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Policy Report

THE RISE OF THE UNDERDOG?

Economy of the Western Balkans

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September 2017

This project has been supported by the Balkan Trust for Democracy,
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Dear Readers,

We are pleased to introduce our new report that includes new formats and somewhat different content. This innovative publication is the unique and timely contribution to the debate on socio-economic matters in the Western Balkans and the economic future of the region. At the time when people are increasingly doubtful about democracy and its power to bring much needed changes in a short run, the economy is one universal thing that requires open, honest and, most importantly, informed debate. To contribute to this relevant discussion in an insightful manner, Populari's analyst Matteo Bonomi, has interviewed a number of intellectuals, scholars, professionals and practitioners, women and men from Serbia, Bosnia and Herzegovina, Macedonia, U.S., Italy, Belgium, Croatia, and UK, actors who have played the central role in a critical examination of the economic prospects of the Western Balkans, and were willing to share their experiences and discuss the region's outlook.

Between January and May 2017, we interviewed Mr. Laza Kekić, Dr. Phil Dušan Reljić, Prof Dr. Vladimir Gligorov, Mrs. Ellen Goldstein, Prof Dr. Milica Uvalić, Prof Dr. Fikret Čaušević, Mr. Hubert Warsmann, Dr. William Bartlett, and Mr. Velimir Šonje.

The interviews covered a range of topics and brought forth a wide range of insights, which served to elaborate the economic future of the region very effectively. Interestingly, although, on the surface, the economic situation does not invite much optimism, our interlocutors believe that all the attempts to restore growth are part of the process and must not be viewed as a failure. Instead of overwhelming despair in the region, some of them see it as all the more cause for broadening public discourse, fostering creativity and mustering new energy.

They also shared their own recollections of the regional dynamics and actions proposed or advocated for, and good strategies, structural reforms, often halted by the politically volatile environment and the governments that lack the will, have little or no interests or knowledge and skills to deliver better economic prospects. While everyone agrees that the region's resources are sufficient to permit greater economic progress, the fact is they are ring-fenced for political elites and until this changes, the economy will not thrive.

The interviews are the central part of this publication, and they were conducted on the basis of a pre-defined questionnaire, but discussions with our interlocutors often went beyond, guided by the desire to fully understand their position and learn from their knowledge and experience.

Both questions and answers were carefully structured and minimally edited, in order to offer the full sense of the ideas, comments, and reflections introduced and recorded. The overarching idea of this report is to share the material, as it is of interest not only to the people working on economic matters of the Western Balkans, but also to people interested in the wider transition processes underway, as well as ideas and plans proposed on the ways to achieve economic progress in this region.

INTRODUCTION

In its 2016 annual report, the World Bank Group offers a cautiously positive vision for the region. According to the Bank, the economic growth in the Western Balkan countries (WB6) reflects two distinct growth patterns. On the one hand, the economies of Serbia and Albania, which account for over half of the region's GDP, experienced steady acceleration as fiscal consolidation efforts were sustained. Structural reforms also made the recovery in private consumption and investment possible, and helped boost Serbian exports. On the other hand, growth slowed in Kosovo, FYR Macedonia, and Montenegro, as private investment softened due to political uncertainty in FYR Macedonia, and external imbalances widened in Montenegro, while the growth in BiH remains steady, even in the context of slower progress on structural reforms. Growth reached an estimated 2.8 percent in 2016—a bit below 3 percent in 2015[1].

Although the tendency of people leaving the region remains high, the report highlights that economic growth has brought jobs to the Western Balkans, and that employment growth accelerated in most countries, driving up the year-on-year regional job growth rate from 2 percent in June 2015 to 4.5 percent in June 2016. Leading in this process is Serbia, at 7.2 percent in 2016, contributing considerably to an almost 6 percent average employment gain for the Western Balkans, while FYR Macedonia and Montenegro also recorded job growth but to a much smaller extent. In Bosnia and Herzegovina, recent labor market reforms have not yet translated meaningfully into higher employment, which was instead down by 2.6 percent year-on-year in June 2016. The youth unemployment rate is about double that of the working-age population, which has implications for future income generation[2].

Analysis and reports like these have a long standing practice in the region. Western Balkans, once known as Yugoslavia, has a long standing relations with the World Bank Group. In 1949, the World Bank had its first mission to Yugoslavia. The aim was to study the country's economy, try to understand post war dynamics and start a financing programme that has continued until today[3]. Since the 1950s, Yugoslavia developed close relations with the Bank, participated in decisions of the Bank's board, and joined the International Development Association (IDA) in 1960. Throughout the 1970s, Yugoslavia's dramatic growth was extensively described in the Bank's reports. Real annual GDP growth averaged 6 percent between 1952 and 1975[4] , and by 1977 per capita GNP was $1,960[5].

However, period of great growth did not last. In 1980s, the Yugoslav economy had been plagued by instability and inflation averaging 40-45 percent a month in the third quarter of 1989[6]. The country found itself unable to cope with the currency crisis and it began printing large amounts of Yugoslav dinars, culminating with the issuance of a new note of 2,000,000 Yugoslav dinars in 1989. Only a few years later, the dissolution of former Yugoslavia created new independent states, each one faced with complex economic realities, some more successful than others. In the 90ies the international financial institutions like the World Bank Group, IMF, EBRD became even more instrumental in the process of transformation for the region.

> “ Their economic advice, once offered as an add-on to large lending programs, has become predominant in shaping domestic economies, to the exclusion of almost everything, and everyone else.

Doubts over the abilities of the Western Balkan actors to engage in progressive thinking about the economy, use their local specific knowledge and use methodologies outside of the narrow mathematical tools have deepened, and over time, World Bank Group views have become prevalent everywhere in the region.

> “ This trend has left consideration of alternative domestic strategies by the wayside, making it increasingly harder to incorporate domestic views and thoughts on what is going on in the region's economies, and how we get to use specific local knowledge to achieve a breakthrough.

While the expertise probably exists, scattered among various schools of economics, institutes and occasional economic conferences, political authorities do not seem to have much interest in (home-grown) economic thought. Deliberately sidelining the best, most educated and innovative scholars and practitioners, economic policy-making by the governments in fact mostly takes place in the inner circles, and broad-minded economic thought, one that should lead in designing new economic policies, remains the work of a few isolated individuals.

> “Given that the overall regional development is supposed to be about the economy and job creation, it is truly remarkable how little the economic analysis features in government planning, but also in the public arena, the media, or in academic circles.

In the region, where distrust in government is a pervasive common thread and where fewer people believe the governments will bring about much needed economic progress, one way to wake up the public interest is to start an informed debate on economics, to set some immediate goals and describe clear steps to be taken along the way, so that the public can understand what is at stake.

For the economy to achieve and sustain significant growth, policy decisions must not be based on the assumption the economy will magically recover. There must be a systemic need to change the approach and to apply a different toolkit to understanding the economy. At the time when the world is a single huge market, and the modern economy is knowledge-intensive rather than capital or labor intensive, telling people exactly what is wrong with our economy and putting together good economic teams is the first step.

> “Decision-makers must be absolutely honest about the scale of the problem that confronts us, without pretending that this is a passing difficulty.

Just the opposite, this will be a long, slow and difficult process, and there can be no magic solution. Whereas the global flow of ideas, information and innovations has skyrocketed, the Western Balkan region still depends on the public sector to shoulder the bulk of unemployment-related issues. The region needs a comprehensive reform of the financial system, with introduction of new financial institutions and instruments, which should allow more flexibility, and which could serve as real engines of development, in contrast to existing impressive commercial bank network, that somehow do not fulfil this role.

So, what are the debates we need to have? What are the forward-looking arguments that take new economic realities into account? Can the region make a breakthrough and use its own domestic knowledge to address these all-important issues, or the international financial institutions will continue to design every inch of our economic future? What are the widespread beliefs about the economy of the Western Balkans and whose interest is to continue using the political instability the region is infected with as an impediment to faster growth? Lastly, we offer a few different and sometimes outright contrasting views on the role of the European Union in the economy of the Western Balkans. The question whether the convergence with the EU is the only option for the region, or whether we should look further and beyond that single choice, and search for other examples of global experience and successful cases is a fair question and should be asked. A complementary, and equally fundamental, topic is whether the region needs closer mutual links if it is to stand a realistic chance to jumpstart growth in the foreseeable future.

To answer these and many other questions, but also to get a full sense of what is the state of the Western Balkans economy and where we take it from here, we bring you the thoughts of prominent practitioners, scholars, and academics.

01

20 YEARS AND COUNTING...

The European Union promised the Western Balkans decades ago (2000 Zagreb, 2003 Thessaloniki), that one day they will have a chance to join the EU. The political question on how the EU will integrate the Western Balkans has evolved over time and the fatigue initially attached to the enlargement process only, has in fact become the fatigue of the EU. The EU dream of the Western Balkans' countries forestalled by the EU's unwillingness, seems further apart than ever. On the other hand, and in a somewhat more realistic view, an argument can be made that the countries of the region will be better able to find their way to stabilize on their own, if the links among themselves are reinforced, regardless of the EU membership goal. Whatever the future brings, more than ever the region needs a socio-economic "sea change" on the ground, a major improvement in the living standards that at least to some extent resemble those in the EU. Western Balkan economies lag behind those of the EU member states in terms of living standards, employment levels and economic opportunities. The average income level in the region is only 36% of the EU-27, varying from Kosovo with as low as 22% of EU 27 average, to 61% in Croatia[7].

> According to the World Bank Group annual reports, the overall Western Balkan economic situation does not give much ground for optimism. Bearing in mind the EU's top priorities and the fact that the EU itself is in the process of recovery, the question that looms large is whether it is realistic for the Balkans to be able to catch-up with the more developed EU in the next 20 years and, even more intriguingly, how that might come about?

LAZA KEKIĆ:

No, of course it cannot happen. It would be well-nigh impossible. GDP per head in the western Balkans is less than 30% of the average in the developed EU and roughly half the level of the east European states that joined the EU in 2004-07.

> For the Balkans to catch up within 20 years, their annual average growth rate in GDP per head would have to exceed that of the developed EU states by 7 percentage points.

As it is, growth in the western Balkans is forecast to average around 4% per year, at best, while the developed EU states would return to trend growth of about 2% per year—thus a differential of only 2 percentage points which would mean that in 20 years' time, the western Balkans would still be scarcely above 40% of the developed EU average.

There are many reasons why the region has modest prospects for long-term growth. These include continuing institutional problems; poor demography; high political risk; fragile fiscal positions; weak innovation performance; the impact of high unemployment on consumption and labour quality.

There is also the important factor of the risk of weak west European growth. Historically, periods of catch-up Balkan growth have tended to coincide with strong growth in the developed European core. Conversely, when developed European growth has been slow, the Balkans has lagged further behind.

To predict the region's long-term growth rate, we can utilise the EIU's model for long-term growth, in which the growth rate in GDP per head is a function of the initial GDP per worker (measuring catch-up potential); demography (working-age relative to total population growth); human capital (measured by schooling and health of workforce); policy variables (openness to trade; government savings; exchange rate valuation), quality of institutions (rule of law, quality of bureaucracy, property rights protection); the regulatory framework (product, credit and labour markets); the external environment: (terms of trade; growth of trading partners); geography (location; primary products share in exports); historic legacies (duration of independent statehood).

There is no way this can be achieved, under any circumstances. Although there has been some catching up during the 2001-2008 period since the GDP growth rates in the Western Balkans were generally much higher than those in the EU, these countries are today still at 23 – 42 percent of GDP per capita of the EU-28 average. Even under the best-case scenario of relatively high growth rates, at the level or above those that preceded the recent crises, it is highly unlikely that any WB country can reach the EU average over the next two decades.

Even the relatively modest forecast 4% growth per year for the Western Balkans is based on some favourable assumptions: the developed EU recovers and sustains trend growth; there is a more favourable demographic scenario; there is a continued trend in deregulation and some progress in institutional change, there is fiscal probity.

MILICA UVALIĆ:

The 20-year experience of Central East European countries illustrates quite well how even under favourable conditions, which have greatly facilitated growth and catching up - including a generally supportive international environment, substantial FDI inflows, continuous assistance from the EU (market access, financial assistance, institution-building etc.) – not even the most developed countries have reached the EU average GDP per capita. Thus by the end of 2015, the Czech Republic was at 85 per cent, while Slovenia at 83 per cent, of the EU28 average GDP per capita (PPS).

But economic development of the individual Balkan countries will obviously vary. Some countries may be able to accelerate the catching up process and move faster than others, by implementing smarter and more efficient economic policies. A more targeted industrial policy that would channel resources towards key priority sectors, facilitate technological upgrading and innovation, help exporting industries and offer major support to SMEs could contribute to faster economic growth. For example, the Serbian government has recently put great emphasis on innovation policy through a series of measures, including incentives for innovative enterprises.

VELIMIR ŠONJE:

> “ It is realistic, subject to political changes.

Main obstacles for faster convergence are weak institutions, corruption and overwhelming government presence in the economy. There is no automatism of convergence, as weak institutions, corruption and overwhelming presence of incompetent governments may create vicious circles that lead to permanent developmental lags. EU entry and/or the prospect of EU entry is the only "outside shock" that may change bad domestic politico-economic equilibria.

WILLIAM BARTLETT:

So if you think over the last 20 years, it's been, I guess a widening of the gap really between the Western Balkans and the EU, since the break of the Yugoslavia and so I suppose over the next 20 years it could be closed again, I don't see any reason why not.

> “ I think the Western Balkans have a lot of growth potential.

The backward countries always have a huge growth potential because they can borrow the existing technology from the advanced countries, and if they can use it and implement it, then they can peak forward to the level of the more advanced countries or closer to it, so there is that huge potential to catch that over a 20 year period and there's absolutely no reason why they shouldn't do it. Well there may be many reasons why they shouldn't do it, but...

If everything worked out in the best possible way, then it certainly could be.

> “Catch up to the EU. Well, of course the EU might break up and fall backwards towards the Balkans, I suppose that's one way it might happen.

But let's say the EU continues to maintain, and move forward and prosper, and it will be, there will be economic growth taking place and so the target to catch up to will be continuously getting further and further away, so they have to catch up pretty quickly and that means they have to have rates of growth of 4-5% a year or more, cause probably the growth rates in the EU countries is going to be, you know, if everything goes well, up to 2% a year, so the Western Balkans have to achieve 5%, in order to catch up.

And the only time that happened was in, over the last 20 years, was in 2000s, 2000 and 2008 when the Western Balkans countries did have average growth rate of 5% and so... What brought that about? Well it was the political stability following the end of the wars and conflict period, which ended with the conflict in Macedonia in 2001. And I suppose that the bounce back from that conflict, the destructions, it's part of it, but also there was some foreign investment coming in, there was a period, also a rapid growth in the world economy, you know, the boom period, so the external conditions were favorable and I think that's an important aspect of catching up to the EU over the next 20 years - the external conditions should be favorable. There should be a market for the exports and it should be an inflow of capital and foreign investment, as long as that happens, then I think the Western Balkans can do very well. And then it has to be also sort of internal favorable conditions as well as external favorable conditions and this is where the Western Balkans can really help themselves. And I think one of the big problems at the moment is the lack of domestic investment. Investment rate in Serbia is about 17% of GDP or something like that, which is very low, you know if it can increase the investment rate up to 20%, then will stop to have more rapid growth. So the question then is, what are the incentives for investment? I mean they can attract foreign investment, but they also need to really have domestic investment as well. It means, first of all, secure property rights, in some countries property rights are still not secured, particularly in Albania or in Kosovo, there is a lot of property disputes going on, probably less so in other countries but there is some of that. And then it needs some sort of political stability, I suppose, in order to make a safe harbour for investment and you can see in places like Bosnia in particular, that political stability isn't there because it's a divided country and all the political problems they have got... Probably, in the other countries, you don't have that to such an extent, so that's a particular problem in Bosnia. And then what else do you need? Well, you need an expansion, you need a demand for the products of the businesses, in which business are you going to invest, it thrives your investments, future expected profits and interest rates. If they think they are going to make a profit in the future, then they might decide to carry on some investments, which means expanding demand.

The problem at the moment is that the policies, which are being imposed on the Western Balkans countries by the IMF and, to a lesser extent, by the EU, are basically the same austerity policies, deflationary policies that are being applied in Southern Europe, countries such as Greece and so on and that's not good for investment, if the demand is being suppressed by cuts to the public budgets and cuts to public employment, public sector wages, cuts to pensions and social programs, all of that is depressing demand for the domestic products. I mean that the justification for having an austerity-deflation program is that you cut the public sector and you cut the domestic demand and you shift resources into the export sectors and that's fine. That's a good argument if you've got a full employment economy and there's a constraint on exports, on the export sectors, which is that they cannot get enough workers because the workers are all employed by the public sector, or by the companies which are providing goods to the domestic economy. But since this massive unemployment in the Western Balkans, that argument is complete nonsense.

The export sector is not constrained by the lack of internal men power and therefore, you have to suppress local demand, in order to shift resources into the export sector. That's not the situation at all. The export sector is constrained...

HUBERT WARSMANN:

I'm afraid the answer to that has to be no. You just need to look at the experience in Central Europe, the first wave of accession countries, you have countries, which I think started from a higher basis and we are now 25 years essentially after the beginning of convergence process and you can see that the convergence has happened but it is far from finished. So if we are talking of a group of countries, which I think are starting from a lower relative base toward the EU, it would be great if convergance could take place in 20 years, but it's not a realistic scenario.

I think it will definitely be convergence, but the convergence would not likely be finished in 20 years. I think that would be an achievement over what has been done in Central Europe, which is quite considerable in itself, but it's not finished.

I think the Western Balkans has a lower starting base, it suffered the wars and the consequences of the wars and then there is a process, which is also not benefiting from a very positive world environment. I think, certainly, in Central Europe conversions benefited from a very dynamic world economy, which is not there, I mean, which is simply not there. And I think if you look at things like FDI, I mean FDI inflows in Central Europe where a couple of magnitude orders larger on what is going into the Western Balkans and part of that can be blamed on specific issues to the Western Balkans but it is also due to the fact that we have a world economy which is not as dynamic as it was when Central Europe had the a big boost.

ELLEN GOLDSTEIN:

> “I would characterize the World Bank reports as giving ground for cautious optimism in the Balkans, in a following sense: we have seen the recovery of growth over the past two years, we have seen this recovery of growth linked to both rising employment in all six of the Western Balkan countries, as well as a recovery in credit to the economy.

So, clearly much more growth is needed over many years, I do think we are at a point where the Western Balkans are in recovery from the global crisis in 2008 and now the question becomes: how can we accelerate growth and job creation and sustain this over a long period of time?

Well we at the World Bank often point out that catching up in the next, say, 20 to 30 years would require the Western Balkan countries to grow at the rate of about 5 or 6% per annum. Now, is that realistic? Well, it's possible, because in fact the Western Balkans grew between 5 and 6% per year between 2000 and 2008, before the crisis. So, it is possible that they grow at that rate, but they are currently growing at between 2 and 3%, so clearly there is need to pursue policies that are going to accelerate the growth rate up to 5-6% in order for income level to converge over the next say 25 or 30 years with the European Union average.

> “It’s a common mistake to think that Europe must grow quickly in order for the Western Balkans to grow quickly and, in fact, the experience before the crisis shows that Europe can grow far slower and we can still see growth rates of 5-6 % in the Western Balkans.

Because the Western Balkans economies are so small, relative to the huge market of Europe and, of course, relative to other large global markets in Asia and in Latin America etc. The Western Balkans needs a small opportunity on a global scale in order to accelerate their growth in a very significant way.

And I often point out that, in fact, since the global crisis, the Western Balkan countries have actually quadrupled their exports to the European Union from a very small base, and that’s been a very important driver of the growth recovery. So again you can see that even at the time when Europe is struggling very much with its own internal issues, small opportunities to integrate into markets, whether they are in the EU or whether they are further field globally, can really change the dynamics for the Western Balkans.

VLADIMIR GLIGOROV:

Well, the prospects for the economies in the Western Balkans or Balkans in general, are not necessarily not-optimistic or pessimistic, not in the sense of how bad possibly the economic situation there is, but in the sense of what are the growths prospects in the region now. Of course, looking forward 20 years is rather long time, but, certainly, in short and medium term, the region is expecting to have a growth rate, which is some about, well, almost twice as much as the one in the EU, or the forecasted growth rate in the EU, so the region should be growing somewhere around 3% or little bit more than that, or in the short run, maybe moving to toward 4%, later, maybe in about three years’ time. Certainly, in terms of catching up, giving the growth rate in the EU, the region will be closing the gap, albeit rather slowly, let’s say by 1 to 2.5 maybe up to 2.5 % per year, so that gives you in 20 years’ time, some closing of the gap, actually not a significant closing of the gap. So, in that sense, that’s not pessimistic necessarily. One reason why this is not being feasible is that there is a very significant, or very high, unemployment rate in the region, which means that if, indeed, there would be a sustained policy effort, and generally, positive economic atmosphere, and political atmosphere, you would certainly have some space, even without productivity growth, you would have a space for an increase so far up to 20% of GDP just due to possible increase in employment. And then of course, there are obvious productivity gains, there could be there, and so on.

So, I wouldn't say that, necessarily, the view is, or the prospective is, pessimistic. I think, most people, international financial organizations including, look at past years, which were very bad for the region, basically, a disaster, so they are sort of extrapolated, of course from that point of view, the perspective is quite pessimistic.

> “ So, the real question is, can the region, have a sort of a historical turn around in terms of development?

DUŠAN RELJIĆ:

I am not into the business of looking at the crystal balls, so I really can't answer you with something based on evidence. However, I do remember that in the early 2000s, there was a calculation by the EDBR in London, The European Bank for Reconstruction and Development, saying that if the Western Balkan countries, at that point including Croatia as well, would sustain the pace of GDP growth that the EU had in the early 2000s, they would catch up with the EU average at 2020.

Now, two or three years ago, we had a new calculation by the World Bank saying that if the EU stagnates, and the South East European six countries (this is without Croatia) maintain a 6% growth per year, of GDP, they would catch up at 2035.

So, this seems to be evidence that it will not work. At least it will not work on the way in which we have imagined this, and in the way in which it was proposed by the international financial and development institutions and most importantly by EU itself through its transition model, which is suggested or imposed on the candidate countries, which ever you want to call it.

However, as I have read in a World Bank report, examples of successful convergence in the world economy are rare, and in that paper, I read those examples, I noticed those examples: Japan and Singapore; in Europe - Italy, after the Second World War, and this is where the list ends. Korea!
Of course - South Korea!

> “And, an example for the country, which have worked quite well – Germany – is that in spite of the fact that, since German unification in 1991, the transfer from the rest of these amounted almost 2 trillion euro. No one else in history received 2 trillion euro.

We are talking about 60 million people to receive 2 trillion euro. For the long time, East Germany would not catch up with the questioned average. Some parts of East Germany will, like the areas around the cities of Leipzig and Riesa, and what is characterized in both those cities is that they have a concentration of, what they call intelligent industries and businesses, high technology.

So, there, where you have growth through innovation and a lot of added value, then you can catch up, and the Balkans, at this moment, don’t have the GDP growth based on knowledge economy and innovation, their growth is based mostly on cheap labor and extractive industries.

FIKRET ČAUŠEVIĆ:

The first thing is that the European Union in itself, and the Eurozone in the first place, is in serious troubles, and I am very sceptical about the future of the Eurozone. The most important trading partners for the Western Balkan countries are: Germany, Italy, Slovenia and Croatia (since 2013) and 60 to 65% of the total trade of the Western Balkans is linked to those four countries. And economic situation in those four countries varies greatly. So, Germany, according to my research, most recent research published in the book “A Study into Financial Globalization, Economic Growth, and Inequalities” is by far the best performing developed country for the last 10 years, or even the last 15, but especially for the last 10 years. The best performer in the group G-10, together with Sweden and Switzerland. But when it comes to the Eurozone, Germany has been the best performer since 2005, especially since 2005. When it comes to the southern part of the European Union and especially to the Eurozone, countries such as Italy, Portugal and Greece have been the worst performers. What is interesting here? Italy has been the worst performer, actually, since 1995, in the 1995-2015 period (over the last 20 years) and Greece has become the worst performer in the 2009-2015 period.

So, when it comes to trade flows and cooperation with Germany, economic conditions and good economic situation in Germany are favourable for Western Balkan countries.

With regards to Austria, Bosnia has been the best performer in the Western Balkans in terms of achieving a trade surplus with Austria, the only country in the region of South East Europe to do so in the period of 2000-2015.

The foreign trade balance has improved very much in the last five years, particularly trade with Austria, partly trade with Germany, while, unfortunately, regarding trade with Russia and China, the whole region has been in a very difficult situation in terms of having very high trade deficit with Russia and with China. But with regard to the imports-exports coverage ratio with Western European countries, it was around 80%, which is relatively good.

When it comes to Croatia, Croatia continually has trade surpluses with Bosnia and with Serbia, which makes Bosnia a very important a trade partner for Croatia, actually the most important one, as it is the only country that ensures that Croatia has a very high trade surplus. Croatia has been able to decrease its trade deficit and turn its current account deficit into a current account surplus, but the country still was the only country in Europe in recession in the period 2009-2015 (so six years in a row).

The Western Balkans has a very good position in terms of being a nexus between the East and the West, and being able to revive some of its manufacturing, especially the sectors related to wood- and metal-processing, and partly food-processing industry, and it has been able to export its goods to Western European countries, particularly to Germany, Austria, Italy, and, to some extent, France and the United Kingdom. Slovenia is an important player in this part of the world, in the Western Balkans, it was the first country in transition, the first socialist country to become an EU member, but it a peculiar paradox occurred after the country entered the EU and especially the Eurozone, it become either less resilient or more irresponsible, financially irresponsible, particularly in the 2004-2009 period. The country's external debt to GDP ratio rose from 60 or 65% in 2004 to more than 100% in 2009-2010.

When it comes to foreign direct investment, financial flows based on FDI, it is very important to know that FDI from Slovenia to other parts of the Western Balkans, especially to Bosnia and partly to Serbia, was primarily based on industrial companies entering different industrial sectors, such as food processing, metal processing industry... And those companies in Bosnia and Serbia that received capital from Slovenia were able to increase their output and their exports, and to lessen the burden of trade deficit; especially in case of Bosnia, even to increase their exports to Slovenia to the level of 90-95% of imports coverage ratio. So trade deficit of Bosnia with Slovenia is just 30 to 35 million euros. Bosnia had the largest trade deficit in trade with Slovenia in the 2000-2002 period, but over the last 15 or 20 years, particularly in 2000-2015 period, and especially in the first 10 years of the century, the largest trade deficit of Bosnia was in trade with neighbouring Croatia, and trade deficit with Serbia has been on the rise. So Bosnia, as a market, a special type of market, is very important, the Bosnian economy is very important for both neighbouring countries, for Croatia and for Serbia. So when it comes to FDI flows from Croatia to Bosnia, those investments, to Bosnia from Croatia are more related to the service sector and not very much to the manufacturing sectors, whose export capacity could be increased.

FDI flows, especially from Germany and Austria, increased also, helping strengthen the industrial base in Bosnia and Serbia and those companies in the two countries were able to increase their export capacities, especially in metal- and wood-processing industry and partially in the food processing industry. We all know, that the industrial base in the former Yugoslavia – which is today former Yugoslavia, minus Slovenia plus Albania - industrial base inherited from the pre-war period from the second Yugoslavia, and especially from the period from 1965 till 1985 or 1990, was relatively well-developed for its time. Let us not forget that the former Yugoslavia, and especially Bosnia, Croatia and Slovenia, in part also Serbia, but especially Slovenia, Croatia and Bosnia, exported a greater part of their output, not very much but perhaps up to 10% to Western Europe and to the U.S., and further 40% of total output was exported to the former, so-called Eastern Block. In the 1985-1990 period, Bosnian manufacturers were able to export some 40% of their total output to Western Europe, especially to Germany, Austria, and Switzerland... And of course to Italy, so those four countries were the most important, especially Germany, Austria, and Italy and to some extent Switzerland.

> “The whole story is related to the level of industrial knowledge.

The worst economic trend, not only for the Western Balkans, but also for many other countries in transition, has been the process of de-industrialization but fortunately, for the last 10 years, at least, some of those companies have managed to survive the period of transition and privatization. Some of them were successful stories or successful examples of privatization, which then allowed them to increase total exports.

02

21st CENTURY BANKING

All transition countries experience high degrees of penetration of foreign capital in their banking sectors. In the case of the Western Balkans, European banks have developed a strong presence in the region, accounting for 75-90% of banking system assets. Most banks in the region are in German, Italian, Greek and Austrian hands. Banking sector privatization has contributed to strong financial and capital market integration with the European Union (EU), and it was motivated by high profitability potential (high interest margins) in the banking sectors of the Balkans and profit-orientation of EU banks. With the entry of foreign banks, availability of loans to the private sector increased fast. Bank lending particularly focused on households, but small and medium-sized companies' access to bank loans has been more limited. In order to understand better the nature, volume and future orientation of this relationship, we have asked who profits most from it and how?

LAZA KEKIĆ:

Some 90% of the region's commercial banking sectors are foreign-owned. This is inevitable, that is also the pattern in east European EU member states. So it is not really worth discussing whether a good idea as there is no possible domestically-owned alternative.

> “ Foreign-owned banks make for certain vulnerability, but they also increase financial sector efficiency—for example, they reduce interest rate spreads.

MILICA UVALIĆ:

There is no doubt that the sale of domestic banks to foreign, mainly European banks, has greatly increased efficiency of the banking sector in the Balkans. The privatization of the Western Balkans banking sector has also greatly contributed to strong financial and capital markets integration with the EU thus facilitating the arrival of fresh capital, particularly important for countries with very low savings rates, as are the Balkans. At the same time, dependence on foreign capital has increased Western Balkan countries vulnerability to external shocks, as became evident after the strong impact of the global economic crisis in late 2008.

> “ The foreign ownership of banks, though a welcome feature in the initial process of bank restructuring and privatization, was also an important channel for contagion

by the global financial crisis.

Financial and trade integration proved to be a double-edged sword: in good times, the European core exported its prosperity towards its southeastern periphery; but in times of crisis, it exported instability.

VELIMIR ŠONJE:

Citizens and corporations profit from this. Well-established EU banks provided safety cushions for local economies although some of the mother banks experienced business problems. Smaller local banks, including those with direct government involvement, had substantial problems during the crisis period.

> Had all banks been owned by domestic owners and governments, crisis would have been more severe, as witnessed by cases of major banks in Slovenia, one medium-sized government owned bank in Croatia (Postal Bank) and a smaller bank in Serbia.

WILLIAM BARTLET:

This took place in the 2000's, 2003-04 or so and it led to a great inflow of credit which partly fuelled the boom in that period, and obviously those banks found it profitable to enter into the market and they were making good profits by giving loans to people to buy new car and mortgages and so on and the consumer credit. And so, that was, the consumers benefited, but the small business didn't benefit so much and the banks obviously benefited. After the economic crisis this growth of credit came to a sudden hold and banks begin to actually withdraw money from the region in a process known as deleveraging and they began to send their money back home to their parent banks to assure their capital base in the context of the Euro-zone crisis.

> So the problem is, I think, that having the banks taken over by foreign banks, it really does make the economies very vulnerable to the decisions made in the headquarters of those banks and you can see that has led to stagnation over the last 5 or 6 years, as those banks have taken money out of the countries.

And probably more importantly is that the banks don't lend to small businesses even if they have a prospective of a good return, because they think that small businesses are more risky and banks are very risk averse so that hasn't been a benefit to economic development.

HUBERT WARSMANN:

In a way, I think, I would probably just dispute the statement a little bit. Yes it's true that in the financial sector, the international presence is very heavy, but it's not specific to the Western Balkans. I think it's been the same all over Central and Eastern Europe with few examples like you have OTP Bank in Hungary, which has remained at least in Hungarian management. It's a publicly stated company, so the ownership is actually, very diverse including a lot of international institutions, but the management is very Hungarian. You have a couple of banks in Poland, PKO mostly which have remained Polish.

> In a way, I think it's been both a blessing and a bit of a curse. I mean it's been a blessing in as much as these banks have been able to reform very quickly to improve capital ratios and so on.

When we've seen the difficult times in Western Europe, you've seen an international mobilization to avoid a reflow of capital towards Western Europe, the famous, you know the Vienna Initiative, which was sponsored by the EBRD, the EU Commission, which has actually been quite effective. If you look at the way banks have behaved in Central Europe, we haven't seen a massive outflow of capital back to the home markets, although in some circumstances the home markets could actually have gotten away with it. If you look at the situation in South Eastern Europe where Greek Banks were very present, the Austrian banks, I think I've already mentioned the Italian banks, I'm sure you know all about this situation, and in fact, there isn't actually being a reflow of capital towards this market. I mean the situation has actually been maintained more or less. Indeed, it's been a credit crunch, but credit crunch has happened anywhere and you could have actually thought that the credit crunch would have been much worse in Central and Eastern Europe than it has actually been. It's not, you wouldn't say it's a blessing, I think, probably, having a mixed ownership in your financial system is not a bad thing, but I wouldn't describe the current situation as an absolute catastrophe. I think when the financial situation started to deteriorate in Western Europe, the key stakeholders were quick to notice the potential problem and the Vienna Initiative has actually been really effective in maintaining capital in these countries, in maintaining some lending. It's true, I mean, it's been a credit crunch, but the credit crunch has actually been everywhere and certainly it could have been a lot worse in the region than it has been. Now, having larger financial system probably helps modernizing a lot, and it's something, which would not had happened on its own. If you look into a country like Hungary where you have a very large, domestically managed and domestically owned bank, I think it has also modernized but you can also, probably, argue the fact that at least 50% of the banking market was owned by Germans, Austrians, Italians and you name it, it has also put the impetus on that bank to catch up, it could have made the choice of living on its Acquis and waiting to see its market share to be slowly eroded by the other guy, but it didn't. So, the impetus of the foreign banks was there for them to modernize, to have a product offering to match them and so on.

If you have to look at countries, which traditionally operate on informal networks, when that tradition is not conducive to, in effect, great banking ethics.

> So I think that mixed ownership is certainly a spur on people to improve or at least move towards better principles and better standards.

VLADIMIR GLIGOROV:

Well, the region actually is lacking in foreign investments when it comes to manufacturing and, generally, what you would call the tradable sector, which would mean manufacturing, agriculture, and even in some places, tourism or services. Due to all kind of reasons, basically, fragmented market and political uncertainty would be, among them, main causes. The foreign investments from Germany, not so much, but from Austria, I mean, in part Italy and so on, went mostly to non-tradable sectors, which means financial services, telecommunications and information services in general, other services, trade and so on. And, these are the sectors that are mostly owned by foreigners, so, now, there is more of interest as economic prospects improve and as regional stability improves, there are more interested investors in a tradable sectors, also, what is helping is a significant change in the competitiveness of the region, with the declining or lower and slower growth of wages and labor costs generally, and other costs also, so, I think, one would expect more of an interest of foreign investors and investors in general, to go for investment in areas or sectors that are more export oriented. That would be one aspect, and the other thing is that, given the need for the region to export more and import less, or to speak clearly, that, in the future, there is much more, involvement of domestic investors, meaning of domestic entrepreneurs, because foreign investment also brings imports of foreign goods, also mostly from Italy and Germany. And that of course is a problem for the trade balance and the current accounts, so what we would expect, for one thing, that foreign investment will be more towards manufacturing and another tradable goods, and possibly region wide, and at the same time, that local entrepreneurs should actually play a greater role going forward.

DUŠAN RELJIĆ:

The relationship was established after the disintegration of Former Yugoslavia and after the regime-change, which happened in this region. The difference from the Central and Eastern Europe, is that we did not only have the end of communism and the introduction of capitalist model, but also had the disintegration of a state through war and this threw back the countries for a long time.

So once they decided that they opted for a different socio-political system, of course, their prime motivation was to try to converge with the rest of Europe and convergence with the West of Europe means also obtaining the membership in the European Union. So, most of these countries changed their patterns of the trade flows.

> “In old Yugoslavia, the politics of the ruling Communist Party was to have 1/3 of trade with the West, 1/3 with the East and 1/3 with the South, to avoid dependences and avoid impacts of global economic crises.

You have now in the successful countries an orientation towards Western Europe. In good times, this is good, because it is a strong pull factor; demand comes from the EU countries. In bad times, the repercussions are big, because the countries lose markets, they lose investments coming from the EU, and they lose money from remittances of the migrant workers.

This was the experience after 2008. In the last two or three years, with some demand picking up in Germany and Italy, we see also some growth in the region, and this growth is also due to the cheap energy prices and because of changes in the demographic structure as well. Altogether, I wouldn't claim what the Economist Intelligence Unit wrote at one point about Western Balkans that that two last decades were lost decades in terms of the economic development and social development, but obvious outcome or obvious result is that the idea that it would be enough to assimilate the Acquis of the European Union, to privatize and to open for foreign investments, that this was lead to converges that this mantra, this idea coming from the World Bank and the EU, it failed, and we are in situation in which simple real life demands changes.

FIKRET ČAUSEVIĆ:

German industry and Germany as a source of foreign direct investments are extremely important, and Germany is the most important export market, not only for Bosnia and Herzegovina but also for Croatia and Serbia. The most important banks present in the region come from Italy and Austria, and then from Germany.
Who profits? The answer is very simple - shareholders. A simple rule of economic life is: shareholders put their money and they are willing to invest in order to earn returns. But in terms of technology, of technological improvement in the banking industry, the banking industry has been strengthened in all countries in the region, thanks to capital coming from the West. Of this there is no doubt. But still, which is the argument you can hear very often in local discussions: "We need local banks!"

> The case of Bosnia and Herzegovina explains this clearly. In 1998, total GDP of Bosnia and Herzegovina was just 4 billion USD. At the time, the country's population was only 3.3 million, and the GDP was just 4 billion USD and there were 70 banks in Bosnia, in such a small country, just 3 years after the war.

Out of those 70 banks, more than 60% were privately-owned banks established during the war. 1/3 of them were little more than money laundering channels and in some cases were used to bankroll war criminals, so helping local banks and supporting local owners, so-called shareholders, who at that time were rather prone to finance criminal activities was not the right answer.

Since 2000, in October 2000, the Raiffeisen Bank entered as the first foreign bank at the market, by purchasing the controlling stake in the Market Bank, a fast growing privately-owned bank, and the bank has since been doing business in Bosnia and Herzegovina relatively or very successfully for the last 16 years. Of course, there were problems during the recession in 2009 and the next recession year in Bosnia was 2012, but Bosnia was not in recession in 2010, 2011, 2013, 2014 and 2015, which was the case in Croatia from 2009 to 2015. All those banks, I mean all, almost all of them coming from the West, were here to improve the quality of business, to lower interest rates, so they did not raise but actually lowered interest rates. Of course the that those banks demand higher interest rates in this country, in this region, relative to the home countries where their parent banks come from - Germany, Austria and Italy.

Of course, that is the case but let's compare those interest rates that were set up in the period 1997-2000, again in the case of Bosnia and Herzegovina, and it was very similar in Serbia, and to some extent in Croatia. In 1998m the annual interest rate in Bosnia was 55%, which meant that the interest rates at that time ranged from 2.5, 2.8, 3.5-4% on the monthly basis, let us not forget that. So, it was 55% on the annual basis, and with such very high interest rates it was impossible to finance industrial production. It was only possible to finance, what? Trade – small-scale trade activities and smuggling, because in the light of the situation at that time, which was evident any time one travelled to Bosnia, the state border practically did not exist. The state border controls in Bosnia were established in 2000, but the total control of the Bosnian borders was only established in December of 2002. So, very high interest rates offered by domestic, private banks owned by locals, by Bosnians or by Serbs from Serbia or by Croatians from Croatia, imposed very high cost of funds or cost of credit at that time, making it almost impossible to finance industrial production, not only in Bosnia but also in Croatia or Serbia, and it was of course almost the same in Macedonia. Kosovo was not at that time independent state, and neither was Montenegro.

All in all, I do not want to glorify the role of foreign banks, I wrote several papers explaining what happened here, in the Western Balkans, and not only in the Western Balkans, because the story was very similar in Central and Eastern Europe. So, those companies, financial companies – banks, and their shareholders, they had a very clear interest to make money, but they also succeeded in increasing the quality of service. So what was the problem? Those companies, corporations, joint stock companies (by law in the Western Balkans, they must be registered as joint stock companies), they were willing to invest more money and not just for very short periods of time but to make more money over the medium to long term. So they invested into activities in which they could make greater profits. Those types of activities were related to what? To services, to the service industry, including trade, both wholesale and retail, to construction activities, so in some cases it was speculative capital, the kind of speculation such as occurs in investment markets in Europe and the U.S. So it is not as if these markets are completely separated.

“ Their logic is similar, of course they cannot earn money here in the Western Balkans by dealing with credit swaps or financial derivatives, or futures or mortgage-backed securities, because the market is very small, too small for them.

03

TOP THREE IMPEDIMENTS TO FASTER GROWTH

Political volatility has always been one of the crucial obstacles to the faster growth of the region. Countries like Macedonia, Kosovo, or Bosnia and Herzegovina fill the international news headlines with new political crises every now and then and political leadership across the region does not seem to be equipped, or particularly eager, to take on the major challenges of our times. At the same time, increasingly pervasive modern technologies require an entirely different set of skills to enhance the growth and education systems in the Western Balkans are in dire need of a comprehensive overhaul. Weak and non-resilient public institutions, struggling with chronic lack of transparency and high levels of corruption, coupled with unfavourable business climate, make for a mixture toxic to chances for faster progress. These and many other obstacles all constitute real challenges for the countries of the region to get on a path to progress, but is it possible to identify top three major, crucial impediments to faster growth in the Western Balkans?

LAZA KEKIĆ:

> “The top three are probably weak institutions, high political risk and under-trading—very low export/GDP ratios.

MILICA UVALIĆ:

First, insufficient export-orientation deriving from essentially limited external competitiveness. Second, underutilization of human capital due to very high unemployment rates and low employment rates. Third, inefficient public administration, primarily very limited coordination of sectoral policies, weak implementation capacity, lack of longer-term planning and impact analysis.

VELIMIR ŠONJE:

> “Weak institutions and corruption, direct government involvement in the economy, lack of faster political convergence to the EU and the weak education systems.

WILLIAM BARTLETT:

> Lack of credit in small businesses, it's the lack of skills of the labor force because the higher education and "the vocational education are not producing people with the right skills for the growing businesses"... the third one could be the austerity policies, which are imposed by the IMF which, and the EU, which are suppressing domestic demand.

HUBERT WARSMANN:

There is definitely an issue of skills; I think generally speaking, I think if you combine the single issue demographics and skills. I mean, demographics are not great in this country where we don't see a lot of growth and we see also a lot of emigration. So you tend to lose the younger people, the better trained people and that is definitely a problem. I think the second big impediment is probably a lack of integration in the global trade and the third is probably the transport infrastructure, which is not really up to part yet and is having many implications.

> Integration in world trade will happen if and when FDI comes and FDI can only come if investors see that all the conditions are there, business climate and also hard infrastructure getting in and out.

ELLEN GOLDSTEIN:

Number one, for most of the countries of the Western Balkans, is the continued oversized and ineffective state apparatus, much of which is the legacy of former Yugoslavia and in many of the countries particularly Serbia, Bosnia and Montenegro has not been adequately reformed yet. The countries are starting to tackle this issue. The second is the weak business environment. Much progress has been made in many of the countries to improve different aspects but the overall investor experience has not improved enough, yet, to really change the dynamic for investment and growth in the Balkans.

> And then there is the lack of integration into regional and global markets and lack of integration into global value chains. This requires a much greater outward orientation, and the countries are really just starting to excel in, and we've seen some progress in both Macedonia and Serbia, in linking into broader global markets and into global value chains.

We've seen a lot of this particularly in the automotive industry, for example, but that needs to be replicated many times over, in order for these countries to grow faster. So again, three things: grappling with an ineffective state, developing a world-class business environment and shifting from an inward to outward orientation and integrating regionally and globally.

VLADIMIR GLIGOROV:

If you look at growth in general, you certainly have a lot of people that can still work, the region is very far from full employment, and there is spare capacity in human capital, so to speak. In most countries of the region, there is now an improved competitiveness, even if you include Croatia, you can see that in the last five or six years, there has been a huge increase in exports from the region, and that should mean there would be more interest in investment in the exporting sectors and then of course, there is also lot of possibilities to improve the regional markets, because both the external markets and the domestic, regional market is certainly attractive if it can be relied on, because it provides for economy of scale basically. The three most important spurs of growth: development policies based on infrastructure investments and similar investments that support increased private investments, then certainly, competitiveness of the region, and the third would be abundance of local labor.

DUŠAN RELJIĆ:

I would point out at the still felt impacts of the wars, not only in terms of material devastation, but also the outflow of people.

> Since 2000, approximately 1/5 of the population of the region has emigrated. And among those who left there were often the best and the brightest.

So for me, I would say that this is the biggest impediment that we have had a huge loss of human capital in the last 20-25 years.

Second point is that the Former Yugoslavia, it had a lot of deficiency, but nevertheless, it enabled some kind of equality in chances regarding social mobility for young people. If you were coming from a family of industrial workers, you nevertheless had chances to go on an academic career. So, huge social economic changes happened in the last twenty years. This stopped with the war, huge human losses, and now, with poverty returning to some parts of the Former Yugoslavia, especially Kosovo and Macedonia, you have UNDP reports that Kosovo is now poorer than it was after 1999, after the end of the war there. The up forth mobility has been stopped, what's remained is horizontal regional mobility, go away, move away.

> “So, I would say: human factor, in both terms of a) physical presence and b) education, these are the two most important things.

And the third one is, of course, that the country itself becomes far more prone to be swayed by external economic and social economic influences. If Greece is in trouble (Serbia's banking market is something like 17 or 18% in Greek hands), so it means that Greek banks can't really fulfill their role there, which means mobilizing capital for the population. Moving on, they simply have to deleverage, what the other banks have done as well. So the external economy is the third biggest threats in the region.

FIKRET ČAUSEVIĆ:

The first impediment to faster growth is political complexity of the region. Beyond any doubt: this is a problem, not only in Bosnia, but for the region - but especially in Bosnia. And also in Bosnia's relationships with its neighbours, first of all with Croatia and Serbia.

Why is this complexity so important?

> “Because the politicians in the region, not only in Bosnia, Serbia, but also in Croatia, Macedonia and even Montenegro, Kosovo... They have been willing to play the game to show their ethnic groups that they can protect their interest, but in fact they have promoted economic policies which were actually detrimental to those ethnic

groups.

What would be good for those ethnic groups, or those nations. It should be about the connectivity, about breaking administrative barriers to cooperation between companies and entrepreneurs, within Bosnia, and between Bosnia and Croatia, and Bosnia and Serbia, paving the way for better cooperation based on so-called production clusters and creating examples of a win-win situation through cooperation, especially between three countries, Croatia, Bosnia and Serbia, because they inherited the industrial structures and industrial base from before the war and there are still some, let me call them, parts of clusters that could cooperate, so companies from these three countries could cooperate, assuming that administrative barriers are removed; and those administrative barriers remain the most important impediment to economic growth.

The second obstacle relates to the still rigid financial infrastructure. We have already discussed the issue of the banking, banking industry, and by definition of commercial banks, which are not the right institution, they are not able to finance economic growth in the long run. Fortunately, we have had involvement of international financial organizations, development banks, especially here in Bosnia, but also in Croatia, Serbia, and Montenegro. Montenegro has received more World Bank Group aid per capita than Bosnia in spite of the fact that Bosnia was hard hit by the armed aggression, while other countries in the region were less impacted by war. But for various reasons, Montenegro has had a very special status.

We need more flexible financial structures, pro-growth oriented, and that is why, 5 or 6 years ago, I made a proposal, my proposal was based on the so-called Euro-Balkan bonds. Issuance of Euro-Balkan bonds, as a new type of financial asset, would be extremely important, particularly if we want to be able to restructure our pension system, which is urgently needed, as you know, and it is something that we must do over the next 5-10 years, because state pension systems are not sustainable, not only in this region but also in Western Europe, in the U.S. etc.

So, as to reconstructing the pension systems in Bosnia, Serbia and in other countries in the region, we have to set up a private pension schemes, or private pension funds. In order to avoid money outflows from the region, if we put our money in private pension funds, you, me and many others here in Bosnia, then the managers of those funds, they would be accountable to us, for management of our funds. And what is a typical structure of pension funds? Typical structure of pension funds' assets consists of financial assets. So, in order to retain the money here, in this region, and use it to finance economic growth, investment, capital investments here in this region, connecting all those countries, we need financial assets of better quality.

By definition, bonds are better quality financial assets, particularly government bonds. Government bonds are the least risky financial assets, but there is a big "but" here, in this region, as in other politically shaky regions. When a government or governments decide to issue financial assets of this kind, they are less risky than shares or stocks but they are still risky because of political uncertainties and institutional instability. So, my proposal is that the European Union establishes a special guarantee fund. So the European Union would establish the guarantee fund for the Western Balkans, and this guarantee fund would be responsible to guarantee such national government bond issues in order to decrease the level of risk, but the EU would have the right of conversion, i.e. to swap the equity of the guarantee fund for equities of public utility companies. This would have the added benefit of not forcing those countries or governments of those countries in the region, to privatize telecoms or power generation companies, at least those that are still state-owned, e.g. in Bosnia and Serbia. In Macedonia the telecom was sold 15 years ago, but still in Serbia and Bosnia, majority stakes are still held by respective governments.

So my proposal is to give the guarantee fund the right to conduct this guarantee-equity swap. The second right could be to let the guarantee fund have the golden share and to appoint representatives to supervisory boards of those companies (telecoms and electricity generation companies). And the third right would be to carry out direct control of public finances every 6 months or every 12 months. So, taken together these are very effective control instruments. Empty promises would not suffice as a guarantee. EU would be able to take part of control in case of inability to repay or service the public debt. Through these mechanisms: through golden shares in publicly-owned utility companies, those companies would serve as a special type of pledge and, cash flows in those companies would serve as a type of pledge for the EU guarantee fund for the Western Balkans.

By issuing these types of financial assets, the quality of financial assets in the countries in the region would improve, and financial investors would be able to increase the quality of their portfolios and cut the level of risk and, in addition, the priority in financing projects to be financed by the sale of these bonds would be accorded to cross-border projects or, in the case of Bosnia and Herzegovina, to inter-entity projects.

This scheme would help create a special type of link between the countries in the region, not only to finance infrastructure, but also to finance clusters between those two or three countries. So all those projects that have export-orientation towards third parties, I mean, e.g. to the Middle East, or to Western Europe, projects of that kind would constitute a win-win strategy, both for Europe and for the Western Balkans. Why for Europe? Because in that case, the level of economic growth and the level of connectivity in the region would be increased, while unemployment would decrease, i.e. the level of employment would be rising and people would be less willing to go abroad to look jobs in Western Europe.

04

WAY FORWARD?

Rising poverty, unemployment and overall bleak socio-economic conditions are just the most visible among many challenges the Western Balkans are facing. All economic data confirm that the Western Balkan economies lag behind the rest of Europe with very low incomes and living standards.

Possibilities to reverse this trend do exist, although there are neither common views nor agreed strategies for change. Revising the existing models of growth, investing in education and skills of a particular cluster, modernization and conversion of the existing economic set up are high up on the list of possible approaches. The fact that technologies have overtaken most traditional mechanisms for acceleration of growth also needs to be taken into consideration. The international community actors often talk about a new growth model for the Balkans, based on investments and exports rather than on imports and consumption, but the decisive question is how exactly we could get there and what the realistic timeframe would be?

LAZA KEKIĆ:

As noted, the region suffers from very low export/GDP ratios, under trading. Exports far below potential: actual versus World Bank estimates of potential exports (40% shortfall for Albania; 33% for Macedonia and Bosnia; 27% for Kosovo, Montenegro and Serbia). In some cases, exchange rates are highly overvalued, which is the main cause. Region is not well integrated into EU and global supply chains. Not enough export-oriented FDI, as opposed to FDI in non-tradeables.

MILICA UVALIĆ:

The global financial and economic crisis has put into doubt the transition model pursued in much of the Western Balkans after 2001, as it has brought to the surface many structural problems, which have accumulated during the past two decades. Limited restructuring and modernization of the real sector of the WB economies has rendered them insufficiently competitive on world markets, so their export/GDP ratios remain low in comparison with the Central East European countries. In order to have a more export-oriented growth model, it is fundamental to implement primarily a more targeted industrial policy that would channel investment towards priority sectors, including key export-oriented industries, improve access to credit for small and medium enterprises, encourage innovation, protect quality and technical standards. Absence of such policies can be detrimental for industrial sectors requiring protection, if tariffs are lowered excessively, or can prevent new investment and modernization of key industrial sectors. Incentives must be offered not only to foreign, but also to local investors. Much of FDI in the WBs has gone towards non-tradable services (banking, telecommunications, real estate), which serve primarily the domestic market and only indirectly support the export orientation of the WB economies.

VELIMIR ŠONJE:

Trade integration and access to EU markets is the key, related both to tariff and non-tariff barriers. Strong recovery of Croatian merchandize exports after EU entry confirms this thesis.

> “ It should be followed by efficiency in use of EU funds and fast Doing Business type of reforms of business environment (better regulation initiatives). These reforms can have substantial effects in 5 years.

WILLIAM BARTLETT:

Well for the export-led growth, you need to have promotion policies, the government needs to step in to promote and to assist companies, to boost their exports, especially the small businesses. There are many ways to boost exports, you can export goods, you can export services, right? So, services exports can be tourism and that's one big sector, which is very underdeveloped in places like Albania, so that's an important element if the new growth model is to make the countries attractive to tourists, which may require more infrastructure spending, but also... And then, another way to do it is through entering into global value circle, global value chains (GVC). So this is actually, one thing that's going on at the moment that foreign investors are beginning to come in to sectors such as the motorcar sector, whereas in the past they were more into banking and non-tradables.

So now, we find that there is many companies coming in from Europe, which are motor parts producers, they produce components for motorcars and these are assembled in the Western Balkan countries and their exports go to Austria, Germany, Italy, for the production of motor cars, and if it's global supply chains, they're getting into that global supply chain, it's a good way to boost exports. On the other hand, it's only good for economic growth if those companies are sourcing some of that supply from the domestic companies, from domestic small businesses, which would create jobs locally.

> It's not good if they just come here in order to bring some imported components, do a little bit of work on them, and export them again. That doesn't generate jobs.

So it's very important for the government to, if this is the strategy, they should begin to develop a local supply capacity to these foreign investors so they can supply, for example, car seats or smaller components, whatever it might be, to these motor cars and start to develop their activity and the government can help in that way by providing an environment in which those companies can get access to credit and get access to skilled workers.

And as we saw previously, the access to credit is problematic under the current arrangement, so the government has to provide either a guarantee fund or development bank that will provide finance to the small businesses that are supplying components to the big foreign investors. And the other way of doing it, the third way of doing it is by developing the indigenous export capacity in various industries, whatever it might be, I mean it might be in the IT sector, it might be in the construction sector, it might be in any particular sector, but to develop a local production capacity you need to have, enable new entrepreneurs to start up their own businesses, new businesses, entry into the market, continue to remove the barriers to enter the small businesses. You need to support the small business sector and the network between small businesses so they can help each other to grow.

HUBERT WARSMANN:

Well I wish I had an answer for that. Well I think definitely growth and convergence will only happen through better integration in the world trade, larger European trade, and that requires a lot of investment, investment in infrastructure to deliver a suitable investment climate and also investment in actual capacities, so the investment in infrastructure, will have to come from the classic sources: some national contribution, a lot of loans from international financial institutions (IFIs) and as much money as possible from donors, within EU being possibly the larger donor, but that on its own it's not going to be sufficient. I mean, there is also a need to attract private investments.

Moderator: How's it going, this process of getting funds for this infrastructure project that we hear a lot about? I think also you in your work are dealing also with this issue.

Warsmann: I'm speaking in a personal capacity. I think, in terms of mobilizing investment for infrastructure, things are actually getting better organized. I think the EU Commission has to take a lot of credit for that. First of all, I think the EU has mobilized the countries in the region and the member-states behind, what they call, the connectivity agenda, which is essentially there to help building the basic transport and energy infrastructure to link the countries between themselves or link the countries with the member-states. The EU has actually earmarked about one billion for the current budgetary period. We can argue whether one billion is enough or not, but at the end of the day, in the current budget situation everywhere, one billion is already a lot of money, which if it is spent wisely will actually get a long way, especially if the way this money is deployed with a big multiplier effects of leverage of loans and additional grants from donors and so on. Now, you can see also that the countries are not putting all their eggs in one basket. I think the countries are also very alert with the other opportunities which exist. The opportunities can be from Russia, can be from Central Asia and increasingly from China.

> “I'm sure you are aware of One Belt, One Road Initiative and certainly the Western Balkans are a key part of that. And there is, I mean, there is a lot of money available in China, these are loans.

I think they are not gifts to be had, but you know, playing on all these cards, there is actually a way to leverage quite a lot of public money, whether it's IFIs, whether it is by bilateral money from various countries to go into this infrastructure, but I think what also should not be lost from sight is that this is not going to be enough. I mean, I think these countries are not going to be able to move, to make decisive steps to convergence if they cannot attract private investments. It is domestic private investment but also foreign direct investment and if that doesn't come...

ELLEN GOLDSTEIN:

Yes, in fact, it's been World Bank documents in particular that have talked very much about how before the crisis, growth in the Balkans was driven almost entirely by domestic consumption, which was fuelled by the inflow of remittances, the inflow of foreign aid and in some cases by real estate investment. But this kind of growth proved not to be sustainable during the global crisis when we saw declines in these kinds of inflows, remittances, real estate flows, aid flows, all dropped in the aftermath of the crisis. To have more sustainable growth, then, the growth needs to be based on investment, both domestic and foreign, and an orientation towards larger markets, so that you are not feeding the consumption of the small internal markets but rather exporting into much bigger markets, again whether it is EU or other global markets. To do that, these countries need to focus very much on eliminating the barriers to regional integration, whether it's among the Western Balkan countries or between the Western Balkan countries and EU or between the Western Balkan and the rest of the world. They need to create a world class environment for investors and that means, you know, pursuing things like clear property rights, improved rule of law, policy reliability and predictability, investment-oriented tax regime. All of these are needed to basically make that shift. Now we are starting to see a bit of a shift in a sense that net exports are playing a more important role now in growth than they did before the crisis and that's particularly true in the countries that had some level of manufacturing base and those that have made some reforms in order to stimulate foreign direct investment coming in and exports going out. We are particularly seeing that in Macedonia and in Serbia, in particular.

Serbia has had quite strong export growth as growth has recovered. It is not sufficient, obviously, as the country is only growing at between 2 and 3% but this is the direction that we want things to go and they need to focus much more on the business environment and their integration into regional and global markets, in order to actually get there. In terms of timeframe, I don't think it's possible to really establish a particular timeframe, but as we said if these countries begin to grow tomorrow at between 5 and 6%, they are still going to need a good 25-30 years to converge with the EU income level based on our best predictions.

VLADIMIR GLIGOROV:

Well, these changes are already happening because if you look at the macro balances, you will see that practically, throughout the region, with some exceptions, but practically throughout the region, there is a slow decline in share consumption in GDP, there is certainly a slow increasing investment to GDP, and also, there is an overall improvement in the trade balance, which means that, basically, exports are growing faster than imports. So in that sense, this growth model, or these adjustments to a more balanced growth is certainly happening already throughout the region, the question really is whether these will be politically, socially and regionally sustainable, this is, really, the main challenge.

DUŠAN RELJIĆ:

If, all at once, we have an incredible search in the qualifications of the population, overwhelming knowledge of new technologies, IT sector, energy saving sector, so, ideal situation, and if you had all, at once, the unlimited inflow of foreign capital, especially in the infrastructure, digital infrastructure, roads, railways and so on, then we could expect this, the Germans would say, this huge change to materialize.

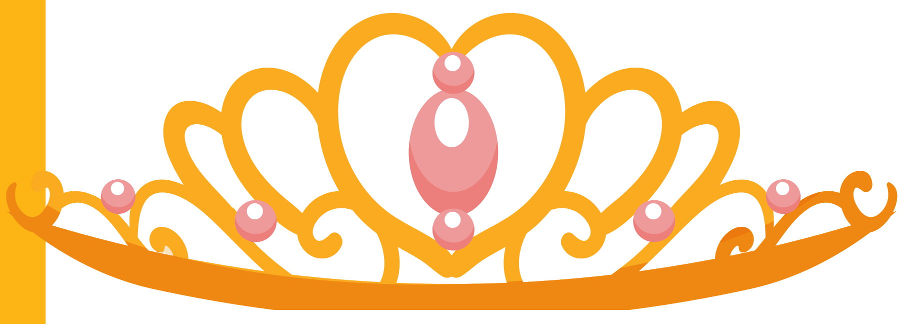
> At the moment, the old mantra that you have to turn towards exports and that in this way you'll increase the GDP and this would lead to growth, I think that this mantra has been simply falsified by evidence.

Look at countries like Hungary. Hungary has a bigger GDP than the whole of Former Yugoslavia together, and this GDP comes mostly from manufacturing for exports. Audi, the German car makers is producing engines and gear, exporting these engines and cars to China, so, Hungary in every many aspects is part of the German value producing chain.

Nevertheless, the average wage of an industrial worker in Hungary is around 500 euros per month, which is not much bigger than the Former Yugoslavia. And with 500 euros per month, the possibilities for the strong domestic market are very limited. So this, so-called middle income trap, in which most of the economies in transition have fallen, is something that is already now impeding for some of the countries of the Western Balkans, look at Macedonia, look at Serbia, there have been investments, especially car in supplies, manufactures, and so on. There are investments in all those branches that need a lot of unqualified labor, and, as we looked in the export charts of the region, the part, which is dominated by products that have a low in-grade of technology and much more labor, is big.

> So, it is knowledge, actually, it is technology and knowledge and organization that is needed and necessary. I don't think that foreign direct investments in the form of opening new factories in which people will work for 400 euro per month is the winning option.

05



THE BEAUTY CONTEST

There are at least two schools of thought about the Western Balkans and its attractiveness to foreign investors. The first version highlights the region's favourable strategic position, abundance of unused natural resources, proximity to western markets, and still affordable and decently skilled labour costs. The other, adverse viewpoint stresses the fact that even if the region is considered as a whole, it still represents a relatively small market, unable to attract sufficient foreign investments to make a real difference, specifically long-term impact investments into technologies, research and modern education. Looking at the structure of companies investing in the Western Balkans market, one can easily see that they do not seek highly educated domestic labour force, but that, the jobs created with such foreign investments are, in almost all cases, geared towards utilizing non- or low-skilled labour. Daily wages they receive for work are often only a fraction of pay for the same work in Western Europe. Governments that invite foreign investors by highlighting the availability of cheap labour are not necessarily promoting the winning formula for the region. While the process of reshaping the Western Balkans economies will not be possible without creating a favourable business environment, it is even more important to define the type(s) of investments that would bring greatest benefits to the region. Governments in the region seem to believe that enhancing business environment and offering tax incentives will attract best investments in the world. Are these expectations well founded? How can we assess FDI promotion policies implemented by the Balkan governments so far?

LAZA KEKIĆ:

Foreign direct investment (FDI) is key to growth, especially when domestic investment and savings are low. FDI in the western Balkans has been weak since a peak in 2006-07 of more than US$7bn inflows per year. However, before that, FDI inflows were actually quite high for some years and the average ratio of annual FDI inflows to GDP of some 7% in the early 2000s was among the highest in the world. FDI penetrations (FDI stocks as % of GDP) are actually quite high, compared with other European states.

FDI is sensitive to the business environment, so improving it is correct things to do. Much of the literature frowns on tax incentives-so jury is out on that. Macedonia in recent years has done most on FDI promotion, but has been very expensive and, paradoxically, Macedonian FDI inflows as % of GDP among the lowest in western Balkans (together with Bosnia and Hercegovina).

MILICA UVALIĆ:

The expectations regarding FDI after 2009 across the Balkan region have generally been overly optimistic. Following the strong effects of the global economic crisis, global FDI flows have still not returned to their record levels reached in 2007. Given the unfavorable global climate for FDI, exhausted privatization opportunities in most Balkan countries and unsettled political issues, the return of large amounts of FDI is unlikely in the short run. Foreign capital inflows in general, including FDI in the Balkan region, are influenced not only by endogenous, policy-induced measures, but also by exogenous, predetermined (given) factors, such as the size of the economy, the level of development and its geographical position. Therefore, there are limits to what governments can or cannot do to attract more FDI. Government policies, such as improving the business environment or offering tax incentives are important, but cannot remove some of the handicaps of WB economies, including smallness, fragmentation, lack of scale economies and political risk.

Improving the business climate is not sufficient to attract more FDI as clearly illustrated by the case of Macedonia, a country that in recent years has had exceptionally good rankings in World Bank's Ease of Doing Business indicators, yet has attracted modest amounts of FDI.

> “My recent work with Saul Estrin suggests that the Balkans still face an image problem: for many potential foreign investors, the word Balkan conjures up troubled images of war and conflict, rather than investment opportunities and economic potential.”

VELIMIR ŠONJE:

> “Tax incentives cannot supplement reforms.

Substantial tax incentives which exist in Croatian, and in particular in Serbian legislation, did not have substantial impact on changing structure of the economy and promoting sustainable growth. This is not to say that incentives are not important, but the focus should be on more fundamental measures depicted above. So, for Croatia benefited only from big investment in IBM call centre which is based on incentives, but its macro impact is not comparable to effects of rising exports of goods and services which constitute more fundamental attractors.

WILLIAM BARTLETT:

Yeah, I mean, the key example is Macedonia, which has set up a number of technology and industrial development zones, which are being established by the directorates for technology and industrial development zones in Skopje and they provide infrastructure in these specific areas, business zones. And the foreign investors have a lot of inducements to go there, there's a lot of attractions for them, including 0% profit tax for 10 years, 0% income tax enabling… what's the word… exemption from paying social security contributions on labour and they have a grant of half of million Euros to build a factory and they have free of imports, raw materials, free of custom duties and VAT, and within the zones, there is no VAT charged on transactions within the zones. And then they have, not only that there are fiscal incentives, and they have non-fiscal incentives, which include the infrastructure of the zone; so the electricity supply, water supply and all other utilities, and they also have a customs office within the zone, which deals with all the customs paperwork, so it's all made terribly easy for foreign investors and, over the last 8 years or so, this attracted very many foreign investors into Macedonia and now they employ about 23,000 workers and they're responsible for about 30% of all of Macedonia's exports, so it's a big success story in a way.

Moderator: So it had a good impact on the economy and modernization of Macedonian economy?

Bartlett: Well, this is the question, I didn't say that. But it employed 23,000 workers and it…… and 30% of the exports… The big question mark is whether there was any spill over into the local economy in terms of technology transfer and the upgrading skills of the workers. That's the question that nobody knows yet, because nobody studied that yet. Thus, actually I'm currently engaged in a project, which is looking at that, and we are studying it and we found some evidence in some cases of good practice where there have been spill overs and there has been upgrading the skills of the workers but there are also other cases where that hasn't happened. So, the government has a responsibility, or it's important that government encourages that to happen and it won't happen, not always, on its own. And then the other countries are looking at that and they are beginning to think about introducing a similar sort of program. In Montenegro they are planning to set up five special economic zones (SEZ) and in Serbia they have a number of, so called, free zones, which don't have the same incentives, but have similar sort of characteristics in terms of providing infrastructure. And so, governments are doing this, but the question is, you know, what's the cost? That's the other question: what's the cost? Are they losing tax revenue and are the benefits of taking that approach… are they greater than the tax revenues that are lost by giving tax concessions to the foreign investors?

HUBERT WARSMANN:

Okay, so, the foreign direct investment, it's a beauty contest. You only win as soon as some project is going around and people tend to focus on the big flagship project, when Daimler-Benz wants to set up a new car factory or you are Airbus and you plan whatever. These things are really beauty contest in which the countries are expected to contribute, and not just soft contribution. In many cases they are also expected to make hard cash contribution. So you can be hopeful but it's not enough. It's not enough. And I think, before FDI can actually be attracted to a country there are sets of basic conditions, which need to be in place. I'm not talking of sort of, I mean, you have some FDI, which is essentially resources dependent. That's a specific show. It will always happen because resources are in finite conditions and if the resource is here and someone is interested resource, they'll find a way to get there, even if conditions are suboptimal. And you've actually seen some investments going in there, in the region. I think if we are talking of outside resources, more sort of tradable, foreign direct investment in tradable sectors, this is where, you have to have the basics in place. I think in the region some of the basics are there, there is macro-stability in all the countries. Yes fiscal positions aren't great in some countries, but, maybe with the exception of Montenegro, things are mostly improving at the moment. I think Montenegro will see degradation for a few years because of its existing programs of works and so on. But, I mean, macro-stability is actually not that bad, I mean, if you look at the half of these countries that actually weathered the global crisis, they've done actually rather well compared to other places. So yeah, macro stability is there. Political, that's another question.

> I think the Balkans are subject to temporary flares of temperaments and whatever.

At the moment, we aren't in one of the greatest times, I mean, the situation in Macedonia is still unresolved, dialogue between Kosovo and Serbia is finding its way, I mean it's trying to find its way, I mean in Bosnia things are what they are. I think political stability could be improved, it could be improved. Now, I think what needs to be worked on is reliability of energy supply, which can be a big problem in many countries, transport improvements, and that are the things that a lot of people are working hard on that. I think there are also issues: skills, I mean, quite clearly. And it's an important thing, especially if you look at a country like Kosovo, which has, quite uniquely, a very young population, a growing population, a young population, but not a lot of skills around.

Moderator: If we compare the tradable sector and export and we compare it with Central Eastern European countries, you can see how their contribution is much more labor intensive, they have less skills and less human capital.

Hubert Warsmann: Yeah, exactly, what you look at, whatever FDI, there is in the region low skills labour intensive, you don't really see a lot of the rest. And that can only happen through the integration in the supply chain. And the rest of Balkan countries are very far behind Central Europe, definitely. I think you see bits of it in Serbia, you see bits of it in Macedonia.

Moderator: Yeah, but for example, you mentioned these two countries are using a lot of incentives to attract...

Hubert Warsmann: Everybody does, I mean it's a beauty contest.

> That's what I called a beauty contest, in a beauty contest you have to look as pretty as you can and the one way of looking very pretty is to offer very strong incentive.

This is the way things work. When Daimler or a Korean or a Thai manufacturer wants to set up a plant, there is no shortage of interested parties and, obviously, people have to offer something for what's a net benefit to the country.

One of the things, I mean, if you take, if you go back to a country like Hungary, which was very early mover in foreign direct investment and you look 25 years later, I mean, things are not necessarily, you know, black or white, but I would say on average, the net outcome is probably positive for the country. I mean, they have managed to attract a number of manufacturers, very early on, who have set up big operation in the country, I mean, this is very true for instance, when they managed to catch Audi, which opened a large engine plants. Initially, when Audi started, it was really an assembly plant, so you had train of parts coming from Germany, arriving in Hungary, parts were put together, and engines were put back on the train to Germany, that's how they started. Low value added, not a lot of skills, but if you look over 20 years how it has moved, I mean, now it's one of the largest manufacturing centers for engines for Audi and it's not just assembly, it's actually proper manufacturing. With skills, there is an element of engineering involved, the plant has grown to also assemble and they now assemble a number of models, of low-volume models are assembled in Hungary and that has attracted a lot of sub-suppliers and you have an entire ecosystem, which has developed out of what was originally essentially an assembling before, a lowest key assembling plan and you now have an investment, which is so large for Audi that they're not going to go tomorrow, you know, they are not going to go tomorrow. Same with the Daimler plant, now it is essentially the Daimler centre of competence for the small cars in Hungary and the plant is expanding, attracting sub-suppliers, attracting a lot of people and once you get a couple of these things, you have a snowboarding effect, I mean, you have now Korean or Thai manufacturers who are coming to Hungary but because they actually like the situation and so on.

Moderator: So, they found the way to escape the middle income jobs somehow?

Hubert Warsmann: Yeah, I mean, it's a long haul. But you can look at another example in Hungary' Bosch. When Bosch started assembling tools, Bosch is the largest foreign investor in the country, they have there all sorts of operations, but quite interestingly is the hand tools for Bosch, electrical tools, and one of the ranges of tools has actually moved from Germany to Hungary, actually to Eastern Hungary, on top of that, and it's not just the manufacturing, I mean, the R&D, everything has moved there. It happened gradually, but now for that line of activity for Bosch, the centre is there including R&D and everything. It is a long haul, you also have to have the situation in place, it happened in Hungary, at fairly decent engineering tradition, there's a fairly decent engineering academic training and so on. It happens. It happens, but it's a long haul and it doesn't happen on its own. That is the problem that the countries will have to cope (with). One thing which I think it's important is your education, investing in education. And in some of these countries, I think, the education sector is probably not as reformed as it could be and maybe it doesn't get as much investment as it should.

Moderator: And where to find this money?

Hubert Warsmann:

> “Yeah, you can always find the money. I mean, if there is a will. If there is a will, the money can be found.

Maybe you'll get a bit less bridges, you'll get slightly less ground road and you could get more money in your university system and so on.

ELLEN GOLDSTEIN:

Well, what I would say is that the glass is currently half-full for the countries of the Western Balkans, then again I speak of them as a monolith, but there are significant differences among the countries of the Western Balkans in the amount of efforts they have made to try to improve different aspects of the business environment. From my standpoint, what works to attract the foreign direct investments also works for domestic investments, so I would like to see the countries moving towards policies and programs, which stimulate both foreign direct investments and domestic investments rather than creating an unlevelled playing field by favouring FDI with special incentives and tax regimes. That's not a recipe for broad-based inclusive and sustained growth over decades.

What works for sustained growth over decades is to have a level playing field, but have a level playing field, which is world class in terms of its attractiveness for investors and, you know, we've seen a lot of progress and you can look at that through many different types of indicators, of course the World Bank Doing Business indicator is one kind of an indicator which shows improvements in some areas. We have really seen excellent progress on things like the ease of construction permitting or improving registration of businesses; you know, the time and costs of doing it have come down dramatically. These are excellent, but they are not enough. They are certainly not enough. And we've seen examples in many countries where you have good performance on things like doing business or the best indicators for competitiveness, but there are still things that remain to be worked on and probably the biggest one concerns aspects of rules of law and that is, sort of, judicial enforcement, speed of judicial decision making, contract enforcement, clarity of property rights and fighting against corruption and informality. These are areas that are difficult, they are much more difficult than many of the "stroke of the pen" kinds of forms that we have seen today, but you know they have to start tackling this in order to really develop a world-class attractive environment. Now the other thing that the countries need, of course, in order to attract foreign direct investment is assured access to bigger markets, because investors are not coming in to serve the small markets of the Western Balkans, so again, this question of trade agreements, of pursuing their integration into markets, whether its among the Western Balkan countries or between the Western Balkans and the European Union or with the global market. This is absolutely critical to attract more foreign direct investment.

VLADIMIR GLIGOROV:

Well, I think this is, more or less, old thinking that by one or another type of subsidies there will be more foreign investments. This I don't think is going to really work, or that is actually something that you can expect going forward, because the effects of these kinds of subsidy, so far have been disappointing, not only in the region, but everywhere, so I don't think that is going to be relied on whatever one region's newspapers say otherwise or, whatever the politicians say. So, this is not the most important thing, or anything like the important thing. I think the key issue is, certainly, the attractiveness of the region as a whole, as long as it can present itself in such a way. The region does have a free trade area; there is CEFTA, which also is designed to attract investments from wherever. So, that, I think, would be, and, that, I think it, certainly, is, by itself attractive. The other thing is, certainly, this improved competitiveness, because in the last five, or six, or seven years, since, in any case, the 2008-2009 crisis, as I said that relative prices have changed significantly in terms of both wages and other costs, compared to in this region, let's say, Central Europe, or Europe itself or the World, so this is certainly attractive. And then, of course, there is a need, or the room to improve overall infrastructure in the region, both physical and others. So, these are really the forces that will drive investment from wherever it comes. I don't think that, necessarily, the next phase of development will be mostly based on foreign investment, so, clearly, in some segments where you would expect multinationals to come in, that would certainly be very helpful and they are not necessarily looking for the tax incentives. The problem with these tax incentives is that these are usually designed or useful or are being used by relatively small businesses, with not necessarily long term interest, and that may be useful in some local markets, but going forward, if you really think to development, region needs bigger firms, bigger enterprises, multinationals hopefully, plus domestic entrepreneurships, and that's basically how it will develop, if it develops at all.

DUŠAN RELJIĆ:

> It is a cutthroat competition!

If a German car components manufacture wants to invest, he looks at the geography, how far is it from his markets, is there transport infrastructure that he can use, and then, what are the labor costs, and, he can choose: 300 (euros) in Macedonia, 350 in Serbia, and perhaps 280 in Bosnia. So he will go where he has better qualification structure, and where perhaps political stability is more pronounced. Nevertheless, this is not something that brings the country forward.

Especially the amount of discount in terms of taxes and whatever you can offer to foreign investors is always determined by the readiness of the society to accept inequality, and, to make it completely clear, all the countries in the region have currencies that are in a way pegged to the euro. They don't have, they don't devaluate their currencies, because they would have a huge problem to pay back their debts, which are in Euro. So, they have an interest in keeping their national currencies even a little bit overvaulted.

So, how do they improve their competitiveness at the international market? By something called fiscal depreciation, which means, if the budget has to be sustained, then they do this through indirect taxation by increasing the value added tax.

And, on the other hand, to attract foreign investments and they lower direct taxes for investments, for profits, for whatever affects the willingness of foreign investors, so, the costs of attractive cheap industries is socialized through a high VAT, and this again, makes the majority, especially the poor people, even poorer, because of the huge VAT, you pay more for your milk, for you bread, for whatever, and the investor pays less income tax. The argument could be: without investor, there could be no production. Nothing, on the other hand, there is evidence that foreign direct investments, at least in Serbia, have not provided the surge in employment and competitiveness, and also employment as promised.

06

THE PUBLIC IS THE BEST THINK TANK

When discussing Western Balkans potential and the level of competitiveness, the question that often resurfaces is whether the region possesses sufficient domestic, nonpartisan, science- and evidence-based capacities to develop sound economic policies. Until early 1990s, various institutes had played a major role in policy analysis. Government departments commissioned studies of across a broad variety of topics to support policy- and decision-making. Working with these institutes, experts and specialists developed their knowledge and skills, then frequently transferring to state institutions, to positions in the government, high-level offices in ministries, government agencies or the central bank. In more recent times, politics and administration became quite separated from scholarly and research institutions, with economic or any other think tanks having almost no influence on key economic policy decisions.

Given little interest and minimal resources allocated for utilizing domestically driven expertise in this domain, critical factors for progress are missing.

The obvious question is why this is happening? Do governments of the region lack capacity or money, or both? Do they have enough economic knowledge and institutional capacity to produce good economic policies?

LAZA KEKIĆ:

I guess that they lack both. The institutional capacity in the region is low, certainly so is outside Serbia which might be in somewhat better shape on this than other western Balkans states, which hardly have much experience with independent statehood.

> “The inferior quality of the bureaucracy and capacity of policy-making elites has been the most lasting negative Ottoman legacy.

Despite a century of subsequent development, this deficiency has tended to be reproduced through the education system and inter-generational transfer of bureaucratic practices and know-how. This has been reflected in much lower institutional and political efficiency, that is, in the effectiveness of governments in implementing policy decisions, than elsewhere in Europe. However, there is no good substitute for domestic policymaking.

> Colonialism and conditionality by external factors have been very poor for development. Sovereignty and taking control of one's own affairs and destiny are essential for development.

MILICA UVALIĆ:

I think they primarily lack sound policies, although the level of expertise varies across sectors. Resources are available, including external financial assistance, that are often used inefficiently or for projects which are not really important for development purposes. Loans at very favourable terms of international financial institutions are sometimes not used simply because of inefficient policy-making, including lack of internal coordination and intra-ministerial cooperation that would allow faster implementation of agreed projects.

VELIMIR ŠONJE:

> Money is not a problem. Political will and capacity are scarce.

Substantial capacity building in terms of reform design and implementation, and in general, in terms of sound policy development is required.

WILLIAM BARTLETT:

They lack capacity and they are basically following the policies that are laid down by the IMF, the World Bank, and the EU and then the donors.

> I don't see any independent policy making capacity in the countries of the Western Balkans.

I don't think it's a question of money really, it's a question of having a good policy, I don't think, I mean, the governments can gain money from taxation, like all governments, and they spend it in a certain way. So it is the way they spend it, that is important. And if they spend it in a way that promotes growth, it is good. If they waste it, it is bad. So it's really all comes down to the policies. It is lot more they could do to develop better policies and that doesn't necessarily mean following advice of the World Bank and the IMF.

HUBERT WARSMANN:

I think, I mean, on the whole, I think as we've said, the macro stability in the region is actually not bad, especially given the local conditions. So on balance it's probably, you know, it's actually not so bad. I think, probably, you have more issues but it's not specific to the Western Balkan, I think it happens in all the transition countries. It's probably when you go down in the administration, the top level of administration is always good to very good, but it's when you go down in the lower levels of the people in charge of implementation, then the situation becomes a bit less clear and not necessarily as positive. It's not specific to the Western Balkans, it has happened everywhere; it's partly a legacy of the past, partly an issue of difficulty with tackling administration reform in countries where the public sector is big pave of jobs. I think as we've said, I've been involved with the transition countries since 1992, or 1991 and it's something, which has happened everywhere including in Central Europe, including in countries which you can deem was having, at the start, probably, a better administrative quality than you have in the Western Balkans.

ELLEN GOLDSTEIN:

I can't never think that money is the problem.

> “When the policies are good and prospects are good, there is never a shortage of money.

But at the time when there is quite a bit of variation in the reform orientation of the countries of the Western Balkans, those that are most reformist are starting to get, are starting to build a more positive reputation, whether they are foreign or domestic, but those that are really lagging on reforms, nobody's lining up to put money into these countries. Now in terms of public money, again, there is considerable variation. But for the most part, these countries have really high ratios of revenues to national income. So the state is large, there is a lot of money in the hands of government. The question is how well is it being spent?

Then again that goes back to the policies and the programs. So what we are very focused on is insuring that public moneys are being spent judiciously for the things that are actually going to matter to accelerate growth and create jobs. The second part of your question is, I think, extremely relevant and I think it's clear that the countries need to continue to strengthen their institutions, the institutions of a market economy. If they had a fully functioning market economy, it would be a different story, but they are not there yet, they are in varying stages of the transition. To that, a really well functioning market economy, and by that I mean both a well-functioning state and a well-functioning private sector, and so they definitely need to continue to strengthen institutional capacity and I think one of the ways to do that is to seek out global knowledge and not just limit themselves to the models that they see, for example, in Western Europe. That has been a bit of a, a tendency in the past, to say well what should Albania be doing or what should Bosnia be doing and to look at, you know, France or Germany and see what they're doing and try to copy that. But these are post-industrial EU member states, their policy decision making may not be the recipe for sustained and rapid growth of the kind you want to see, let's say, in East Asia. So you may want to learn a little more from models that seem a little less conventional for the Western Balkans.

VLADIMIR GLIGOROV:

Well, the main problem of the politics in the region is that it has not really been driven for a long time now, by, basically, economic policy considerations, but by more traditional security and territorial control type of policy considerations, which has had the consequences. There is a big gap between what are the social demand and what are the political delivery. So, all the surveys that have been made in the region show that the main interest, the main problems seen by people and business people also are unemployment and economic deterioration and basically, low or inefficient supply of public and communal services, or, if you put it differently, corruption. So, I think that's the main problem. These things are slowly changing with countries going through significant political challenges, mostly legitimacy crises, where there is a pressure on the government to start thinking otherwise, or to be more responsive and accountable to the local population, and that, possibly, would goes into the direction of the government thinking more about things like the condition in the labor market, the condition of the businesses, small businesses, especially local entrepreneurship and so on, and, that change, when it happens, will be very helpful. Now, as far as the knowledge and capacity is concerned, I don't think that is really lacking in the region, it has been misapplied in the sense that people, intellectuals, professionals and so on, have been driven into considerations, having to do with ethnicity and nationality, who controls which territory, who or what type of policy towards minorities, towards neighbors and so on, should be pursued, and that has been very costly, both in terms of this responsiveness and accountability of the Government on one hand, and on another hand, this has also been very supportive into corruption and oligarchic type of economic development, which is so prevalent in the region. That has to change and so I don't think that the policy knowledge or the policy ability even, is a problem if you look at it.

Moderator: What about money? Is there enough money?

Vladimir Gligorov: When you look at how much money the government can actually, the governments can actually extract, these are not necessarily weak governments. The tax and overall revenues are close to an average probably close to 40% of GDP, in some cases, like in Albania is lower, possibly in Macedonia is lower, but in some cases is much higher, like in Serbia or Bosnia, or Montenegro, so, the issue of money in terms of taxing people is not a serious problem. In terms of public debt, I think, obviously, there are issues, especially in Serbia and Montenegro, so that the capability may be problematic, but Serbia seems to have taken and hold on that problem, and Montenegro, so far, hasn't had the problem with financing public debt, so it is not an urgent issue. The main issue has been really foreign debt, meaning the imbalance in trade, and generally in international economic relations, and that has been correcting in the last few years, as I already said several times, so I don't think the money is a major issue or the shortage. Poverty and underdevelopment of course are.

DUŠAN RELJIĆ:

> The best analysis and the best think tank is what a society thinks about the policies and about the political leaders. And, in full opinion by the voters, who are the ultimate decision-makers, is only possible if the voters get a fair picture of what is happening in their lives, and especially in the economy.

So, only if the information media provides and objective picture, evidence based picture, non-biased picture of what is going on in their societies, and if it can be discussed freely in universities and so on, then you can really determine best policies in all aspects. If there is a skewed public opinion, if there is a manipulation, if there are limits to freedom of expression, and in all of the region we still have to cope with a lot of it, then the ultimate think tanker - the population is not in the position to form an informed opinion and they might, when they made the decision, in votes, chose an option, which is not going to provide the deliveries they expect.

FIKRET ČAUŠEVIĆ:

In the first place, they lack knowledge, both of policymaking and of economic policymaking. Because of pretty bad selection in terms of human capital, in those services or civil services.

> “There are some cases that you cannot believe that people are selected in very important institutions at the state level without knowledge, almost without knowledge of the matter.

There are some cases in Serbia, in Bosnia, even in Croatia, but in Croatia to a lesser extent, and significantly more in the other two countries. The first thing is a lack of knowledge; the second is the very special status of this region as a nexus of, I would say, four different interest groups from different parts of the world, so from the East, from the West, and, therefore even European Union, Western Europe.

Moderator: So what you are saying is that there are colliding interests, economic interests?

Fikret Čaušević: They are colliding... not only economic, but also political interests.

Moderator: Political interests.

Fikret Čaušević: ... in some countries in the EU, continental EU, for example Germany, France and Italy. I'm not sure whether of those countries or just of diplomacy in those countries, in these three countries, is or has been always very, how to say, synchronized in giving their recommendations unanimously and in support for the development of the region. There were some cases when they would be officially saying one thing and doing the other, which is almost the same as here, with local politicians willing to say one thing when they discuss those things with European politicians, but they talk about complete different stories when they are here and with local political parties and local groups.

Moderator: A follow-up question: in whose interest is it to have the Western Balkan region underdeveloped economically?

Fikret Čaušević: First of all, this region is not, according to the World Bank statistics, is not an underdeveloped region.

Moderator: Okay, economically challenged.

Yeah, this region is lagging behind, there is no doubt, it is lagging behind

Western Europe, so the GDP per capita now is close to 40% of the average in the EU, even taking into account all those problems facing southern Eurozone countries, the countries that have been declining, not only relatively, but they have been in recession over the last 5 or 6 years. But even with all that, the Western Balkan countries are still lagging behind significantly. They are lagging behind the rest of Europe, even Central Europe, but let's not forget the fact of life, that this part of the world, this part of Europe was the only one that suffered a very destructive war, the dissolution of Yugoslavia, the former Yugoslavia, and it was the war that lasted almost four years. So we have to take into account all those losses...

Moderator: And we do. But whose interests... Just projecting into the future, are there forces that maybe do not want this region to be as successful economically?

Fikret Čaušević:

> Yes, let's say it very clearly. Nationalist forces, or, more precisely, forces and politicians in this region, sometimes unfortunately supported by some politicians from Europe and even from the U.S., some, but not all of them, fortunately, those politicians are able to keep control over their ethnic groups, or at least of the majority of their ethnic groups.

At the same time, those so called elites, political elites, in all three ethnic groups dominant in Bosnia, but also in Serbia and in Croatia, and it has been a very similar story in Montenegro and Macedonia, even in Kosovo, they have been able to concentrate, not only political power, but also money, so just take a look at the officially registered assets of the most important politicians in Bosnia, in Serbia, in Croatia, not to mention other countries in the region, recorded every election year, for the general elections every four years ...

Moderator: So it's down to local political elites in the region...

Fikret Čaušević: But supported by some people abroad. So don't forget that Milorad Dodik was very successful in selling the story that he managed to attract a very high amount of FDI as prime minister, former prime minister of Republika Srpska (from 2006 to 2010). Unfortunately, again, he was supported by some politicians, even experts, economic experts, or some of them so-called experts, who would come to Bosnia and to this region, spread the story and supported him as prime minister and the Republika Srpska government at that time, and they were able to carry out the so-called "Regulatory Guillotine" of existing regulations to attract FDI. And what happened with those FDIs? Birač Zvornik - a complete disaster, in the Bosanski Brod oil refinery, the Russian oil producer accumulated huge loss, almost 350 million euros now, another complete disaster with the Czech CEZ and the thermal power plant in Gacko, yet another disaster with the Ugljevik thermal power plant, which had at the time been described as one of the largest FDI projects, etc. The Balkan Investment Bank represented another type of FDI in RS, which was used as a channel for money laundering by an Litvanian tycoon, and the bank was de facto bankrupted and had to be taken over by the RS Government, with taxpayers' money. And still foreigners strongly supported Milorad Dodik as a success story.

07

DOUBLE EDGED SWORD

Emigration of people from this region is hardly a new phenomenon. The trend intensified in the early 1960s, when Yugoslavia experienced a sharp increase in unemployment, caused by market-oriented economic reforms, eventually leading to factories reducing their workforce. Hoping to ease the pressure on the job market and the economy, and perceiving the opportunities emerging outside the Yugoslav borders, the government preferred to let unemployed workers leave, so they could work abroad, gain new skills, send back remittances and help boost domestic investment. The *Gastarbeiter* census of 1971 counted more than 670,000 workers abroad, while over one million was a more realistic estimate, [8]with some 60 percent of them in West Germany, 12 percent in Austria as the second most important receiving country, and overall totalling around five percent of the population of Yugoslavia who resided abroad, or more than 20 percent of all employed Yugoslavs working in a foreign country. The single largest category were farmers, young and male.

Republic of origin	1971
Bosnia - Herzegovina	146,819
Montenegro	11,057
Croatia	24,856
Macedonia	60,088
Slovenia	53,524
Serbia	229,389
Serbia proper	133,389
Vojvodina	70,493
Kosovo	25,500
"Workers"	671,908

Number of migrant workers by republic of origin
Source: Federal bureau of statistics, Belgrade 1971[8]

The government at the time sought to avoid classifying these people as migrants. The official terminology in Yugoslavia was: "temporarily employed abroad", their status was regulated through bilateral recruitment treaties, the most important being the treaty with Germany concluded in 1968. But migration did not solve the government's problems. Although migrant workers sent remittance back home, very little of the accumulated savings ended up invested into business and creating new economic value.

The present-day situation resembles the past in many ways. Due to a chronic underdevelopment and staggering unemployment across the region, governments of the Western Balkans turn a blind eye to the massive emigration and hope that unemployment can simply be exported. To add to this problem, the phenomenon of depopulation is spreading like a disease throughout the region, with, for instance Serbia or Croatia, losing an equivalent of a small city a year to predominantly economic emigration. Together with plunging birth rates, emigration combines to contribute to increasingly unfavourable age structure of the population, adding to the region's economic woes, most prominently from the standpoint of increasing fragility of pension systems.

According to a 2016 Regional Cooperation Council survey, nearly one in two survey respondents contemplated leaving their economy and looking for a job abroad. This is probably the single worst indicator of the state of affairs in the region. The greatest share of respondents who gave this answer were from Bosnia and Herzegovina (50%), while Croatians were least likely (36%) to choose this response. The major difference relative to the 1970s is that nowadays those who wish to live abroad are not only farmers or predominately men. This time they are both young women and men and highly educated (SEE - 43%, highly educated - 50%)[9].

It is clear that the trends of people, particularly the young and the educated, wishing to leave are deeply discouraging. At the same time, remittances represent a significant contribution to the region's GDP and domestic budgets, while the skills acquired abroad are still often enough brought back home. The ultimate question is where does this leave the economy?

LAZA KEKIĆ:

One quarter of the population of the western Balkans lives outside their home countries. Since the early 1990s, steady flow of migrants to the EU occurred, about 5 million, positive for the migrants themselves. As for those left at home, it had a mixed impact. Migrants tend to be of working age, reducing the size of the labour force in their home countries. Also, the "brain drain" - migration of highly skilled individuals – further worsens the problem. Still, migrants are a considerable source of remittances, which help finance domestic consumption and some investment, they also bring back skills, act as "shock absorbers", and help maintain political stability.

MILICA UVALIĆ:

Unfortunately, "brain drain" has been a major problem in the Western Balkans for over a quarter of a century. Many of those that have left the region early were well-educated professionals who are unlikely ever to return to their homelands.

> Moreover, many young people have left their countries to study at western universities and are bound to stay abroad if they find jobs, since employment opportunities in their own countries are minimal.

While such trends may have had some positive consequences (e.g. remittances as a welcome addition to low income), in most cases they have also meant the permanent loss of valuable human capital.

VELIMIR ŠONJE:

Impact varies greatly across the region. In general, emigration is not negative as long as there is a prospect for some people to come back. Reforms mentioned here are the key to bring back the people. The lack of skilled workers is already putting a break on prospects for growth.

WILLIAM BARTLETT:

Well, in one sense, the down side is the so-called brain drain, whereby skilled workers leave the countries, so that is bad news for the economies, presumably.

But the good side, the positive side (as I understand it) is that many of those people send money home in the form of the remittances, which covers some of the deficits and the international trade of those countries that supports the standards of living of people living at home. And I think Kosovo and Albania particularly are very much dependent upon the remittances, incomes from the emigrants. Kosovo, for example, is basically, a labor export economy. Its main export is people, the same for Albania, and Bosnia and Serbia to some extent as well.

But I mean these things are going in long cycles.

> If you look at Italy, for example, Italy is used to be a labor exporting economy in 1950s and 60s and 70s, and there was net migration from there to Germany and other countries.

And then at the later stage when those people who had left it, they made some money, and they decided, many of them decided to go home and set up their own small businesses, and it was a return, a sort of returns phase in migration cycle. And now Italy is a net importer of people, there are more immigrants coming into Italy than people leaving it.

So that is in the long run cycles and the people go abroad to work, they are going to learn skills, they are going make some capital, and in the future they will probably going to bring it home, not all of them, but some of them will return and bring the skills and money back with them. For example, I met one businessman in Kosovo who had been working in Germany, and he had been working for the company named Tetra Pak, which is producing cartons... wood paper and cardboard cartons. He decided to set up a fruit juice factory in Kosovo, so he bought some land near a river and imported the latest technology from Tetra Pak and set up this little factory producing fruit juice, using, well actually he didn't use local fruit, he imported fruit concentrate from Italy but he gave some jobs to local people and he produced a high quality product. So, that is an example of return migration. So migration is not all bad, it has some good aspects, as well.

HUBERT WARSMANN:

> I think it's both a blessing and a tragedy. It's a blessing because it brings remittances, it's a blessing because people get an opportunity to access new skills, see new things. It's a tragedy because you are losing your better people and it's a double tragedy when these people aren't coming back.

Now, when you are living on the edge of Europe and just getting a bus to Germany, it allows you to triple your salary; you can understand why people want to do it. I think it's an issue, which needs to be managed by the governments and try to get a part of that emigration back, when conditions improve. But it's not specific; I think it's probably more occurred in these countries, which have such a gap with Western Europe while Western Europe is still fairly open and still relatively close and accessible.

It's a question of opportunities. I mean, you do see, certainly in the Balkans, there is a lot of people are actually attached to their country and would gladly come back if the opportunities were there, but again, I mean, if you are a doctor and your choice is between making 250 euro a month in a hospital somewhere in the Western Balkans or making 2.500 euros in Germany, why wouldn't you do it? So I think it is really a question of opportunities, I think people, in my experience, people are even prepared to probably take a pay cut, I think people do necessary fixate on the gross number but they also do understand the relative value of the money between Western Europe and the Balkans and people are probably prepared to take a pay cut to come back, knowing that the cutting in the standards of living will not be equivalent to the pay cut, but the opportunities have to be there. Which means, we've been talking of doctors and medical sectors but also in terms of business, providing job opportunities, which actually pay decent wages, providing entrepreneurial opportunities, especially I think it's quite important for people who've been exposed to a more Western way of doing business to have a chance of accumulating that money, if they can come back and actually start businesses in an environment, which is conducive, why shouldn't they do it? I think, I do believe that people from the Balkans are actually quite attached to their countries of origin.

ELLEN GOLDSTEIN:

Well, impressive, I guess is one word for it... What we could say is this.

> “That if you look worldwide at the share of the sourced population in countries that are living oversee, the rate is only about 3%, ok? But in Western Balkans, the rate is about 25%. In other words, 1 in 4 people who identify as Albanian or Kosovar are living outside of their countries, so the Western Balkans are literally the world champions of out-migration; mostly this is economic migration, in search of better economic opportunities.

And you know, when you ask what it means for the economy, what I would say is that it is a double edged sword, as we say. In the sense it has been a tremendous source of growth for these countries to have many times the most dynamic workers, sometimes the most educated individuals leaving in search of bigger and better economic future and then, sending, you know, both remittances, financial flows home, but also bringing back through the diaspora, capital skills and experience and linkages to global market. That has been actually very important for the Western Balkans, and I think will continue to be very important for the Western Balkans. But clearly if you look at the long run growth potential of the Western Balkans, there needs to be economic opportunity that causes young people, particularly, skilled young people, to choose to remain at home or to return home if we want to sustain rapid growth rate internally in the Western Balkans. Now, of course recent global focus on a refugee situation has actually in some sense reduced the prospects for economic out migration from the Western Balkans. So, this issue is actually becoming even more critical for the countries in the Western Balkans that may not be as many people leaving, and this may affect future flow of remittances and it means that they need to be able to absorb their young labor force more, you know, within the domestic market or at least within Western Balkan market. So again, this just leads us to the conclusion that flagging reformers need to pick up the pace and need to focus on the legacy of reforms, in many cases legacy from former the Yugoslavia or from communist isolationism in the case of Albania, things that have simply not been addressed, which are major barriers to investment, to trade and to the absorption of young labor into the labor force. You know, we've seen examples in the rest of the world.

> “For example in India, where for a very long time, the best and the brightest were leaving India because the economic opportunities outside were better than the economic opportunities inside.

But that dynamic shifted and the best and the brightest are now returning and investing not just their money but also their own human capital in growth within their own country. So it is possible to have that turnaround and I think that is something that the Western Balkans needs to strive towards.

VLADIMIR GLIGOROV:

Well, the parts of the Balkans, certainly parts of the former Yugoslavia, but historically, the Balkans as a whole have depended on outward migration, and then, obviously, on remittances from these outward migration, and that is certainly one aspect that is important for the region as a whole. If you look at the amount of remittances that most these countries receive, these remittances are way higher than, let's say, foreign direct investment in the region. So, the region certainly does depend a lot on the expatriates' money coming back to support local consumption and in part even investments. So that is certainly an important incentive for people to continue investing in outwork migration. People prepare their kids to go and work abroad, and that is structural problem in the region. It certainly solves the problem of sustainability of standards in the region in the short run. In the longer run, this has to change in the sense that there will be more incentives for people to stay and work at home. These, in fact, have to change relatively quickly because, once this high unemployment rate drops, in, let's say, four – five years, if current development continue, obviously, it would be exceptions, like Kosovo and so on, for demographic reasons, but if we take that away, I think and there will be a problem in Bosnia and Herzegovina, for, mostly, political and social reasons, but overall, one would actually expect that there will be increased demand for people to stay in the region, in better conditions in the region, which indeed will not last long but when that happen, given that the population in the region is pretty old, actually among the oldest in the world, the region has rather quickly gone to the situation where there was basically a shortage of labor force. This is also what we see in the Central Europe and in the Baltics, and so on and in all countries, which have had a significant outwork migration, there is now increasingly a shortage of labor. So, that is sort of how it will eventually and hopefully work. I don't expect people to necessarily come back but there should be certainly a better regional labor market where people move from one place to another and also generally higher level of employment.

DUŠAN RELJIĆ:

Well, this region has been exporting populations since hundred-fifty years, which is normal. Europe, as a whole has been exporting population, Italy, Germany, and Greece, whatever you want. Because, at some point, the economic growth can't keep up with the population growth, so, is history of migrations. In the Balkans: poor development, wars, patricians, whatever the history was not nice to the region.

However, in socialist Yugoslavia, the government achieved two things by letting people migrate. The first one was to let steam out of the boiling pots of less political issues that were produced, because people could move out and then simply have better life. And second, there were transfers, coming from the migrant workers, and these transfers have stayed up to today very important. In Kosovo, approximately almost a third of the GDP, perhaps a couple percentages less, comes from migrants' remittances, the whole region depends on very much.

Remittances do two things, or three things: first thing is that they improve the market, there is a better choice, because people have money to ask for products; they also increase prices, because there is more money and it would be normal, so things are charged, there is some cash coming from outsides, which is mostly invested in the consumer goods, it is not into the investments but into the consumer goods.

And third, there are opinions by the World Bank and others that a lot of foreign investments lift the so-called entry point to the labor market. If you are woman and if you live at home, and if there are remittances, then women are less prone, and elderly people as well and even young people who receive remittances, to enter the labor market, it doesn't matter at what price, but to go and find themselves jobs.

So these are the three things that foreign investments and migration do to the countries.

However, we could also claim that if there was circular migration, in the sense that the people were not doomed to stay all their life outside, but like here now in Poland, as part of the EU, Hungarians and so on, if people can move outside, working abroad for a while, then come back with some cash and some knowledge, and reinvest at home, this could also a driving force of the development, but examples are not that encouraging.

FIKRET ČAUŠEVIĆ:

> That people are leaving, that is not the whole story, but there are many people coming back to BiH, among them people who completed their studies and obtained master's and doctoral degrees, and came back to Bosnia.

They got jobs in, not only academia, but also in the financial industry. Just take a look at the financial industry in Bosnia and in Serbia and in Croatia. What is the average age of the people that work in these companies? And at least 1/5 of them hold foreign degrees. But unfortunately there are still many more people going abroad than those coming back. So, in the age of open markets and free flows of goods, services and labor, you cannot say it is not or it wasn't expected to see this kind of outflow of people from this region to Western Europe, especially to Germany - to best performing economy in Western Europe.

Moderator: But what does it mean for the economy?

Fikret Čaušević: For the economy, there are some pluses and minuses of course. Pluses are that those people establish their companies and they need a market. Markets in Western Europe are to some extent saturated, so those companies, I'm talking about small companies and the medium-sized companies, they need new markets. This region is one such new market, quite naturally, we are a part of Europe.

Moderator: Okay, and remittances as well?

Fikret Čaušević: Remittances as well, although remittances should not be the most important source of money, but remittances have been a very important source of stability, I mean, of keeping current account balances in the region at the levels between -5 to -7% in those countries that were not able to achieve full coverage of imports by exports. Croatia has been successful in turning their current account deficit into a current-account balance. They still have a trade deficit, very important, very high trade deficit or relatively high trade deficit. The same is with Bosnia, but in the case of countries such as Bosnia, Kosovo and Albania - Albania has actually, according to the EBRD data, the highest level of remittances in this region, in Southeast Europe, not only Southeast Europe west of Bulgaria, but Southeast Europe, including Bulgaria and Romania. So remittances are highest in Albania, then Kosovo, then Bosnia. But still, what is the most important win-win combination, what could be the most important win-win situation? It could be creating knowledge-intensive connections between Western Balkans and Western Europe...

Moderator: But these are all pluses. What would be the minuses?

Fikret Čaušević: The minus is the fact that this part of the world has already been depleted or that the total population dwindled by almost 10% over the past 20 years. When you take into account the total population losses, adding those killed during the war and people who went abroad and remained, many of those are people who are unwilling to establish any connection with this part of the world. They had been well-educated here, so these are people in their forties or fifties, they were educated here; attended primary school, secondary school and in some cases universities. All those types of investments are public investments, so Western countries received finished "products". They do not need to invest in education of those people.

Don't forget that such investments are long-term investments; they pay off only in the long run. I mean in the long run, over several decades. Take the former Yugoslavia: people who had been educated in 1950-1970s were most important business managers or CEOs of those companies in 1970-80s, they brought increased levels of knowledge to their enterprises. Emerik Blum, who established the Energoinvest Company here in Bosnia in 1950, received his undergraduate degree in Prague between the two world wars and he preserved it during the Second World War. In 1950, he established a company with just 50 people, and got them to focus on winning 20 years a quarter century later. "We need, not only Yugoslav market, we need European market, we need to export knowledge!" Can you imagine!? In 1950, this guy, who was a visionary, he talked about the knowledge-based economy.

08

MYTHS

The entire Western Balkans region is deeply mired in pervasive myths that often find mysterious ways to new generations. Among the most prevalent ones are the myths related to the ways former Yugoslavia portrayed itself as an economically sustainable country, and millions of its citizens were convinced they lived in a healthy economy, disregarding the fact that the former country borrowed billions of US dollars and was among the IMF's heaviest borrowers during the 1960s. And even more impressive is how resilient and persistent this distorted perception of solidity of Yugoslavia had been despite years of observably deepening economic decline. Decades later, the Western Balkans seem to be ensnared in similar misconceptions. While the region's politicians keep promising incredible wage increases, new jobs, GDP growth and societal modernization, this progress somehow never even starts to emerge. These unlikely promises for the future become even less credible as the overall economic development in the region cannot be seen as successful by any objective measure. The belief that economy will naturally fix itself, once the markets are open and liberalized and regardless of government policies persists and remains common. The promise of privatization, a key theoretical recipe for helping economies in transition, is widely seen as unfulfilled in all the countries of the Western Balkans, despite a handful of success stories that managed to generate new economic value. Lastly, there is a shared narrative that the Western Balkans must follow the exact path of the developed EU countries, or those that joined the EU in the most recent round of the enlargement process, and that moving ahead is only possible within this framework, disregarding other global experiences the region can potentially benefit from.

In economic terms, these widely accepted misconceptions lead governments, in their policy-making role, to inadequate responses, but also help perpetuate misinformation and ignorance among the general public, resulting in confusion and lack of confidence to take effective action for change. Which are some of the wrong ideas that have characterised economic strategies in the region so far?

LAZA KEKIĆ:

The belief in fixed exchange rates tops the list, I think.

MILICA UVALIĆ:

In the Balkans, for too long, the invisible hand of the market continued to be glorified, while clearly there is need for a new role of the state and active government policies - not just less government but a different role of the government. The glorification of liberal market-oriented policies has often meant the lack of any form of consistent government policies in terms of regulation and control. There was strong emphasis – as in Central Eastern Europe earlier – on economic and trade liberalization, macroeconomic stabilization and privatization, while some fundamental structural and institutional reforms were postponed or not considered, which are essential for improving the institutional framework of a market economy - including measures facilitating the entry and growth of new private enterprises, the general hardening of budget constraints, restructuring public enterprises instead of bailing them out, effective competition policy, active labour market policies, improvements in corporate governance. Many institutions that are fundamental elements of a market economy are still not in place today, including efficient government institutions for enforcing laws, collecting taxes, or supervising the financial sector. The quality of institutions is important also with respect to non-state institutions: markets will not function well if they are not competitive and if there are barriers to entry; corporations will not function well if corporate governance is poor and minority investors are not protected. Supporting state institutions are fundamental, such as a functioning legal system to enforce contractual obligations, or competition authorities to ensure a competitive market structure. These issues are extremely important for the WB countries, particularly today when economic policies must be carefully reconsidered. They all need to improve the quality of their state and non-state institutions.

VELIMIR ŠONJE:

> “Economic policy is a technical issue which is independent from politics. This is terribly wrong.

Development of democracy is required for institution building and robust institutions are required for economic development.

Government will drive growth. Government is certainly important because it sets the stage by regulation and fiscal policies; however, political elites in Balkans usually think that they have to drive growth via direct influence on enterprises and markets, which is actually the most important impediment to growth.

> “State is the key, not the free trade. The mercantilist mindset is deeply embedded in people in the Balkans.

WILLIAM BARTLETT:

Well, mainly, that creating a pure private market economy and reducing the role of the state is going to stimulate economic development, which is basically not true and hasn't happened. And anyone needs to look at Montenegro or Albania or Kosovo, and you see, you know, in the case of Montenegro, if you went for free trade, real free trade and abolish your import tariffs, which is what they did in 1990s and you got a flood of imports, which undercut local producers, and your local industries collapse, and that is what happened to the wood industry in Northern Montenegro. It just completely collapsed in 1990s and early 2000s, and tens of thousands of people were out of work. That is one false belief.

> Another false belief is that you don't need to have a government; you could have a free for all, I would say some sort of wild capitalism.

And that is what you find in Kosovo where the government is very weak and it does not have any industrial strategy and you basically have this sort of wild capitalism, which is totally unregulated, producing enormous environmental damage, even though it may have some positive aspects, say from the entrepreneurial standpoint...

What I mentioned already is the idea that having... That bringing down the budget deficit is the most important focus in economic policy, and you should definitely cut off expenditures as much as it possibly can, and have fiscal consolidation and the zero or very low budget deficit. And the problem, there is some reducing of the domestic demand and it is not even that there is a big problem of public debt. I mean, the public debt in Western Balkans is very low. In Kosovo for example it's 30%, I mean, they could borrow for the next 20 years and don't have any dangerous side effects. And then they could expand the public sector without any problematic side effects, as long as they have it done in the sensible pro-growth way. The country with the highest public debt in relation to GDP is Serbia, which has now got a public debt of 75% of GDP. But that is only equivalent to the average public debt in the northern EU countries, like Germany, for example. It is not out of line with what is going on in the best performing countries in the EU. So it is completely false to say that public debt is the problem that needs to be corrected by massive deflationary policies.

HUBERT WARSMANN:

A difficult question... I think, not that this is necessarily a wrong belief, but there is probably a lack of coordination among the countries, which could be linked to the fact that nationhood for these countries is still paramount, these countries are very young but at the end of the day, they have to realize that there is no other way, there is no way forward for them other than cooperating among each other, cooperating with their neighbors and cooperating with the rest of Europe. So I think that is probably the tendency to try to do it alone, which is not helping. Possibly also lack of realism to what it takes to actually attract investment and how hard the effort is and how much you need to put in. That I think, I would say, are the key things.

MODERATOR: Related to what you are saying; we have recently heard a lot of talking about this integration of the Western Balkans' market, to have a more integrated marketing region. Should we have great expectations regarding that?

Hubert Warsmann: I think, I mean it's already happening, I think in a way it's already happening, there is free trade within the region, there is largely free trade with the rest of the EU, it's already happening. Now, most of these markets, I think, aren't that interesting as markets, at the end of the day it's... I think the Western Balkans' six put together; it's not even 20 million people spread over 3 languages, six countries and borders and so on, so it should happen. But it's not... I don't think investors will come to the Balkans for a market of 18 million people split among six countries. It certainly helps if you have much better integrated border processes and so on, and things can actually move reasonably quickly without getting stuck for hours on the border, it will help, but this is not a key driver for investments...

ELLEN GOLDSTEIN:

Well, I think I've already mentioned the two most dominant misconceptions.

> “ One misconception is that the European Union must grow fast in order for the Western Balkans to grow fast.

And the second is that the policy choices and the programs that one sees in the post-industrial, highly developed European countries are not necessarily the right policy prescription for the Western Balkans. I think these two ideas are being replaced now, I think, in the Western Balkans by a more, if you want, sophisticated understanding that, again, giving the small size of the Western Balkan economies, all they need are small opportunities to enter big markets, whether that is the European Union, or those are the large Asian markets or Middle eastern market, it doesn't matter. The ability to produce, you know, higher value goods and selling it out into those markets is going to be the key to sustain the economic growth in the Western Balkans and in order to figure out, you know, what are the right policies for the countries of the Western Balkans, the countries need to look not just towards what Western Europe is doing, because they may very well be a good model there, but also to look at what fast growing countries, whether they are in Latin America or in East Asia or in Africa, you know, what have these countries done right in order to sustain growth rate for decades, you know, not just one or two years but literarily decades; and sustain that through a high level of investment, through a high level of export and through high level of job creation. And these are the models that countries need to look at and focus on when implementing policies in this area.

Moderator: So, they have to broaden their view and not look only at the successful story of the Central and Eastern Europe and you don't think this should be the model they have to follow.

Ellen Goldstein: Well, I think they're important. Just, one of the comparative advantages of the World Bank is that, you know, we are a global institution and we bring global knowledge, truly global knowledge to the Western Balkans in trying to identify what are the success stories that are out there and what can Western Balkans take from those success stories, whether it is, you know, the story of Chile or the story of Singapore's success. You know, looking at countries that are approximately the size of the Western Balkans or have similar characteristics in terms of income level or proximity to a large market, like the European Union; what have those countries done in order to integrate themselves, particularly in terms of trade in goods and services. Right now, the Western Balkans, the ratio of export to GDP ranges from only about 20% to about 45 or 50% across the Western Balkans. Whereas countries that have grown, small countries, small open economies that have grown rapidly for a sustained period, their export to GDP ratio has to be more like 100% and can go as high as 200% in the extreme case of a small country like Singapore. So, that is for goods, the situation for services is even less integrated. So, it is fair to say that all of the countries of the Western Balkans, with some variation among them, are not very well integrated in terms of trade in goods and services. They are well integrated in terms of exporting people, as we've already discussed. But now, we need to move into the round of trade of goods and services, and this is really, where the focus needs to be in order to allow the countries to grow quickly.

VLADIMIR GLIGOROV:

Well, I think the main problem has been that the region has enjoyed the good several years after the 2000s, when there was plenty of money, and abroad and generally in the world, and the borrowing was plentiful and so the main policy problem that the regional policy makers have been blind to, or have disregarded, the growing imbalances in foreign trade and consequently the increasing in foreign debt. And that has cost the people in the region dearly after 2008 and 2009, because these imbalances had to be at least partly corrected and so the economy has stagnated in most countries for some time, especially in larger countries for some time, and the problem, which is not unusual for the region, but it has been rather strongly visible there, and that's sort of the main problem, if you wish, it looked at that time politically stabilizing to essentially allow people to or enable people to borrow a lot and to consume a lot, and that, of course, has become a major macroeconomic problem since after 2008 and 2009 and till then it must have been the biggest mistake.

DUŠAN RELJIĆ:

Well, we have mentioned that. This belief that privatization and the European Acquis leads to good foreign direct investment, leads to growth. Yes, perhaps, especially in good times, when there is demand from outside, and companies within the EU have interest to invest in the cheap labor, nevertheless, it is not enough.

Obviously what has been neglected is investment in human capital and the role of the state in terms of education, investing into research in development and better infrastructure. This is what a good state, a good government, should do. This has been really evident that very naïve belief in the invisible hand of the market, in Smith, that the invisible hand would take care of everything, but it is just the other way around. If you look at well-ordered countries like Germany or Sweden or the Netherlands, you see that the hand of the public authorities is absolutely visible, that the state is delivering goods to the society.

FIKRET ČAUŠEVIĆ:

Wrong beliefs?

> First of all, there is a wrong belief that this region is a backward region.

It was the case more in the period 1995 to 2005. Since 2005, especially over the last 5 years, the IMF World Bank Group officials, people from EBRD and EIB, they have been well aware that the region has a good potential, or that these countries have good economic potential, good resources, they may not be resource-rich, but in some cases when it comes to water, to forests, the countries in this region are relatively rich.

The level of knowledge, especially industrial knowledge inherited from before the war period is still quite high, and it is possible to restart manufacturing and increase output in a relatively short period of time by tripling, quadrupling, quintupling or in some extreme cases by achieving tenfold increases in just 5, 7 or 10 years, just take the Arcelor Mittal Steel Company as an example. In 2004, when Lakshmi Mittal decided to acquire the 85% controlling stake in the Zenica steel mill from the Kuwait company that had been the majority owner of BH Steel at the time (2003-2004), the company was a loss-maker, with the total loss close to 20 million euros, or approximately 40 million KMs Just three years later (2007), in December 2007, the company called, at the time, the Mittal Steel Zenica, later on Arcelor Mittal Zenica, was a profit-making company with the profits of 28 million euros (55 million KM). What was the cause?

Unfortunately there are many engineers who lost their jobs and their knowledge became obsolete. When the Daimler Chrysler, at the time (in 1999), it was a big story, have you heard of it? It was about the Soko Mostar and Daimler Chrysler, they came to Mostar in 1999 in a search for a partner to manufacture aviation parts, and they found almost 400 engineers who used to work in the industry before the war in the Soko Mostar Company. Unfortunately, the very bad political situation in Mostar, led them to decide not to enter the market. So, all those people were not able to get new jobs and to continue to work in their field of specialization to upgrade their knowledge originally gained in the pre-war period.

There are tens, not just some - tens of companies that are good examples of upgrading, that inherited knowledge from before the war and were able to add not only investment, but investments in the human capital and new knowledge, to increase productivity and to renew their contracts with foreign companies, especially with the companies coming from the West, from Western Europe.

Moderator: So going back to the question, it is really about underestimating what we have and what we could work with.

Fikret Čaušević: Yeah, it was a myth, especially from 1995 till 2005, since at the time many people from the West simply did not know that there were people here, in this region, who could learn very quickly. What is the other myth? The other myth, from my point of view, is that the region, this region, or any other region in Europe, is or would be able to recover with a restrictive fiscal policy - that is impossible. All the countries in the region have restrictive monetary policies and the combination of restrictive monetary and restrictive fiscal policy is a complete disaster. By definition, there is no doubt about it, it is well known not only in economic theory, it is well known in economic practice.

So again, it is about expansionary monetary, combined with expansionary fiscal policy, but there is a bigger "but", or a very important notice when it comes to continental Europe: Germany has been able to conduct restrictive fiscal policy over the last 5 years and the country succeeded in bringing its public debt to GDP ratio from 78% - almost 80%, to just below 66%, which is still above the 60% threshold established by Maastricht Treaty, but still, the country managed to achieve fiscal surpluses over the last 5 years, however it was the only country that managed such a feat. As regards France, France has not been able to reduce its public debt to GDP ratio, while Italy, Greece, or Portugal: all those countries have conducted extremely expansionary fiscal policies. It is extremely important to keep in mind that, if it is impossible to boost economic growth in advanced countries without having at least expansionary fiscal policies, but it would be easier if expansionary fiscal and monetary policies went hand-in-hand at the same time.

Moderator: ... Then how can we expect it here?

Fikret Čaušević: We cannot expect in this region, bearing in mind that such monetary policies are extremely restrictive, which is good, because of institutional problems and shaky institution capacities we cannot allow local politicians to issue local currency, or to increase inflation rates in order to finance their political programs. Monetary policies in these countries should be restrictive, but with both restrictive monetary and fiscal policies, I would say that it is impossible to achieve sufficient level of economic recovery.

For example, just for comparison, take the average growth rate in China over the period from 2005 till 2012, it was close to 9%, and I'm still talking about short term. Both by definition, or by mathematics, if you want, if your country wants to double its GDP per capita in 9 years or 8 and a half years, its economic growth rate must be 8.25%. Otherwise it is mission impossible. If the real GDP growth rate is 3, 3.5 or even 4%, which is generally regarded as relatively good economic growth, but if the starting level is low, then 4% is not sufficient to close the gap. So we need the expansionary fiscal policy, but controlled fiscal expansion. And that is why I proposed that type of Euro-Balkan bonds, because EU officials and experts would have the right to control those capital investment projects effectively, but the countries could still keep their money here and not be forced to privatize their best state-owned companies, I mean the best in terms of value that remain in this region. Why? Because private ownership of itself is not a guarantee of success.

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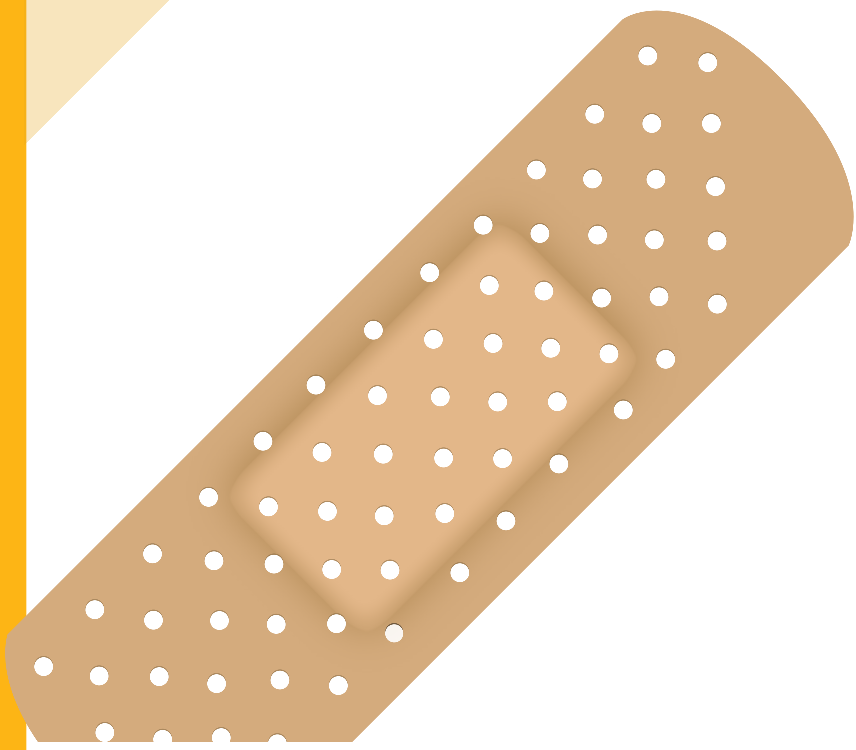

FIXING THE BOX

There is much talk about ways to improve the economy of the region. On one hand, there are strong arguments for the fast-track approach pushed primarily by the EU, which must create conditions for the EU accession within a reasonable timeframe, integration into the markets, opening up possibilities for faster economic growth. Such scene setting would benefit not only the Western Balkans, but also the markets of the EU member states, providing much needed fresh evidence of the Union's continuing coherence and potential. On the other hand, experience suggests that the only path to progress for the region is to move gradually, relying very much on domestic processes and not so much on external pressure, and it may take longer than originally envisaged. Considering the size of the Western Balkan economies, regional economic integration in sectors such as transport and energy is often considered as key to economic growth. If the region's economic prospects are to improve in the short run, what are the most urgent steps to be taken?

LAZA KEKIĆ:

I would not be so presumptuous to tell them what they should do. I've said record of EU/IFIs etc are very poor in giving advice; so who am I to do so? It's up to the people in the region to decide—or rather to vote for parties whose policies they agree with. May be too pessimistic, but it is also possible that there is simply nothing they can do, that some regions simply destined to remain marginalised and never catch up (i.e. southern Italy).

> “ Well-known Serbian/American economist Branko Milanovic said one that the only thing Western Balkan people can really do to better their lot is to emigrate.

MILICA UVALIĆ:

The WBs will have to rely much more on their own resources to finance investment and growth, instead of waiting for foreign investors to come and restructure their economies. To do so, WB governments should offer stronger incentives for private investment in domestic firms and substantially increase public investment, which is still at extremely low levels. As stressed earlier, they will need to implement a more focused industrial policy to encourage investment and the faster transformation of key industries. Public administration reform is also an urgent priority, in order to raise transparency in policy-making, impose greater inter-ministerial cooperation, increase efficiency through long-term planning and impact analysis of alternative policies.

WILLIAM BARTLETT:

Well, I mean, at the moment, the economic conditions are looking quite favorable because there is a conjunction of circumstances, which has come about, for example, interest rates have fallen to very low levels, lower levels that have been in the past, there is a pickup in stimulating investments, which is stimulating growth. And then the EU economy is going through some sort of slight recovery so that is stimulating investment. And then the American economy has been growing quite fast, and is projected to grow even faster and the world economy is coming out of the recession. So demand is increasing internationally, which is all-good for these countries. So economic growth is beginning to pick up, unemployment rates are beginning to fall, and so… I think in that context, governments should stop worrying about public debt. They should, with very low interest rates, they should start to borrow more in order to generate more employment by providing funds to small businesses, which are currently unable to get access to funds because the banks won't lend to them but they lend to the large companies and to the households but they won't lend to the small entrepreneurs. And this is the main issue that needs to be tackled.

And then the other issue that needs to be tackled is the education system needs to be reformed in order to make the graduates more … provide them with skills that are more updated, and curriculum needs to be revised, so the companies can have the properly skilled workers. And then in the countries like Albania and Kosovo, the property rights on land need to be sorted out, and on the land ownership because it is deterring investment. And then in Bosnia, they need to sort out this ridiculous political situation where they try to pretend that it is not a single country, which is dragging Bosnia down and behind everybody else. And I don't know, the EU should step up and accelerate its accession process so the countries can join the EU within the given time period, like ten years or something, they have a definite date for membership, which is not being completely postponed and put off, which just creates uncertainty and suppresses the investments by business and by foreign investors.

HUBERT WARSMANN:

I think macro stability has to be there, public investment, the amount of money that the public sector can invest is fairly limited because of the fiscal situation and we have to have a very wise and well-targeted public investment strategy.

“ Avoid “white elephants”, which are common occurrences, especially in countries where the tradition is still of strong man.

So avoid white elephants, invest the money wisely, do not neglect the investment in skills in the soft sector, I think investment is not just road and rails, and power plants, we are living in the world where investment in skills is about as essential as the rest and it's probably not something, which is done very well in these countries at the moment. And, yeah, keep modernizing your structures. The world does run and especially if you look around the Western Balkans and how countries in Central Europe have moved on, there is no choice but to keep running after them and hopefully you'll run a little bit faster than they do.

ELLEN GOLDSTEIN:

Well, we... Our message is the following: the countries need to create high quality jobs for the young people. This is the only route to sustained growth and prosperity in the Western Balkans. Now, how are you going to create high quality jobs for young people? You know, we focus on four things: unleashing the power of the private sector in these countries, again, by creating the world-class business environment; shifting the growth model away from consumption towards the investment export-led, you know, model of growth. Building trusting government, rightsizing government and providing high quality public services, because, you know, investing in human capital for example, helping education services, this is going to be absolutely critical because having the right education and the right skill for the labor force is proven to be among the most important variables in creating jobs and employment. And finally, eliminating barriers that continue to exist to entering the labor force and to working in the Western Balkans; and this is especially true for the young people, for women and for the minorities, where their participation on the labor market is far lower than the average. So, these are the four things that we think are absolutely essential to really accelerate growth in the short run but also to sustain it in the long run.

Moderator: Are the governments in the region investing in the education and the human capital?

Ellen Goldstein: Well, I think that, they are beginning to. I think what were pleased to see in the past couple of years is that, you know, during the global financial crises, many of the countries saw their fiscal deficit widen dramatically, partially because of the countercyclical stimulants of the economy and sometimes simply because it's fiscal indiscipline; and we saw that the public debt level rose dramatically. What this meant was that many of the countries find themselves now, with all of their fiscal buffer exhausted and with little fiscal space to increase spending on, you know, things that might be very important, like helping education. But at the same time, what is clear is that these countries spent already quite a bit in the period. The key question is not whether you're spending but what you're spending on. Are you spending, you know, the public sector money, on the things that are going to matter? And when we look, for example, at the education sector, you know, what we see in many of the countries, is that the spending pattern has remained a kind of frozen even as demographic shift, for example, has had changed rather dramatically and, you know, there is a new dynamic in the education sector. So, for example in Serbia, we have seen the number of students in say primary and secondary school declined by about 20%, 15 to 20% over the past 15 years and that is just a demographic phenomenon that won't be changing anytime soon. And at the same time, you have seen no change in the number of classrooms, and the number of schools and we have seen an almost 20% increase of the number of teachers. So that is just one example where it is not clear that you really getting the most for your money. And where, you know, where they should perhaps be focusing is reforming the curriculum, so it creates a labor force that have skills and that are being sought after in the new economy and that means, you know, general problem solving skills, IT skills, language skills, entrepreneurship skills, risk taking. These are the talents that are needed for the new labor market. And much more effort needs to be made to invest in reforming the education system and I mean from age 3 all way through university education. You know, this is the kind of things that has happened but in terms of the amount of money being spent, particularly given the income level, these countries spend a lot and some of the countries spend more than you might expect in areas like health and education.

VLADIMIR GLIGOROV:

What are the most urgent steps? Everything that basically, sort of addresses the problems in the labor market, because, again, you have an unemployment rate from, I don't know, low teens, so to speak, all the way up to 30 or 30-something percent, so that is certainly the main problem. So whatever helps the labor market helps the economy.

DUŠAN RELJIĆ:

It depends where you sit. If you sit in the armchair of the think tanker or whatever, I would take the latest book by Thomas Piketty "Capital in the Twenty-First Century", page 41. In the long term, he says that decisive driving power of the equalization of the living conditions is the spread of knowledge and qualification. This is what the countries of the region need badly, better education, and better knowledge.

If I was sitting in the armchair of a Minister of Economy, I would say I need more jobs. And I would be happy to have any kind of jobs, because governments are elected for four years, and they have interest to be reelected.

If I was sitting in the chair of an European investment banker, I would probably think that it would make sense to increase the income of the people in the Western Balkans by higher salaries, because then, they will be in a better position to buy more products and services from the core countries of the European Union and this will be mutually beneficial.

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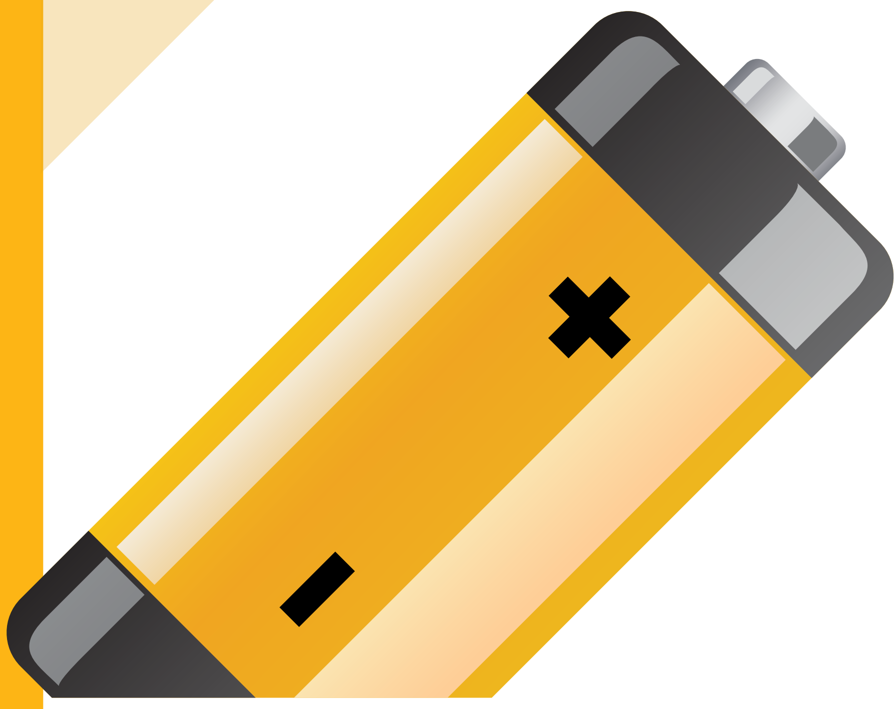

"THE WORLD DOES NOT END WITH A BANG, BUT WITH A WHIMPER"
T.S ELIOT

Most Western Balkan countries today are reasonably stable and peaceful, but still far from EU membership. An overwhelming majority of people are dissatisfied with their living standards and fairly disillusioned with the prospects for the future. Lack of development, entrenchment of nationalist political well-off elites, who keep using same old nationalistic strategies and absence of common vision for the entire region to spread and maintain divisions are just some of the commonly cited reasons for pessimism. The outmoded governance models, poor judgment and inadequately aligned incentives among actors who design, adopt and implement economic policies, together with actions that undermine confidence of investors and the public, all give cause for profound concern. Undoubtedly, some room for optimism exists, but those who believe in better, decent and happier economic future are harder to find. Looking closely into the regional dynamics in the coming years, what are the best- and worst-case economic scenarios for the region?

LAZA KEKIĆ:

> The best-case is probably, as noted above, the forecast growth rate of 4% per year. The worst case—still unlikely but not impossible—is a return to the conflicts and chaos of the 1990s.

MILICA UVALIĆ:

> The worst case economic scenario is that the WB countries give up all hopes regarding EU accession, and abandon ongoing processes of EU accession and increasing economic integration with the EU, opting for the long-term orientation of increasing economic links with Russia, China and some other emerging economies, where the current apparently favourable economic environment could easily be jeopardized by unfavourable political developments.

The best case scenario is that the EU realizes that the costs of entry into the EU of the tiny six WB countries would be negligible, and thus accepts another "big-bang" – allow all six countries to become EU member states soon after 2020, but giving them even earlier access to substantial structural funds that would reduce the gap in economic development and facilitate their faster catching up with the more developed parts of Europe.

VELIMIR ŠONJE:

Worst case:

No substantial changes in economic policies. No significant outside pressures and visible opportunities. Weak institutions and corruption affirm their deep roots. No convergence. Economies change up and down together with economic cycle in the EU, but long run growth rates do not exceed EU average growth. Political elites participate in a kind of zero sum game, meaning that inter-state as well as intra-state conflicts within countries continue to rise, with all dangers which usually accompany such destructive processes.

Best case:

Good policies as described above and trade integration lead to substantially faster growth than in the EU, based on exports. As institutions strengthen, relatively cheap labour and low corporate tax rates attract investment. Stronger institutions and enhanced capacities in the public sector enhance ability to utilize EU funds and other sources and to effectively conduct public sector investment in the fields of infrastructure, education and health.

WILLIAM BARTLETT:

Well, it is really a big a question, requires an hour to reply to that, but in the worst case, it return to conflict and war, which should put them in backwards again. The best case is I think probably, well, they are able to release the entrepreneurial potential of the people and reform the education systems to generate the skilled workers that are the bedrock of the future economic growth.

HUBERT WARSMANN:

I'm not very strong in divination. Well, I think, probably, the rosy outcome is a smooth EU integration path with harmonious relationships between the countries and dynamic world economy. Now, the rest, the worst case: continued political instability with a lot of nationalist reflexes in some of the countries in the region, which means that the region would remain very marginal, considered as the marginal investment case for the world economy. I think that's the two extremes.

ELLEN GOLDSTEIN:

Well, to tell you the truth I could describe the best and the worst, but both of those scenarios would be a sort of fantasy scenarios and I do not find them particularly interesting. What I can describe is a scenario that is ambitious yet realistic, and I think, you know, the main message that I would like to sort of leave you with is that, and leave the countries of the Western Balkans with, is that the countries themselves have sort of unique individual history, especially since the early 1990s with the breakup of Yugoslavia, the fall of the Berlin wall, the end of communism in Albania, and yet what we find when we do the analysis and we look individually and as the group at the countries of the Western Balkans, what we find is that their challenges and their opportunities, economically, are much more similar than they are different. And what that means is that collaboration among these countries, and of course, you know, there is history that needs to be taken into account, but collaboration rather than competition among them is actually going to be the key not only to faster growth and job creation, and therefore to ultimately prosperity, but also is the key for furthering the EU accession and aspiration. So, you know, the ambitious but realistic scenario is to expect that growth will continue to recover, you know, we are running around 3% now, but that means to rise to 4, 5 or 6% in the medium term and stay around 5% or above over the long term, and again, the way to do that is by focusing on creating an environment for job creation, especially for young people. And this is going to require them to focus much more heavily on that world-class business environment. OK? On the outward orientation, shifting from the domestic consumption towards an investment oriented and an export oriented type of growth, which is integrated into regional and global market; to focus on the effectiveness of the state, its size and the trust, the relationship of trust with citizens and the quality of the services provided, and finally to get as many people active in the labor market. I mean, we see huge differences, for example, in Kosovo, you have almost 20% points' difference between men and women, in terms of their participation in the labor force; and you simply cannot grow quickly if half of your population is not engaged actively in the quest for shared prosperity. So with the focus on these areas and with collaboration, and putting the past sort of behind them, and focusing on the need for rapid economic growth and job creation, I think the Western Balkans can accelerate growth in a way that will lead to shared prosperity in the medium and long term.

VLADIMIR GLIGOROV:

Well, the best case scenario would be that the region moves towards growth rate of about 4%, let's say, three years from now, because that is probably where the potential growth rate for the region is, and then stays there for some time, until there is no slack in the labor market in employment, and then there will be an issue of productivity and so on. So that's the best scenario. The worst scenario I think is basically political one. If indeed these legitimacy issues in countries like Bosnia, tomorrow perhaps even in Serbia, but then of course now in Macedonia, if these cannot be resolved democratically and with appropriate constitutional adjustments then, of course, we could see political tensions and that would be very bad for the particular economy and the region as the whole.

DUŠAN RELJIĆ:

You know, there is a famous poem by the T. S. Eliot and one of the line says that "The world does not ends with a bang, but with a whimper", and I guess that this is the probable development ahead of the region with huge migration, with sort of middle income trap development, that we will see this muddling through, which is happening now, if, for instance, the EU has some growth in the next couple of years, there will be more exports from the region. So with the diminishing of the population, unemployment will go down, less energy will be used because of the new industries, so they are more energy efficient, and so on so on. So I guess that a kind of not-so-dramatic entropy is the most probable and the worst scenario for the region, because if you don't change, it is like aging: Every year, you lose a little bit of your capability from your young age. You don't see it. Every year, you don't notice it, but in five years, you see it. So, in the whole region, like in Serbia you have an annual loss of 40,000 people, through less babies being born than people die - not migration, just smaller birth rates.

40,000 people to 7 million, doesn't look at the first glace that big, but it is a town, which evaporated from Serbia every year, and similarly from Croatia, from Bosnia and Herzegovina. The only region where there is still population growth is in Kosovo, and there, you have between 20 and 30,000 children entering the world every year, in the region which is the size of 1/3 of Belgium. No economic model can provide 30,000 jobs every year on 11,000 km2, no one has done it ever and no one will never be able to do it. So these people have to move, and it is not by chance that in the last two years, alone in Germany, there were almost 160,000 asylum seekers from Kosovo, which means about 6-7% of the grown-up Albanian population has left, and this is the only way that Kosovo can survive without a major explosion.

So we see that the problem of the lack of integration into the European Union economic space and political space is the determining factor, I would say, in some aspects. Because the kind of the structure of the socio-economic relations established between the core-countries of the EU and the Western Balkan countries, is reproducing this entropy and making these countries weaker about the year.

> “The best scenario would be that some of the economy branches, which have shown themselves to be quite resilient in the last couple of years, first of all tourism in Croatia, mostly Montenegro, some parts of Serbia as well, winter tourism and so on, agriculture, especially those parts of agriculture that moved into the organic production, and so on, and also some high tech sectors, like the IT sector in Serbia, which is, I think, providing a couple of percent of GDP already. So if these sectors are left from tutorage by the state, and receive support, and especially support by external finance, then perhaps we can hope for the future in which it will again become attractive to live in this part of Europe.

This increase of exports, which is visible in Serbia, Macedonia, Bosnia, is not something that should be taken at its face value. It doesn't mean that because the gap between exports and imports is closing, that this is something which is, in the long term, really changing the situation on the ground. You have to look at the structures and the quality of these exports and then you will determine if this is sustainable and really provides profits in the future.

FIKRET ČAUŠEVIĆ:

The best scenario is full support by the EU, better financial programmes, an EU guarantee fund for the Western Balkans and Euro-Balkan bonds would be one of the possibilities, but okay; if they are not willing to finance, to help create such bonds, guarantee funds and make bond issues and other sources of finance available for local governments, but don't forget that in that case, when those countries get credits from the EBRD, from EIB, from IMF, all those countries have to repay annuities. Annuities you repay in instalments, so face value plus interest. When you issue bonds, you only pay interest on a yearly basis and repay face value on the day of maturity, and then you can renew, i.e. sell new a bond issue, which is a regular practice in the West, essentially creating a revolving source of financing.

So I'm talking about macro-economic management, in terms of macro liquidity and solvency of this country. That is why we need better and improved ways of financing our capital projects, both infrastructure and development of knowledge-based economy, I mean, the process of development of clusters, hand in hand with the increase of the level of knowledge, especially in manufacturing, engineering and so on. So the best scenario actually creates a win-win situation: in the first place, economic growth is supported; second, existing political structures are replaced by political structures in this region of better quality and with much higher level of knowledge - so the education should be of higher quality, right people in the right places, and they should be empowered to communicate with the West openly, but not just to repeat the story: We are willing to enter the EU and keep all those ethnic groups under control, while speculating in favor of so-called political elites. That's not what I am talking about that, I'm talking about connectivity closer links in the region, so political leaders can cooperate. One of the stories is this proposed project financed by the Turkish Government - the highway connecting Sarajevo and Belgrade, which is okay, the project is a good idea, but a much better idea, or more important for the region, would be to develop a manufacturing base, e.g. clusters on the inter-entity level within Bosnia and with neighbouring countries. The best solution, the win-win solution is to have a combination: very good politicians (or at least better politicians) here, people with advanced degrees or better knowledge, especially in state-owned companies, monitored by the West, but by politicians from the West and from the EU who are more unified and more coherent in terms of knowing what they want to do in this region and with whom.

The worst scenario is, of course, dissolution. The split of Bosnia, which, unfortunately, is not unrealistic, taking into account all political tensions in the modern world in different centres of political power in the world. So the worst possible scenario is to create more tensions here, in first place in Bosnia, or in Macedonia. And then, how to put it, to start a new type of conflicts, as the region is very sensitive to conflicts and to bring about dissolution of some countries, say Bosnia and Macedonia. Then there is a danger of a war over huge swathes of territory and such a war could not be stopped, nor kept under control, as had been the case with the former Yugoslavia. Now, the situation has changed.

Moderator: So you think there is potential for things to get that bad?

Fikret Čaušević: Yes, absolutely.

CONCLUSION

These interviews compellingly demonstrate how much economic policies matter to both individuals and nations, even when obscured against the convoluted backdrop of socio-economic structures, demographics, geopolitical realities and intertwining national histories and cultures in the Western Balkans, and bring a sense of urgency to the need to start discussing the economy of the region in a competent and future-oriented manner. While the interviews reveal many similarities and differences, we opted to focus on issues that came up repeatedly and most frequently. After taking a close look at the economy of the entire Western Balkans, one can understand why the sense of prolonged stagnation is pervasive among the region's citizens. High unemployment, averaging near 25 percent, i.e. at almost twice the west European level, is immediately identifiable as the most prominent problem with broadest and direct consequences for huge segments of the population. The sense of hopelessness is augmented because even most of those who have a job barely manage to pay the bills and struggle to make ends meet. Geographic depopulation and migration of highly educated young people, modest annual growth rates of around 3 percent, a general lack of political and economic vision for the region, absence of a real prospect for enhanced economic growth, all contribute to a persistent economic weakness.

The region's policymakers' task of managing budget deficits, public debt, lagging structural reforms and erratic progress towards creation of investment-friendly environment to bring about and sustain faster economic growth is daunting, but it is not qualitatively different from what has been achieved in CEE countries, nor, indeed, from the day-to-day mission of all modern governments. But the underlying and profoundly troubling challenge is that, having suffered economic hardship for so long, the citizens of the Western Balkan countries have lost confidence that governments have their wellbeing at heart, and it is precisely this loss of confidence, combined with daily existential uncertainty, that makes the benefits of the EU accession process hard to imagine and harder still to believe in.

More anxiety arises from the fact that, from the economic standpoint, very few people have a sense of where the governments in the region are headed. The problem is that the most important debate, on what we want to achieve, and where the region ought to be in 20 years' time, is not happening. Simply put, decision-making about those issues has neither been properly participative nor has it been adequately communicated to citizens.

What are the prospects? While it is true that common people are not invited to participate in this decision-making process, much can still be done. Ordinary people can make a real difference by increasing their engagement and actively campaigning for the issues that matter to them, or for clearer economic policies as well as greater accountability. When it finds clarity by learning enough on economic underpinnings of both their own and society's existence, the public should be empowered to take an active part in this fundamental debate.

To be able to articulate our economic interests and identify what should be considered, an honest debate on difficult issues must be opened at the national level. Depending on the alignment of political and social forces in each country, this may be done independently of the drive for the EU membership. Exchanges of views, such as the one compiled in this report, ought to be supported, expanded, institutionalized and universally disseminated, to inform and drive these broad debates and help outline generally understood and accepted strategies of economic development and growth. While the economic science will always have to contend with politics when it comes to guiding a society or a nation, a greater focus and enhanced clarity of economic issues will take us a long way towards reaching a broad consensus, not only about prosperity that we want, but how to get there and what might need to be sacrificed in the process. What might be the most important, when we know what, why and how it can be done, we can expect results and demand accountability.

And lastly, while it may seem like a long shot, formulation of a regional strategy for investment promotion and developing a common overarching vision for the region as a whole, and promotion of such perspective outside the region's borders, would not only create positive effects for economic growth, but it would also open the doors wide for development of modern economy.

BIOGRAPHIES

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Laza Kekić is Regional Director, Central and Eastern Europe, Economist Intelligence Unit, London. He heads the EIU's largest regional team of analysts who provide economic, political, and business coverage for Eastern Europe including the former Soviet Union. He also heads the Country Forecasting Services, which prepare the Economist Intelligence Unit's main traditional product, the Country Reports, as well as the Country Forecasts (medium and long-term forecasts for 82 countries intended for foreign direct investors). His main areas of specialization and interest are: Russia, the Balkans and other transition economies, foreign direct investment, economic forecasting, and growth economics. Laza has written extensively for the Economist Intelligence Unit and other outlets on these topics. He is a frequent speaker at Economist and other conferences and seminars. Laza was educated at the London School of Economics (BSc and MSc Econ) and joined the Economist Intelligence Unit in 1993.

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Ellen Goldstein is the World Bank's Country Director for the Western Balkans, which includes Albania, Bosnia and Herzegovina, Kosovo, FYR Macedonia, Montenegro, and Serbia. She is based in the World Bank Office in Vienna, Austria. Prior to holding this position, she was World Bank Country Director for Bangladesh and Nepal, where she led the policy dialogue with governments and stakeholders, and collaborated with development partners to promote greater aid effectiveness. In these two countries, she managed a portfolio of more than 50 operations totaling nearly US$ 6 billion in soft IDA credits. Goldstein joined the World Bank in 1985 as a macroeconomist. During her career, she has worked in West and Southern Africa, South Asia, and Central Europe as a macroeconomist, human development specialist, and as Country Manager in both Burkina Faso and FYR Macedonia. She also was the founding manager of the World Bank's Results Secretariat. Prior to becoming the Country Director for Bangladesh and Nepal, Goldstein spent three years on special assignment at the African Development Bank in Tunisia, where she established and led the Quality Assurance and Results Department. Goldstein earned master's degrees in public health from the John Hopkins University and in public affairs from Princeton University.

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Dušan Reljić is Balkans expert at the German Institute for International and Security Affairs in Berlin. Dr. Reljić worked between 1996 and 2003 as senior researcher and subsequently Head of the Media and Democracy Programme at the Dusseldorf-based European Institute for the Media (EIM). Previously, he was i.a. Senior Editor at Radio Free Europe in Munich, foreign editor of the Belgrade weekly Vreme, and co-founder of the Beta Press Agency in Belgrade during the critical years of 1991-93. Dušan Reljić works on international relations and security with focus on the EU and Southeast Europe; democratization, nationalism and ethnic strife, issues of transition in former socialist countries and the media performance in situations of tensions and conflict. Areas of Expertise: Southeast Europe, Western Balkans, EU enlargement policy, European Union, NATO. Further topics of research: media studies, in particular media, democracy, and security; political and social effects of digitalization in the media sector.

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Vladimir Gligorov is a prominent economist and he was a founder of the Democratic Party in Serbia in December 1989. Gligorov is Senior Researcher at the Vienna Institute for International Economic Studies (wiiw). He lectures at the University of Vienna and University of Graz. Previously he was associated inter alia with the Bureau of Applied Social Research, Columbia University, New York; The Center for the Study of Public Choice, George Mason University, Fairfax, Virginia; Uppsala University, Sweden. Vladimir Gligorov is Senior Economist at the wiiw and country expert for Balkan countries, in particular for Serbia, Montenegro, and Macedonia. His research focuses on long-term growth in transition countries, macroeconomic analysis, and financial markets. Vladimir Gligorov has been a regular contributor to Oxford Analytica (Oxford and New York). He has contributed opinion pieces to the Wall Street Journal and writes regular columns for several newspapers and weeklies in Southeast Europe.

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William Bartlett is Visiting Senior Fellow in the Political Economy of South East Europe in the London School of Economics and Political Science (LSE). He holds an MA in Economics from the University of Cambridge, an MA in Development Economics from the School for Oriental and African Studies, and a PhD from the University of Liverpool in political economy of unemployment and migration in former Yugoslavia (1979). He was Lecturer in Development Economics and Comparative Economic Systems at the Universities of Southampton, Bath, and Bristol, Research Fellow at the European University Institute in Florence, Italy, and Professor of Social Economics at the School for Policy Studies, University of Bristol. He was President of the International Association for the Economics of

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Fikret Čaušević is a professor of economics and international finance at the School of Economics and Business, University of Sarajevo. Prior to joining the School, Čaušević was a senior researcher and Deputy Director at the Economics Institute Sarajevo (1996-2007), where he was author, coauthor, and team leader of more than 50 studies and research projects, ranging from projects for Bosnian companies, to studies and reports for domestic policy makers and international organizations, such as UNDP and the World Bank. Over the last fifteen years he taught the following courses: Principles of Economics, Financial System of the EU, International Finance (undergraduate and graduate courses), and History of Economic Thought (PhD program). Since the fall of 2016, Čaušević has taught two courses at the Szechenyi University Doctoral Program in Transdisciplinarity, Budapest: Economic Aspects of Globalization, and Finance. In the last four years Čaušević published three books on some of the key issues in economic theory and global economic policy:

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HUBERT WARSMANN

Hubert Warsmann was educated in France and received a Master in Management at HEC Paris in 1984. He has a long experience in banking and private equity in both Western and Central and Eastern Europe. He joined the EBRD in London in 1993 and moved to Hungary in 1995. From 1998 to 2005, he was based in Budapest and responsible for the activities of the EBRD in Hungary with a team of 10. During this period, he was involved with or oversaw some 70 transactions representing cumulative EBRD finance in excess of €1 billion.

Since 1993, he has been involved with transactions such as privatization projects in industry, services and banking; project and corporate debt, equity investments, large scale PPP infrastructure projects (transport and utilities sectors), private equity funds as well as several similar projects in neighboring countries (Czech Republic, Slovakia, Slovenia and Macedonia). He was also responsible for the management of a €800 million portfolio of debt and equity investments, including relationship management, investment monitoring, refinancing, exit and in some cases restructuring. In addition, he was actively involved in board work with several portfolio companies, either as a director or as an observer.

Since 2005, when he became an independent professional, Dr. Warsmann has been involved with a number of buy-out, turn-around or investment fund projects, in cooperation with private investors as well as equity funds. He retains an interest in the corporate world through non-executive directorships.

His prior experience includes corporate finance in the UK with Hambros Bank in London (1990-1992) and private equity in France (1987-1990) with Elysée Investissements, an independent mid-market buy-out operation then listed on the Paris Exchange (FFR 2 billion under management) where he focused on construction materials and transportation sectors.

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A PROJECT OF THE GERMAN MARSHALL FUND

This project has been supported by the Balkan Trust for Democracy,
the German Marshall Fund of the United States.
Opinions expressed in this publication do not necessarily represent those of the
Balkan Trust for Democracy, the German Marshall Fund of the United States, or its partners.