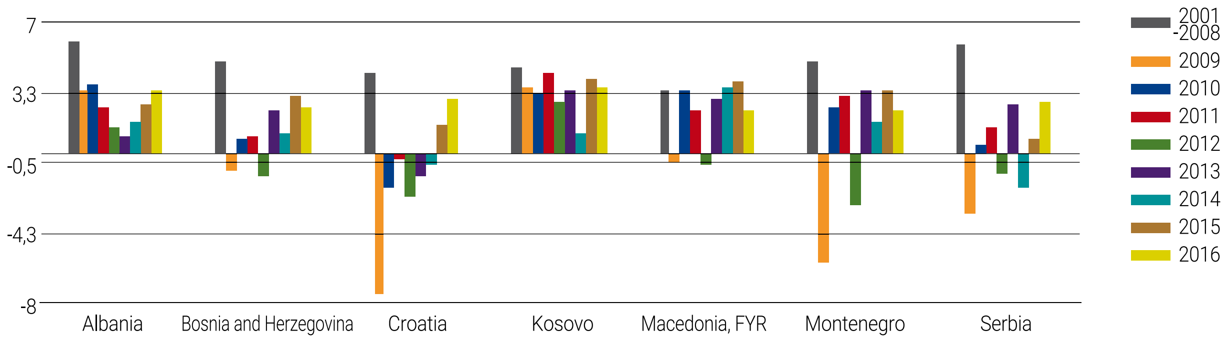
4. The effects of the global economic crisis

The global financial and economic crisis hit the WB economies in the last quarter of 2008 through two main channels: (1) reduced inflows of foreign capital, including bank credit, FDI, migrant workers' remittances and donors' assistance (Bartlett and Prica 2012, Bartlett and Uvalic, 2013); and (2) declining demand for WB countries' exports on foreign markets. In addition to reduced capital inflows from abroad, the credit crunch in the EU led to a sharp reduction of credit availability in the local mainly foreign-owned banks. This was almost immediately transmitted to the real sector of the WB countries, causing a sharp contraction in production and aggregate demand. A notable slowdown in economic growth took place in 2009, when most countries registered negative GDP growth, particularly Montenegro (-6%) and Croatia (-6,9%); the only exceptions were Albania and Kosovo that registered a substantial slowdown (see figure 3). In 2009, the positive trends in foreign trade were also reversed, as all countries saw a contraction of both exports and imports.

The WBs were particularly affected by the global economic crisis because of their huge current account deficits, which until 2009 were covered by massive inflows of foreign capital. Moreover, during the 2000s the WBs had become dependent on trade primarily with the EU, but along with increasing trade deficits due to insufficient export growth. The recent privatisation of the WBs banking systems had rendered the WB countries additionally vulnerable, due to the risk of capital withdrawals or reduced credit to local clients under the impact of the economic crisis in their home countries. All three factors continue to be a threat to economic stability in the WBs.

In the immediate aftermath of the global crisis, most WB countries implemented specific economic policies to sustain domestic demand and help the financial sector, which in part helped attain a mild economic recovery in 2010-11. However, the sovereign debt crisis in the eurozone pushed most WB countries into a second recession in 2012 (all except Albania and Kosovo that again registered a strong drop in GDP growth in comparison to 2011). Due to the high degree of euroisation, the WB economies have become

Figure 3: Real GDP growth in the Western Balkans (in %), 2001–2016



Source: IMF (2017a).

highly vulnerable to external shocks coming from the EU/eurozone.[16] After 2012, economic recovery has been very slow, especially in Croatia, which had negative GDP growth rates for six years (only in 2015 did it register positive GDP growth), and in Serbia, which after 2008 had three recessions (in 2009, 2012 and 2014). Although in 2016 all WB countries registered relatively strong GDP growth, of 2–3 per cent, growth rates have still not returned to their pre-2008 levels.

The WBs received external support to help alleviate the severe impact of the global economic crisis, particularly by the IMF and the EU (Bartlett and Prica, 2012). Starting from 2009, the IMF concluded several stand-by arrangements with Bosnia and Herzegovina and Serbia. Even more important has been the so-called "Vienna initiative", a multilateral agreement between the IMF, the EBRD and other banks operating in the region. The agreement ensured that host governments would provide deposit insurance and liquidity support for banks, that EU-based partner banks would recapitalise and refinance their subsidiaries in the region, and that home governments would allow bank groups to access home country financial resources without restrictions (Bartlett and Prica, 2012, pp. 28-29). This agreement, designed to prevent foreign-owned banks from pulling out of the region was, in fact, one of the most important factors in stabilising the banking system in the WBs in the early years of the crisis (Barlett and Prica, 2012, pp. 29). The initiative was relaunched in January 2012 ("Vienna 2") in response to renewed risks for the region from the eurozone crisis, but was far less successful, since there was substantial deleveraging by foreign banks as they continued to scale back their exposure in WB countries.

After late 2008, many problems became unsustainable (see sections 5 and 6 below). Although EU policies greatly facilitated economic recovery after 2001, increasing EU – Balkan integration has also rendered the WB economies more vulnerable to external shocks. Increasing integration with the EU has proved to be a double-edged sword: in prosperous times, the European core exported its prosperity towards its southeastern periphery; but in times of crisis, it has exported instability (Bechev, 2012; Uvalic, 2013).

5. Long-term structural problems of the WB economies

The three main groups of structural problems of the WB economies became evident after the outburst of the global economic crisis in late 2008: severe external imbalances; mounting social problems deriving from the unsatisfactory situation on the labour market; and very fast structural changes, characterised by strong deindustrialisation and the very fast expansion, primarily of services. These structural problems have fundamentally contributed to the present low level of economic development of the WB countries.

(1) External imbalances

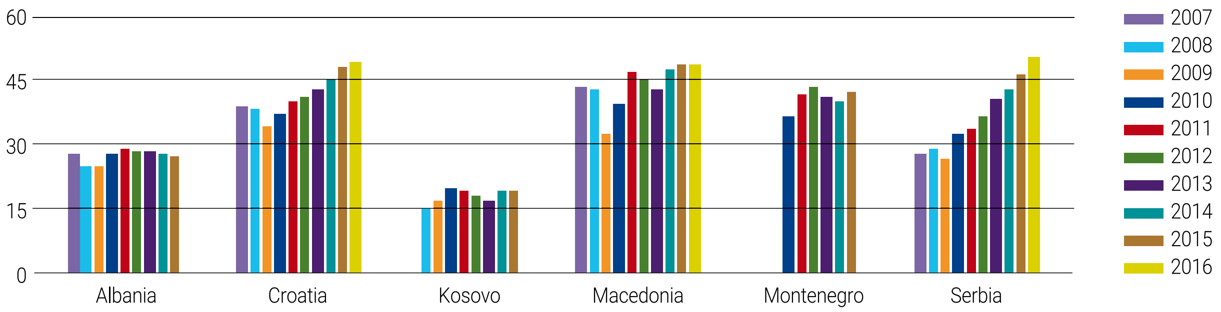
During the 2000s, the WB countries had been facing severe external imbalances. Due to delays in large-scale privatisation, the late arrival and relatively unfavourable structure of FDI, ineffective industrial and competition policies and inadequate changes in the business environment, the process of industrial restructuring of the WB economies has been slow, contributing to insufficient export growth and increasing trade and current account deficits. Limited restructuring of the real sector of the WB economies, along with policies of strong national currencies, has rendered the WB economies insufficiently competitive on EU/world markets, so their export of goods and services to GDP ratios remain low in comparison with the CEEB countries (Uvalic, 2013) (see figure 4).

Despite a remarkable increase in WB countries' foreign trade after 2001, exports have often been half the volume of imports, contributing to large trade deficits (see figure 6), which in turn are responsible for the rising current account deficits

16. Though only Montenegro and Kosovo have officially adopted the euro as legal tender, Bosnia and Herzegovina has a currency board which ties its currency to the euro while the other countries have also, officially or unofficially, fixed their currencies to the euro – only Albania has a floating regime; Macedonia has *de facto* fixed its currency to the euro while Croatia and Serbia have a managed float (inflation targeting). Moreover, all WB countries have very little room for implementing effective monetary policy, since a large proportion of domestic liabilities are denominated in euros.

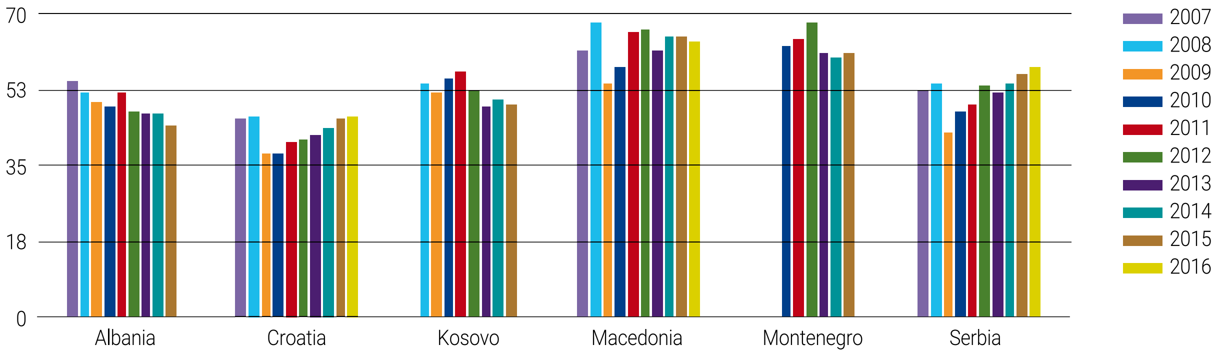
that in late 2008 were among the highest in the transition region. As indicated earlier, these current account deficits have for years been covered by capital inflows from abroad, which have drastically fallen after 2009. Although there were some adjustments in the meantime, most countries have had to recur to additional borrowing while some, like Serbia, have also applied a more flexible exchange rate policy allowing some depreciation of the dinar. This has contributed to a rapid increase in external debt, particularly of Montenegro, Serbia and Croatia (see section 6 below). For all these reasons, strengthening external competitiveness through a faster restructuring and technological upgrading of the real sector remains a key priority of all WB countries.

Figure 4: Exports of goods and services in percentage of GDP, 2007-2016



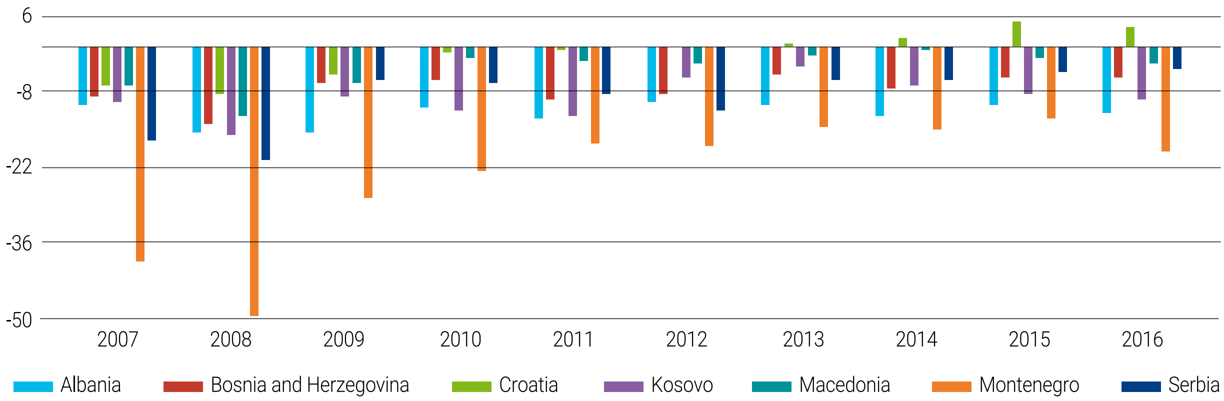
Note: No data is available for Bosnia and Herzegovina.
Source: Eurostat (2017a).

Figure 5: Imports of goods and services in percentage of GDP, 2007-2016



Note: No data is available for Bosnia and Herzegovina.
Source: Eurostat (2017a).

Figure 6: Current account balance (in % of GDP), 2007-2016



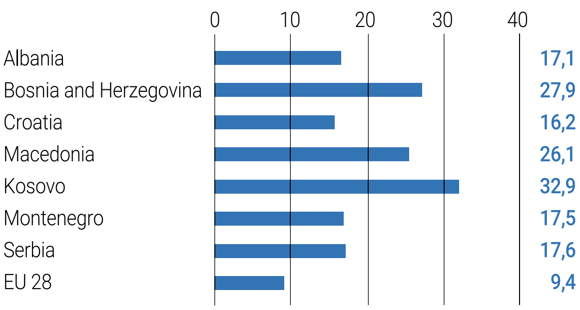
Source: IMF (2017a).

(2) "Jobless" growth and increasing social problems

The WB countries have had mounting social problems under the pressure of increasing unemployment, very low employment and participation rates, rising poverty and inequality (Bartlett and Uvalic, 2013). The labour market in the WBs has been characterised by the phenomenon of "jobless growth" and severe long-term structural problems. The restructuring process led to the closure of many firms and loss of jobs, but economic growth was not accompanied by an equally dynamic process of job creation. Although the CEEB countries have also faced similar problems in the 1990s, the extent of these problems in the WBs has been much more pronounced. In recent years, the WBs have been the countries that have registered among the highest unemployment rates (see figure 7) in Europe. Long-term and youth unemployment rates have also reached alarming proportions. In 2015, the average unemployment rate of graduates with a higher education diploma in the WBs (without Croatia) was 15,6 percent, therefore three times higher than the average of the EU28 (5,5 percent) (Bartlett et al, 2016). With such high unemployment rates, it is clear that economic growth in the WBs remains below their potential. Recent employment rates of the WB countries have also been extremely low, well below 50 percent, at a time when in the EU the objective is to reach a 75 percent employment rate by 2020 (see figure 8).

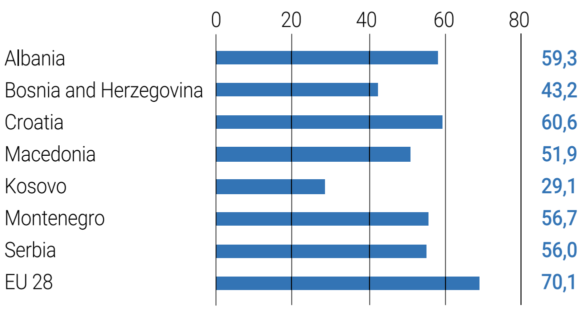
The WB countries also face a worsening of their social climate, under the impact of further increases in poverty and inequality (Bartlett and Uvalic, 2013). A substantial part of the workforce still works in the more flexible informal sector, preventing the collection of badly needed public revenues. According to some estimates, the level of informal activity, measured as a share of household income, is highest in Albania (52 percent), Kosovo (45 percent) and Macedonia (39 percent), while the Bosnian Federation, Serbia and Croatia have lower levels of around 18-19 percent (Bartlett, 2008, p. 125). Income inequality has been substantial: Gini coefficients range from 26,2 in Montenegro, 30,4 in Croatia, 33,4 in Bosnia and Herzegovina and 33,7 in Macedonia to an extremely high 38,2 in Serbia – therefore in three of the five countries higher than the EU28 's average of 31 (Eurostat, 2017a; European Commission, 2016a, 2016e). A report on social protection and social inclusion in Albania, Bosnia and Herzegovina, Kosovo, Montenegro and Serbia claims that the major drivers of social exclusion and inequalities lie in labour markets and educational systems; in addition, public insurance-based pension systems are under strain due to negative demographic trends, early retirement practices as well as the labour market situation (Stubbs, 2009, p. 15, 70). However, social protection benefits in percentage of GDP were lower in the WB than in the EU28 in 2012, for the countries for which data are available (Eurostat, 2017, 2017a). In sum, negative social trends and weak social safety nets mean that the WBs face considerable obstacles for socio-economic development.

Figure 7: Unemployment rate, 2015



Source: Eurostat (2017a): codes cpc_pslm, lfsa_urgan.

Figure 8: Employment rate, 2015



Source: Eurostat (2017a): codes lfsi_emp_a and cpc_pslm.

(3) Structural changes

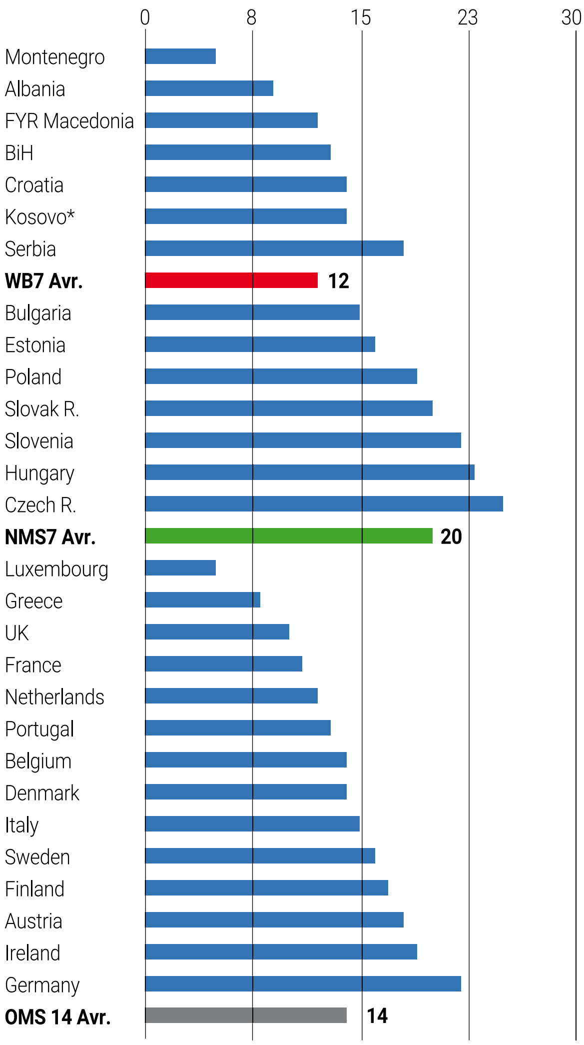
All transition countries have experienced radical structural changes during the past quarter of a century: a notable decline in the share of agricultural value added; deindustrialisation with falling absolute employment and output in all branches of industry, particularly manufacturing and energy; and a substantial expansion of the services sector, which remained underdeveloped during socialism. However, the WB countries have gone through an extreme process of deindustrialisation, since industrial decline typically occurred not only in the early 1990s (as in other East European countries), but continued in most WB countries in the 2000s as well. The share of tradable goods, dominated by manufacturing, has declined significantly, further aggravating the problem of insufficient export growth and low competitiveness. Structural changes in the WB have resulted in an oversized services sector and the premature reduction of manufacturing, to levels inconsistent with these countries' levels of economic development. By 2013, the share of manufacturing value added in the seven WB countries was only 12 per cent of GDP (unweighted average), therefore lower than in many EU countries, particularly the new member states – the Czech Republic, Slovenia, Hungary and Slovakia, where it ranged from 20–25 percent (see figure 9). The structure of foreign investment has greatly contributed to such patterns of structural change, since most FDI has gone into non-tradable services (Estrin and Uvalic, 2014).

Mencinger (2003) recalls the important difference between greenfield and privatisations-related FDI: while a strong link between greenfield FDI and capital formation is self-evident, acquisitions by foreign partners cannot be automatically considered as investment in real assets. Proceeds from privatisation sales might be spent on current consumption and imports, in which case FDI would not directly contribute to the growth of productive capacities and to economic growth, but to an increasing current account deficit developing into foreign debt. Though Mencinger's arguments are based on the experience of the more advanced CEE countries in the 1990s,[17] they are very relevant for the WB countries (Uvalic, 2010, p. 188).

17. Mencinger's regressions suggest a negative impact of FDI on economic growth in eight CEE countries. The results are explained by the fact that FDIs were predominantly acquisitions related to massive and often politically motivated privatisation, while proceeds from sales were spent on consumption and imports (Mencinger, 2003, p. 504).

Still, industrial changes have resulted in less polluting production per unit of GDP in all countries except Bosnia and Herzegovina. Data for the past several years, available for only some countries from the OECD (Green Growth, 2017), shows that CO_2 emissions per capita fell in Serbia, Macedonia and Albania, slightly grew in Croatia and Montenegro and steeply grew only in Bosnia and Herzegovina. However, while carbon productivity (GDP per kilogram of CO_2 emissions) somewhat fell in the latter, it grew in all aforementioned countries for which data is available.

Figure 9: Manufacturing value-added (in percent of GDP), 2013



Note: Countries not included are those for which 2013 data were not available (Latvia, Lithuania, Romania, Cyprus, Malta, Spain).

Source: Compiled on the basis of World Bank (2017).

The share of industry[18] value added in GDP sharply fell in Eastern Europe after 1990, a normal consequence of an oversized industrial sector during socialism. The scale of the decline was much greater than in the EU. In the EU during 1991–2015 this decrease was on average 21,32%, while in Albania and in Macedonia it was 40,45% and 26,56%, respectively. Unfortunately, the lack of comparable data does not allow us to show what was probably an even more drastic decline in the share of industry in Bosnia and Herzegovina, Croatia and FR Yugoslavia (Serbia and Montenegro). Furthermore, the share of manufacturing value added in GDP in 2015 in all the WB countries but Serbia (in 2013), was generally lower than in the EU (World Bank, 2017, see also Figure 9).

These are some of the structural problems that have hampered the process of economic recovery and catching up of the WBs with the more developed countries. Since the early 2000s, some catching up has taken place with respect to the EU average GDP per capita, thanks primarily to higher growth rates in the WB countries (but also because of a slight lowering of the EU average after the EU 2004–07 enlargement). Nevertheless, strong growth in the WB countries during 2001–08 has not been sufficient to compensate for the very substantial output fall in the 1990s. Only Albania, Croatia, and Macedonia have surpassed their 1989 real GDP level (the latter two fairly recently), while in 2008 Montenegro was still at 92 percent, Bosnia and Herzegovina at 84 percent, and Serbia at 72 percent of real GDP produced in 1989 (Uvalic, 2010). After the recent recessions, most countries have experienced a further setback: by 2012 Croatia was again under the level of its 1989 real GDP, while Serbia was at 70 percent. There has been little convergence in incomes with the more developed EU: with the exception of Croatia, GDP per head remains low.

18. Industry corresponds to ISIC divisions 10-45; it comprises value added in mining, manufacturing (ISIC divisions 15-37), construction, electricity, water, and gas (World Bank, 2017).

6. The current economic situation in the WBs: specific policy constraints

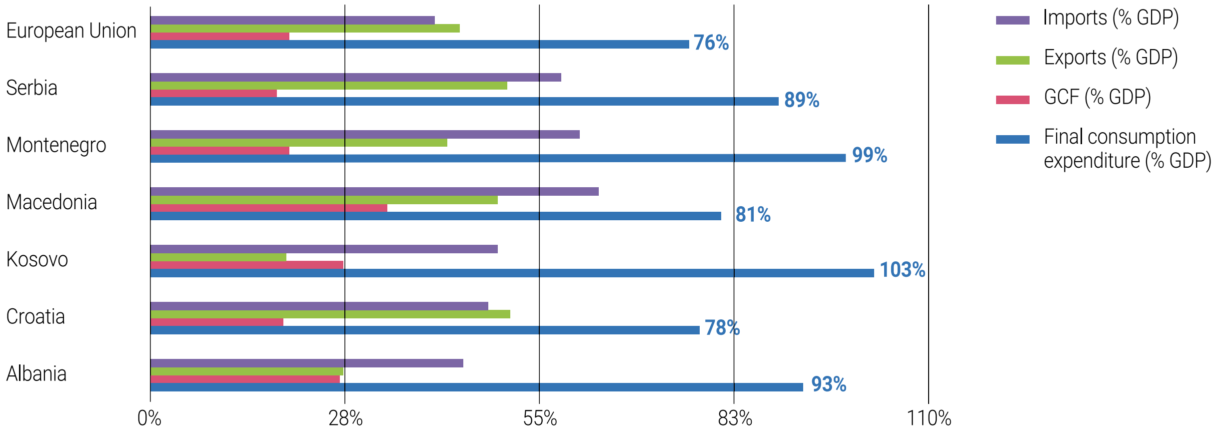
The WBs today also face a number of challenges due to specific constraints on their economic policies. Regarding macroeconomic policy, the WB countries share a rigid monetary policy coupled with generally restrained fiscal policy. As Kosovo and Montenegro use the euro as their domestic currency, Bosnia and Herzegovina has a currency board, while Macedonia and Croatia have more or less fixed their exchange rate, all these countries effectively cannot use monetary policy in order to boost their economy. Albania is an exception, as it has maintained a flexible exchange rate. Serbia has combined a flexible exchange rate policy with high interest rates (the latter case described by Becker, 2012), though they have lately fallen. In addition, all WB countries have a high degree of euroisation of their economies, which seriously hampers the effectiveness of monetary policy instruments.

As regards to fiscal policy, austerity policies have generally been implemented in recent years throughout the region, except in Kosovo and Albania (see Bartlett and Uvalic, 2013; Bonomi, 2016). However, there is room for a different type of fiscal policy in most countries, as their general government consolidated gross debt (i.e. public debt) relative to GDP is lower than the EU28 average in all countries except Croatia (being an EU member state, it needs to respect the Stability and Growth Pact's limit of 60 percent). In fact, in Bosnia and Herzegovina, Macedonia and Kosovo public debt is still much lower than 60 percent of their respective GDPs (Bonomi, 2016; for data see Eurostat, 2017a). Serbia has recently "overperformed" in fiscal policy consolidation: in 2016 the general government deficit dropped to 1,4 percent of GDP (the lowest since 2005), contributing to a reduction in government debt to 74 percent of GDP (see IMF, 2017). Yet the European Union is in favour of further fiscal consolidation in all the WB countries, which remains substantially under its control (see Cvijanović, 2017). It should also be stressed that difficult policy measures are rather restrained in situations of generally, weak, social dialogue (see European Commission, 2016, 2016a, 2016b, 2016c, 2016d, 2016e) that makes it harder for social partners to agree on a policy direction.

Although the pace of GDP growth gradually picked up in the 2000s, this was due to a model of economic development that until 2008 relied heavily on an excessive increase in credit, fuelled by increasing foreign capital inflows. Becker and Ćetković (2015) found that financialisation[19] was the main factor behind GDP growth in the pre-crisis period in Bosnia and Herzegovina, Croatia, Serbia and Montenegro, characterised by the rapid growth of banking credits driven by foreign-owned banks. Hence, the financial sector grew in scale and importance, driving GDP growth until the outbreak of the crisis. Thereafter, GDP growth rates slowed down substantially.

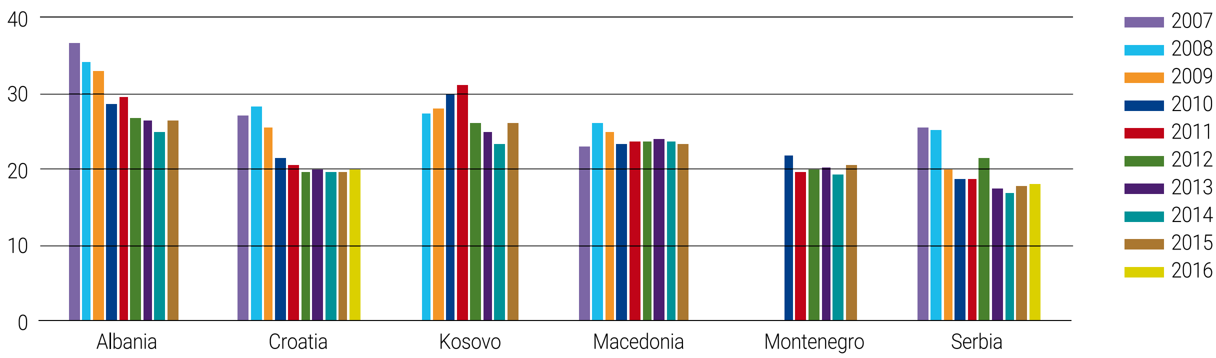
The structure of GDP is unfavourably skewed towards domestic consumption (see figure 10) which may remain subdued due to the budgetary pressures on both households and the general government. Furthermore, all countries but Croatia have negative net exports (of goods and services). Hence, the attention of policy makers should turn to major investments, which have generally seen a downward trend after the crisis (see figure 11). As to the financing of investment, all countries except Croatia and Macedonia have much lower savings rates than the average in the EU (see figure 12).

Figure 10: Structure of GDP



Note: Data for Croatia, Macedonia, Serbia and the EU refer to 2016. The rest of the data refers to 2015, except for the data on GCF in Albania (2014 was the last covered year). There is no data for Bosnia and Herzegovina in the cited source.
Source: Eurostat (2017a).

Figure 11: Gross fixed capital formation[20] (in percentage of GDP), 2007-2016

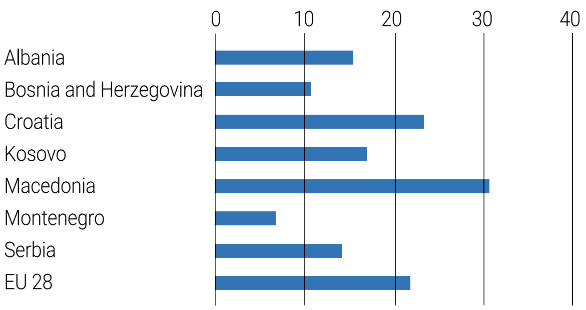


Note: There is no data for Bosnia and Herzegovina. We use gross fixed capital formation (GFCF) instead of gross capital formation (GCF) since there is more detailed data on the former than the latter.
Source: Eurostat (2017a).

19. Financialisation can succinctly be defined as growth in size and importance of the financial sector.

20. Gross fixed capital formation "consists of resident producers' investments, deducting disposals, in fixed assets during a given period. It also includes certain additions to the value of non-produced assets realised by producers or institutional units. Fixed assets are tangible or intangible assets produced as outputs from production processes that are used repeatedly, or continuously, for more than one year" (Eurostat, 2017a).

Figure 12: Gross savings in percentage of GDP, 2015



Note: Data refer to 2015, except for Bosnia and Herzegovina for which the last available data were taken, for 2014.

Source: Own calculations based on data of World Bank (2017).

Regarding exports and employment, for the Visegrád countries and Slovenia, what was particularly important were FDI inflows into complex industries. This is precisely where the WB countries failed. As their institutional structures grew more similar, their production structures developed in a different direction and could not catch up with the more advanced economies of the post-socialist world (Bohle and Greskovits, 2012). Recent empirical evidence suggests that FDI in the WBs has not only not had any positive spillover effects on manufacturing value-added, employment and exports, but has even had negative effects, as for example on employment in the textile industry (see Estrin and Uvalic, 2016).

7. Long-term policy failures and future priorities

There are further reasons why economic development in the WB countries has produced suboptimal outcomes, deriving from more general long-term policy failures: (1) political/constitutional problems; (2) transition and growth strategies; and (3) inappropriate regulatory, institutional and legal frameworks.

(1) *Political/constitutional problems.* Two countries have major problems of a constitutional nature – Bosnia and Herzegovina and Kosovo. While the former has a complicated two-tier structure comprising the Federation and Republika Srpska that produces constant nationalistic tensions, thus preventing the effective implementation of a model of development for the country as a whole, the latter still has substantial institutional problems and has not even been recognised by all EU member states since its unilateral proclamation of political independence in February 2008. Furthermore, Macedonia has been halted in its EU integration process due to Greek demands regarding its name, while the tensions and sporadic violent clashes between ethnic Macedonians and ethnic Albanians have made it difficult for the country to focus on developmental priorities. Croatia, first affected by the war (1991–1995), had a late start in important transition-related reforms, so some of its public policies are still tied to interest groups directly connected to the war. Serbia and Montenegro have not been very different in this sense, as sanctions against FR Yugoslavia in the 1990s and later the NATO air strikes led to a substantial regression in all socio-economic indicators. In 2006, the separation of Montenegro from FR Yugoslavia (Serbia) meant that both countries had to deal with major political challenges, while the situation in Serbia after 2008 has been additionally complicated by Kosovo's declaration of independence. In contrast, Albania has had a much smoother transition path, uninterrupted by major political events (aside from the pyramid schemes crisis in 1997 ending with an abrupt fall in GDP and mass protests). However, it started from an institutional and economic development level which was much lower than in the other WB countries.

(2) *Transition and growth strategies.* The growth strategy based on fast trade and financial opening, rapid credit expansion and increasing dependence on foreign capital has been much less successful in the WBs than in CEEB (Uvalic, 2012). The transition in the WB region, similarly to that in CEEB, was prevalently based on the prescriptions of orthodox mainstream economics, or the "Washington consensus", which placed strong emphasis on liberalisation, macroeconomic stabilisation and privatisation. Other important areas of reform, particularly at the microeconomic level, were neglected – such as improving the business environment, firm restructuring or competition policy. Although the "post-Washington consensus" developed in the second half of the 1990s had suggested the high

costs, in terms of slower growth, of excessively restrictive macroeconomic policies (Kolodko and Nuti 1997, p. 49-52), in the WBs this was not taken into account.

In particular, the neoliberal policies implemented in the early 1990s in Albania and Macedonia, backed by the IMF-supported shock therapy programs, included substantial cuts in government expenditure that reduced the role of the state to a bare minimum, which had adverse consequences for sectors such as education and health. In Bosnia and Herzegovina or Kosovo the neoliberal policies brought even more disappointing results, a stable currency being probably the only important exception (Uvalic, 2012). The economic recovery of these war-devastated and highly deindustrialised economies has been very slow, institution-building has taken much longer than expected, and many solutions imposed externally by international donors have not been appropriate. In Serbia, capacity restructuring was expected to take place almost entirely through privatisation, a process which has proceeded very slowly and has not been accompanied by other important measures, such as improving the regulatory environment for enterprise entry and exit, or increasing competition through effective anti-trust policy (Uvalic 2010). Croatia has achieved faster progress with regard to many transition objectives and is the most developed Balkan country, yet it also has a number of reforms to complete, its recent growth has been based on heavy borrowing from abroad making it the most indebted Balkan country, and it has been among the most severely hit by the global economic crisis.

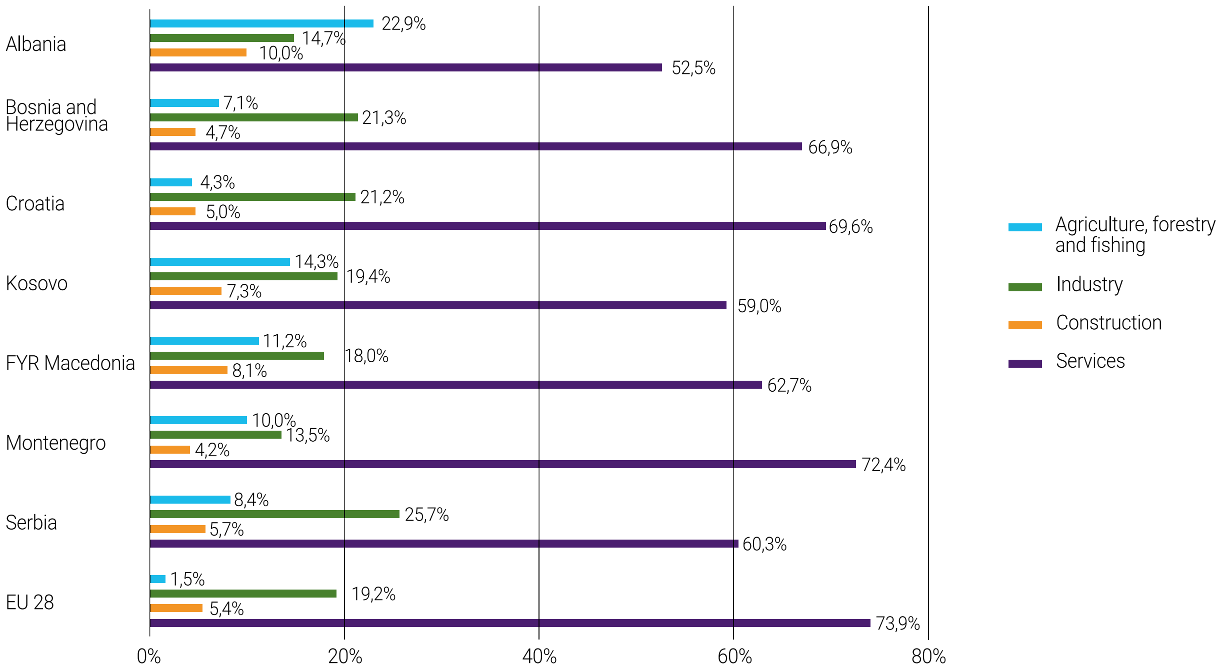
(3) *Institutional, regulatory and legal frameworks.* The failure to establish appropriate institutional, regulatory and legal frameworks has impeded the supply response necessary for reducing unemployment and generating sustained economic development (Daviddi and Uvalic, 2006; Uvalic, 2012). As a result of neoliberal policies that reduced the role of the state to the bare minimum, the WB countries have failed to develop active government policies in many important areas. They have mainly implemented a horizontal-type industrial policy (Bartlett, 2014), which has only marginally contributed to the process of industrial restructuring. Recent institutional, economic and political indicators highlight a substantial gap between the WB and CEEB countries, including indicators on technological readiness and rule of law (Estrin and Uvalic, 2016).

In future strategies of economic development, there are four areas that need to be considered by all WB countries, as they seem to be common priorities: agriculture, energy/environment, investment in R&D (human capital) and public administration reform.

(1) *Agriculture* has so far not been given the right attention, although it still contributes a very high share of gross value added in all the WB countries (see figure 13), much higher than the EU average. The importance of agriculture for employment, exports, food sovereignty and fight against climate change has traditionally been neglected. During the 2005-15 period, Albania, Bosnia and Herzegovina, Kosovo, Macedonia and Montenegro had trade deficits in food, live animals, drinks and tobacco, partly due to an early and exceptionally fast liberalisation of imports from the EU, while only Serbia had a surplus (see Eurostat, 2017a). Croatia has had a huge trade deficit in agricultural trade in recent years (European Commission, 2017), despite having a rather developed food industry. Znaor and Landau (2014) find that a switch to organic farming in Bosnia and Herzegovina, Croatia, Montenegro and Serbia would result in an increase of 100.000 jobs, provide higher gross value added and have beneficial ecological effects.

(2) *Energy* is another important sector, though the situation in the WB countries is very heterogeneous. There are wide differences regarding total primary energy supply, the energy mix, the volume of national energy production and dependence on imported energy. Most WB countries are not able to cover their essential energy needs through domestic production, but import from other countries. The size of the WB countries' markets, in terms of final energy consumption, varies, but most of the markets are very small (Uvalic, 2014). Most WB countries are not just dependent on imports, but produce energy in a highly polluting way, while their power

Figure 13: Gross value added by sectors, 2014-2015



Note: Data for Albania, Bosnia and Herzegovina, Kosovo and Montenegro are for 2014, for the other countries they are for 2015.
Source: Eurostat (2017a) and European Commission (2016a), pp. 78-79.

plants are in need of investment. Yet renewable energy sources have been mostly neglected. The recent increase in EBRD's financing of the green economy by 85 percent so far in 2017 opens excellent opportunities for the WB countries to raise funding for developing renewable energy sources. The EBRD's Green Economy Transition (GET) approach aims to dedicate 40 percent of its annual investments to climate finance by 2020, compared with an average of around 25 per cent in the previous five years.

(3) *Investment in human capital* should also be a priority in all WB countries, since expenditure for education, R&D and innovation is generally low. Sectors of innovation and research have faced serious underinvestment not only in the 1990s but also more recently. The WBs have failed to develop systems and institutions that would support modern innovation policies. Among WB countries ranked in the European Innovation Scoreboard, Macedonia is at the bottom end with "modest innovators", while Croatia and Serbia are among "moderate innovators" (the latter being ranked higher than the former). Innovation promoting strategies must become part of a wider policy framework that would include other areas of reform, including education, the development of skills of young people through vocational training, more opportunities for internships and introducing closer cooperation between higher education institutions and the business sector (Bartlett et al., 2016).

(4) *Public administration reform* must come on top of the policy agenda of all WB countries, since giving priority to the above areas will not be sufficient without a more efficient public administration. This is suggested by the Worldwide Governance Indicators (see World Bank, 2017a).[21] Although Croatia is situated at the bottom among EU member states, it fares better than all WB countries except for the indicator on "regulatory quality", in which Macedonia is slightly better. The WBs have weak administrative capacities which cannot adequately respond to the increasing demands of the EU to develop modern, forward-looking public policies. Other indicators confirm the poor quality of the WBs public administration (e.g. the Economist Intelligence Unit Democracy Index).

21. The Worldwide Governance Indicators measure six areas: 1) voice and accountability, 2) political stability and absence of violence/terrorism, 3) government effectiveness, 4) regulatory quality, 5) rule of law, and 6) control of corruption.

8. Conclusions and policy recommendations

After a prolonged and difficult transition path, the WB countries still do not seem to be on a development path that would guarantee future socio-economic prosperity. Key long-term structural problems of the WB economies – limited competitiveness on world markets, "jobless" growth, increasing social problems, extreme deindustrialisation – have not been resolved, while growth based on excessive credit expansion has come to an end. Although the macroeconomic situation has recently improved, GDP growth rates are still subdued in comparison to the pre-crisis period, while fiscal and monetary policies have limited room of manoeuvre. Current economic and social problems are a serious constraint for the future development of the WB economies. Rather than just strive for increased economic growth, the WB countries should aim at implementing *a more balanced model of development* that would take into account social, economic and ecological aspects. High inequality, unemployment and poverty ask for redistributive policies that would combat mounting social problems and secure decent living standards. The WB countries should enable its population to enjoy decent work and pursue the goal of social inclusion, envisioning a just transition to an economy that is also environmentally sustainable (see ILO, 2015, p. 4).

In order to pursue these goals, WB policy-makers need to elaborate and implement *a more efficient industrial policy*. Such industrial policies need to be country-specific, carefully prepared in each country on the basis of national priorities. Governments need to influence the quality of investment – both foreign and domestic – particularly its sectoral distribution. In order to diversify and upgrade the production and export base, policy makers should not wait to see what international market forces bring to them; recent findings by Harding and Javorcik (2012) show that sector targeting by investment promotion agencies – not simply opening the host economy to FDI – doubles FDI flows into the chosen sectors and results in higher unit-value exports (Moran, 2014, p. 32). The WB governments also need to devise such mechanisms for selecting industries and providing packages of public sector support to address coordination externalities, overcome imperfections in information markets, while providing investors with public goods, such as a well-trained labour force. Such an approach is what Moran calls "light-form industrial policy" that could harness FDI to development and generate backward linkages as deep as possible into the host economy (Moran, 2014, pp. 32-33). The potential benefits of FDI for the host economy depend, among other things, on national infrastructure, market size, systems of education and training, institution quality, political stability and the control of corruption (Estrin and Uvalic, 2016).

Investment promotion policies directed towards potential foreign and domestic investors need to be linked to the *most important objectives of national economic development*. After more than eight years of economic crisis and feeble economic recovery, it seems risky for the WB governments to merely wait for the return of foreign investors and to continue relying on their capabilities to restructure their economies. An investment promotion strategy needs to aim at attracting not only more, but also better quality, investments that would facilitate a faster restructuring and technological upgrading of key industries. Such an investment policy should also influence the sectoral distribution of domestic and foreign investments, that should extend across sectors of agriculture, energy, R&D, education and innovation. More efficient policies promoting organic farming and those connecting the agricultural sector with food industry should be implemented. The WB countries should reduce their dependence on highly polluting energy production (coal) and increase their energy sovereignty by reverting to renewable energy sources. FDI can be a welcome supplement to the still low domestic savings characterising all WB countries, but it is unlikely to be sufficient to secure faster and sustained economic development. As elsewhere, FDI is influenced not only by government policies, such as institutional reforms and tax incentives, but by exogenous factors such as size, level of development and geographical position (Estrin and Uvalic, 2014). The economic smallness and fragmentation of the WB region implies the lack of economies of scale, which remains a serious handicap for these countries.

One way to overcome this handicap and accelerate WB economic development is through *more intensive regional cooperation.*[22] The current institutional crisis of the EU and the related bleak prospects of a quick accession of the current candidates and potential candidates implies that they ought to devise new mechanisms to accelerate economic development in order to prepare for the future competitive pressure within the EU. Coordinating national policies in some of the priority areas in order to implement regional initiatives jointly makes a lot of sense for small economies such as the WBs, particularly considering the legacies and economic linkages inherited from the former Yugoslavia. Although the benefits of regional cooperation have been emphasised for long (Uvalic, 2001), its potentials have not been sufficiently utilised. More intensive regional cooperation in the area of R&D, energy, transport, agriculture or specific industries has the potential of accelerating growth in the WBs in the medium term. Industrial policy at the regional level through the creation of trans-national networks and supply chains could be mutually beneficial, since multinational companies created by enterprises from several WB countries are bound to be more competitive on EU markets than small national firms. The SEE 2020 Strategy adopted by the Regional Cooperation Council and the ministers of the respective SEE countries in Sarajevo in November 2013 is an attempt to implement the desired regional cooperation initiatives. The Berlin process also represents a step forward in this regard. Whereas recently there has been some progress in initiating a Regional Economic Area in the WBs (see European Commission, 2017a), a lot more could be done in most areas of regional economic and political cooperation.

Regarding the *role of the EU*, the renewed EU enlargement policy based on three pillars – Public administration, Rule of Law and Economic governance – now grants major importance to problems of economic development. This is promising, since in the past, and for too long, economic problems were in the shadow of political issues. In particular, the new policy instrument recently introduced by the European Commission – the Economic Reform Program (ERP) – ought to contribute to improvements in WB's economic governance (see Bonomi, 2016). Mirroring in part the European Semester, the new policy instrument, in addition to more efficient macroeconomic, fiscal and monetary policies, imposes on the WB policy-makers the need to adopt a longer (three-year) planning framework, introduce the prioritisation of structural objectives and an impact analysis of the desired goals. However, only a few countries have for now had the administrative capacity to actually undertake this type of longer-term policy planning and assessment (see Arandarenko et al., 2017).

A major constraint on the implementation of the desired reforms in the WBs are the limited financial resources, especially for investment purposes. Even a radical reallocation of budgetary funds that would substantially increase public investment and reduce consumption-related expenditure would not be enough to provide the necessary resources for investment in those areas that have been singled out as crucial for faster economic development in the WBs. The financing provided by the EU through the IPA II to the WBs is still rather low and largely insufficient to provide for accelerated economic development. The WBs must be supported with additional financial resources from the EU and its institutions much before they actually fulfil the conditions to enter the EU. Flessenkemper and Reljić (2017) suggest that the WB accession countries "should be granted access to the EU's structural funds, be permitted to participate in the EU's financial stability mechanisms, and be treated in all other respects as part of the European integration project". Major EU financial support could help the aspirant countries to boost their public investment and adopt a clearer developmental perspective. This would be beneficial both economically and geopolitically, not only for the Balkans but also for the EU itself (Bonomi and Reljić, 2017).

22. The Regional Cooperation Council (previously the Stability Pact for South East Europe - SEE), has been promoting a series of objectives at the regional level, within the Southeast Europe-2020 Strategy that should reinforce cooperation among countries in the region (see: www.rcc.int).

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