

Executive Summary¹

Motivation for the Study

The last decade, especially the last five years, has been relatively good for SEE5 countries. With the exception of FYR Macedonia, all other countries of SEE5 have witnessed annual growth rates over the last decade in excess of 5 percent, and even FYR Macedonia has seen acceleration in its growth rates since 2003. As a separate entity, Montenegro has witnessed accelerated growth since 2002. UNMIK/Kosovo's growth is estimated at 3 percent in 2006, which is also up from lower or negative growth in previous years. Growth has accelerated in most countries in the last few years, as recovery from conflicts and disturbances takes root. Only FYR Macedonia is a candidate country within SEE5 for EU accession, while the others are potential candidates at different stages of the pre-accession process.

However, SEE5 countries now need to improve and then sustain their past growth performance, amidst concerns about sustainability and the need to avoid a possible "middle-income trap." With still-high poverty rates and EU aspirations, SEE5 countries need to accelerate their growth rates and sustain them. However, this is made more difficult because much of the easier part of transition-driven growth has already been achieved. Future increases in total factor productivity (TFP) may need to

depend more and more on within-sector improvements. In addition, much of the trade preferences enjoyed by SEE5 countries has been eroded. China, through the dynamic of multilateral trade liberalization, looms increasingly large in SEE5 markets for both low-skill as well as skill-intensive products, even as exports from SEE5 are dominated by low-skill and natural-resource-intensive products. Indeed, China's export performance has led to some pessimism in neighboring Asian countries about their competitiveness (the middle-income trap). Finally, many SEE5 countries are also witnessing increasingly large current account deficits (CADs), which raise concerns about macroeconomic stability.

Sustaining and improving growth in SEE5 countries will require top priority being assigned to improving export performance. There is little doubt that the key response to the challenges of improving and sustaining growth would involve a sustained increase in exports, given small country size and the experience of EU8 countries. Exports also have to increase to keep pace with the likely increase in imports driven by increasing integration with the EU. So far, trade has not played a compelling role in the SEE5 growth story, and exports, especially merchandise exports, are in fact the weak link in growth. Despite recent faster growth in exports, the region has been undertrading relative to its potential, and per capita exports of both goods and services are much lower than in comparator countries.

Bulgaria, Croatia, and Romania (BCR), which are at the same time regional collaborators, comparators, and competitors, show that faster development is possible in SEE5. Croatia (an EU candidate country) is by far the richest country in the region and has a current GDP per capita approaching \$10,000, more than 70 percent higher than Romania's. Compared with SEE5, BCR has seen steadier growth in the last five years, never falling below 4 percent. In Romania and Bulgaria, the latest EU members, growth has accelerated to an average of around 5.5 to 6 percent over 2004–06. The BCR examples demonstrate (as do those of other neighbors, such as Slovakia and Slovenia) that faster development is possible in SEE5, including in those countries that were part of former Yugoslavia (both Croatia and Slovenia were part of the former Socialist Federal Republic of Yugoslavia).

Key Messages

The association of convergence-driven, growing CADs in SEE with improved fiscal prudence means that exports and thus foreign direct

investment (FDI) will remain a key determinant of external sustainability. While the CADs may be at least partially widening because of convergence factors, they will nevertheless create actual and perceived macroeconomic vulnerabilities. In this situation, export growth becomes crucial for the sustainability of the CAD, in addition to its importance for GDP growth. Both in SEE and in ECA as a whole, FDI is strongly correlated with exports.

In addition, relatively inflexible currency arrangements and strong remittances in many countries place the onus for competitiveness and export performance on structural reforms and productivity growth. The exchange rate is a very important adjustment mechanism in an open economy. In many SEE countries, relatively inflexible exchange rate management would call more strongly for structural reforms, other things equal. In this situation, the onus for competitiveness and export performance shifts clearly to structural reforms—a line of thought pursued in this report—and implies primacy to improvements in productivity.

The report suggests that improving and sustaining export performance and thereby GDP growth will require sustained improvement in FDI inflows, pointing again to the need for significant structural reform. Despite recent increases, FDI inflows in SEE5 remain low and below potential. The onus for encouraging FDI falls on structural reforms, given the above limits on both fiscal and monetary policy.

Deeper integration within CEFTA countries will increase market size, improve service quality, and help attract FDI. Deeper integration among SEE countries—such as through the completion of the implementation of CEFTA 2006, the reduction of border frictions through the establishment of a single management of Border Crossing Points, the regionalization of the rules of origin among CEFTA 2006 countries, and the expansion of SEE participation in pan-European/Mediterranean Cumulation of Origin arrangements (an ongoing process)—would contribute to market contestability and the development of a larger market, thereby helping to attract FDI. Deeper integration among CEFTA countries in services could also contribute to improving service quality significantly, thereby enhancing the overall productivity of the economies. This report mentions several areas, in different sectors, where there could be opportunities for regional harmonization and cooperation, including those areas where the agenda is defined by commitments to the *acquis*.

Benefits from EU and regional integration would be maximized by creating a “shadow customs union” with the EU for industrial products. Currently, CEFTA countries’ tariffs are higher and more dispersed than

those of the EU, providing scope for trade diversion. It is suggested that all CEFTA countries (who are simultaneously adopting CEFTA and the trade components of their Stabilization and Association Processes) adopt EU MFN tariffs for industrial products. This would amount to creating a virtual customs union encompassing the SEE5 countries and the EU, and thus would reduce the extent of trade diversion. Also, speedy implementation of CEFTA would help ensure that firms in SEE5 countries have as much access to each others' markets as would EU firms (following the SAAs).

Attracting more FDI in SEE5 would also require (apart from a larger market size and deeper integration) improvement in selected areas within each country. This report suggests that there are a few areas which may hitherto not have received as much attention as they deserve from policy makers. These areas include human capital, telecoms, and power.

Human capital development and return migration can help the region to attract FDI and prepare for faster and more export-oriented growth. Human development—both in terms of quality and quantity of skills—is critical to upgrade the skill content of exports and reduce vulnerability to low-wage competition (in exports as well as increasingly open domestic markets), to prevent human capital from becoming a bottleneck to FDI and investment in general, and to prepare for faster and more export-oriented firm growth. It is urgent that this process of upgrading skills start now, considering the region's poor education outcomes, long gestation lags in human capital formation, the likely increase in demand for skills, and the fact that education and health are not part of the EU *acquis*. This apart, countries can also use return migration programs to encourage people to return to their countries, which would help reduce skill and other bottlenecks because the returning migrants bring with them skills, entrepreneurship, networks of contacts, and financial resources.

In the shorter run, reducing labor taxation can at least partially help address problems of relatively high wages and informality. While SEE5 wages may not be high compared with those of the EU or most EU8 countries, these wages are still high in relation to the product composition of exports, which are dominated by low skill-intensive and natural resource-intensive products, and which leave SEE5 vulnerable to competition from the lower-wage countries of Asia. This vulnerability can also affect FDI flows. In addition, the wage gap between SEE5 and neighboring countries has been insufficient to attract large volumes of FDI to SEE5, due in part to business climate disadvantages found in

SEE5 when compared with EU8 or BCR. In this situation, lowering labor taxes aimed at reducing gross wages and the cost to business may provide at least a partial and temporary palliative, and could help increase the attractiveness of the wage component of the overall investment decision to investors, even as the long-run solution will continue to lie in accelerated skill acquisition. Lowering labor taxes is also expected to help reduce the pervasive informality in the work force in most SEE countries (recognizing that labor taxes are only one reason why workers/firms choose to remain informal).

Reduction in telecommunication costs can have high payoffs and also help deeper integration. Telecom costs in many SEE5 countries, including FYR Macedonia, Bosnia and Herzegovina, and Albania, are still very high. Potential payoffs for reduction in such costs can be large, based on an analysis of infrastructure and productivity growth in ECA and on the ubiquitous application of telecoms in virtually every aspect of the economy. Better telecom infrastructure also helps in regional integration by enabling better coordination, specialization, and supply chain management. It can also help firms partially overcome diseconomies of scale arising from the small size of most countries in SEE5.

Preemption of energy shortages will help avoid potentially significant impacts on growth. In Albania and other countries (such as in South Asia) where there are power shortages, business surveys show that power availability emerges as one of the biggest constraints to doing business. The recent experience of Albania shows that such shortages can have a significant impact on GDP growth. Energy shortages can therefore have a major impact on both FDI and domestic investment.

In addition, each of these areas has a regional dimension. Each country can potentially benefit from exploiting regional integration in these areas by using the undefined part of the policy space that is not covered by EU agreements (if any):

CEFTA agreement on movement of skilled labor. This report argues that CEFTA could negotiate an agreement on preferential liberalization of professional services that focuses on the movement of natural persons (mode 4). A starting point for this would be mutual recognition of professional qualifications. Over time, this could progressively be extended to all labor, skilled or unskilled (following the Caribbean example in the CSME), and would help present the region as a single economic space. Regional cooperation could extend further upstream to the supply of skilled labor in tertiary and technical education, where

different countries could seek to specialize in different areas (given high fixed costs and hence scale economies in tertiary education). This could help attract more FDI to the region and better utilize its labor force (people would move to maximize their private returns), while setting in place a mechanism to improve the supply of skills. Another, not mutually exclusive, approach is for countries to negotiate bilateral temporary worker agreements, which are classified as win-win for both host and source countries.

Coordination in telecoms. In telecoms, regulators in the region could gain from sharing experiences and information, because they often face similar problems requiring similar solutions.

Progress in the regional energy market. In energy, regional cooperation is well advanced through the Energy Community Treaty for SEE. Areas where regional-level initiatives could be useful include power-sharing arrangements between countries, cooperation in regulatory practices, and the creation of strong and independent regulators.

The suggested emphasis on human capital, telecoms, and energy implies an eye on the future. The above agenda does not mean that the most important current constraints (as revealed by business surveys), which include tax rates, anti-competitive practices of others, access to finance, the judicial system, etc., should be neglected. However, the report suggests that government priorities may need some reordering to avoid potential constraints to *future and possibly faster growth in SEE5* (as well as in SEE in general).² The italicized part of the last sentence implies that as the easier, post-transition phase of growth winds down, future growth will increasingly be led by the private sector, and based, among other things, on stronger export performance and improved labor skills.

Reordering priorities does not necessarily mean reordering government expenditures, and certainly not to the same relative degree as would be suggested by changes in priorities. In different countries, improving human capital formation may require more expenditure, but, knowing that expenditure and outcomes are very loosely related, it may need greater attention to improving the quality of education.³ In telecoms, the private sector could take care of most investment needs, but more competition and stronger regulators would be needed to further reduce costs of telecommunications. In power, too, more effort at attracting private sector investment within a sound regulatory framework and furthering regional energy cooperation could help alleviate current and future energy shortages.

The focus on human capital and productivity is also consistent with recent findings on poverty. Ongoing research in the World Bank is finding that the phenomenon of the working poor is quite common, arising, among other things, from low productivity and hence poorly-paid jobs. This report's focus on human development and productivity enhancement would therefore be fully consistent with a focus on poverty alleviation.

A question that may arise is whether SEE5 should target EU integration and not be diverted by the process of intra-SEE regional integration. This study argues strongly in favor of intra-SEE integration. The reason is that for most of the Western Balkan countries (noting that Croatia and FYR Macedonia are candidates), accession is still some (indeterminate) time away. In the interim, regional integration can help to secure FDI and exports, and hence improve sustained growth prospects. Also, since much of the process of regional integration is best addressed by advancing the adoption of the relevant EU *acquis*, it can in fact help to reduce the time lag for accession. Moreover, even after EU accession, free movement of labor may not come about for a while (as recent experience shows). This paper, therefore, will suggest that SEE adopt economic integration as a key objective for economic reasons, including the goal of free labor movement (starting with skilled professionals) as a means to deepen its own integration and attractiveness as a single economic space.

Notes

1. In this report, SEE5 refers to all the former Yugoslav countries and Albania, irrespective of how many countries are actually being referred to. Thus, SEE5 refers to Albania, Bosnia and Herzegovina, the Former Yugoslav Republic of Macedonia (FYR Macedonia), and Serbia and Montenegro. UNMIK/Kosovo is usually not included in the discussions, because of a lack of data. For the same reason, Montenegro is not always included separately in the discussion, although for the period of the analysis of this report (with much of the data going up to 2005), Montenegro usually enters as part of Serbia and Montenegro. The Western Balkans refers to SEE5 plus Croatia (i.e., former Yugoslavia plus Albania); BCR refers to Bulgaria, Croatia, and Romania; and SEE refers to SEE5 plus BCR. In the case of Serbia and Montenegro, data may include Montenegro, but does not include Kosovo after 1999. UNMIK/Kosovo and Montenegro data is recent and often on a shaky foundation.
2. There could be nuances or variations of priorities between different countries in the region, which can only become apparent through an in-depth analysis at the country level. This report tries to suggest some broad directions, based

on its interpretation of some common emerging constraints in the countries of the region. It is hoped that this work could be used as one of the starting points for further in-depth work (including for World Bank country economic memorandums [CEMs] in the region that are slated to be done in 2008 and 2009).

3. This report chapter does not examine health issues and the relationship between health and productivity, but it is undoubtedly important. Issues relating to health benchmarking, financing, sources of revenue, etc., are being studied in the regional context in the World Bank's Human Development Department in Europe and Central Asia.