DEMOGRAPHICS AND ECONOMY

Challenges of economic development in the Western Balkans

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Construction of the "Belgrade Waterfront" project, an urban development initiative led by the government of Serbia with the aim of changing the landscape and the economy of the city of Belgrade. Photo: Mitar Mitrovic

What are the challenges linked to the economic development of the six Western Balkan countries in the last three decades? [1] There is growing awareness today among academics and experts within international organisations that the Western Balkans have not yet developed sufficiently, since over the years they have converged only marginally towards average European Union (EU) income levels. Yet there is insufficient understanding about the causes of such trends and disagreements about the main remedies for the future.

The article aims to offer insights into these questions by analysing the main obstacles to economic development in the Western Balkans from a long-term perspective. It proceeds to discuss the key structural problems that the Western Balkan economies have been facing over the past decades. The region’s prospects of further integration with the EU are also discussed, before drawing the main conclusions.

Long-term economic development in the Western Balkans

The disintegration of the Socialist Federal Republic of Yugoslavia (SFRY or SFR Yugoslavia) in June 1991 has had a profound impact on the economic development of its successor states. The break-up of the federation led to the creation of five independent states: Bosnia and Herzegovina, Croatia, the Federal Republic of Yugoslavia (consisting of Serbia with its two autonomous regions, Kosovo and Vojvodina, and Montenegro), Macedonia and Slovenia. In the meantime, two countries have joined the EU, Slovenia in 2004 and Croatia in 2013, while the other countries remain in the queue for EU membership. The Federal Republic of Yugoslavia (FR Yugoslavia) further disintegrated after Montenegro's referendum and subsequent separation from Serbia in 2006, and Kosovo's unilateral declaration of independence in February 2008. [2] Consequently, the "Western Balkans" today consists of six countries: Albania, Bosnia and Herzegovina, Kosovo, North Macedonia, Montenegro and Serbia. [3]

Yugoslavia's disintegration was accompanied by a series of disruptive political events. The region suffered five military conflicts: in Slovenia (1991), Croatia (1990-91), Bosnia and Herzegovina (1992-1995), FR Yugoslavia/Kosovo (1998-1999) and Macedonia (2001). During the 1990s, most Western Balkan states pursued policies of state building guided by inward-oriented nationalistic objectives. The Federal Republic of Yugoslavia was under severe United Nations (UN) and EU sanctions due to the country's involvement in the war in Bosnia and Herzegovina (1992-1996) and its policies in Kosovo (1997-1998), which culminated in 11 weeks of bombing by the North Atlantic Treaty Organization (NATO) in the first half of 1999.

Political instability in the 1990s had profound and long-term consequences for transition-related economic reforms, economic development and the integration of the Western Balkans with the EU. Although the transition to democracy and a market economy started before the break-up of federal Yugoslavia —the first multi-party elections were held in all the Yugoslav republics during 1990 and the federal government launched a package of radical economic reforms in December 1989— these reforms were discontinued. The disintegration of the Yugoslav federation caused regional fragmentation and the loss of a protected internal market, a monetary and currency union, and other advantages of a larger economic entity. The Yugoslav successor states lost, almost overnight, the excellent starting conditions available to SFR Yugoslavia for implementing the transition, including the legacy of several decades of market-oriented reforms, privileged international relations with the West and excellent relations with the European Economic Community.

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The Western Balkans’ economic performance during the 1990s was highly unsatisfactory. [4] All the countries experienced a sharp fall in GDP in 1991-94, more profound than in most other Central East European countries, and recessions recurred in the second half of the 1990s as well. All the countries except Albania underwent episodes of hyperinflation, particularly FR Yugoslavia, which registered a 15-digit inflation rate in early 1993 (at that time, the second highest inflation in economic history). [5] The extraordinary economic conditions had deep socio-economic consequences: a continuous fall in living standards, and widespread poverty, inequality and social differentiation. The international isolation of a large part of the region during most of the 1990s due to UN sanctions stimulated illegal trade, the flourishing of the informal economy, and widespread corruption and criminality.

Only in 2000-01 did the general conditions start to improve, in part thanks to more democratic regimes established in two key countries, Croatia and Serbia. These political changes facilitated a fundamental turnaround in international strategies towards the Western Balkan region. A new comprehensive EU (and international) strategy was launched for the Western Balkans in June 1999 after the end of the Kosovo conflict, known as the Stabilisation and Association Process (SAP), which will be discussed in greater detail below. With the political stabilisation of the region, the Western Balkan countries also registered substantial improvements in economic performance and progress with transition-related economic reforms.

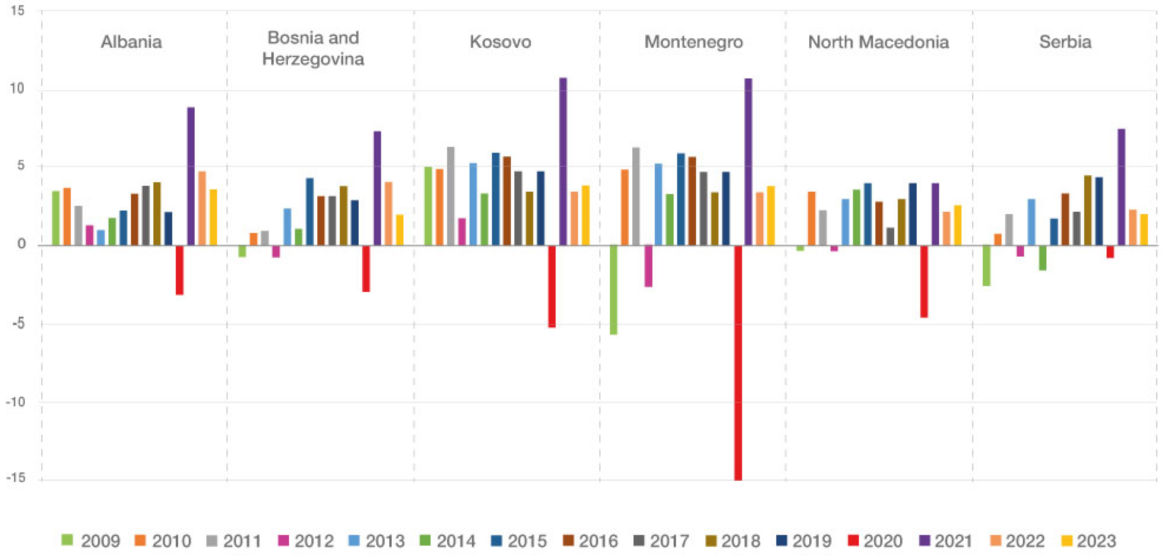
A rapid economic recovery took place after 2001, with an average GDP growth rate for the whole region of over 5%. Macroeconomic stabilisation was achieved in all countries, as inflation was also reduced to one-digit figures in countries that had previously had very high inflation, such as FR Yugoslavia. Reduced political risk and improved economic prospects stimulated the arrival of Foreign Direct Investment (FDI), attracted by the new waves of privatisations of enterprises and banks. Trade liberalisation ensured better access to EU markets, facilitating the gradual economic integration of the Western Balkans with the EU economy. Many important transition-related economic reforms were also implemented, including price, trade, financial and foreign exchange liberalisation, banking reforms and economy-wide privatisations. Already by 2010, the private sector contributed between 60 and 75% of the Western Balkan countries’ GDP.

Four workers carry a large glass panel by hand through the streets of Belgrad, Serbia, on 24 August 2018. Photo: Mitar Mitrovic

These positive trends in economic recovery were interrupted by the global financial and economic crisis. In the last quarter of 2008, the Western Balkan economies were severely hit by two external shocks. Their financial sector experienced a sharp reduction in all forms of foreign capital inflows, including cross-border banking loans, FDI, worker remittances and donor activity, while the real sector was strongly affected by reduced demand for their exports on EU markets. The gradual economic integration of the Western Balkan countries with the EU has sustained their economic recovery since 2001, but it has also increased the vulnerability of their economies to external shocks.

In 2009, the Western Balkan countries registered much lower GDP growth rates (Albania and Kosovo), or negative growth (Bosnia and Herzegovina, Montenegro, North Macedonia and Serbia (see Graph 1). During the whole of the 2009-23 period, Bosnia and Herzegovina, Montenegro and North Macedonia have had three, and Serbia four years of negative GDP growth. Reversals in growth recovery were influenced by multiple crises within the EU, including the global financial and economic crisis (2007-2009), the Eurozone crisis (2011-12) and the COVID-19 pandemic (2020). Although most countries registered very strong GDP growth in 2021, thereafter growth rates have generally been more modest.

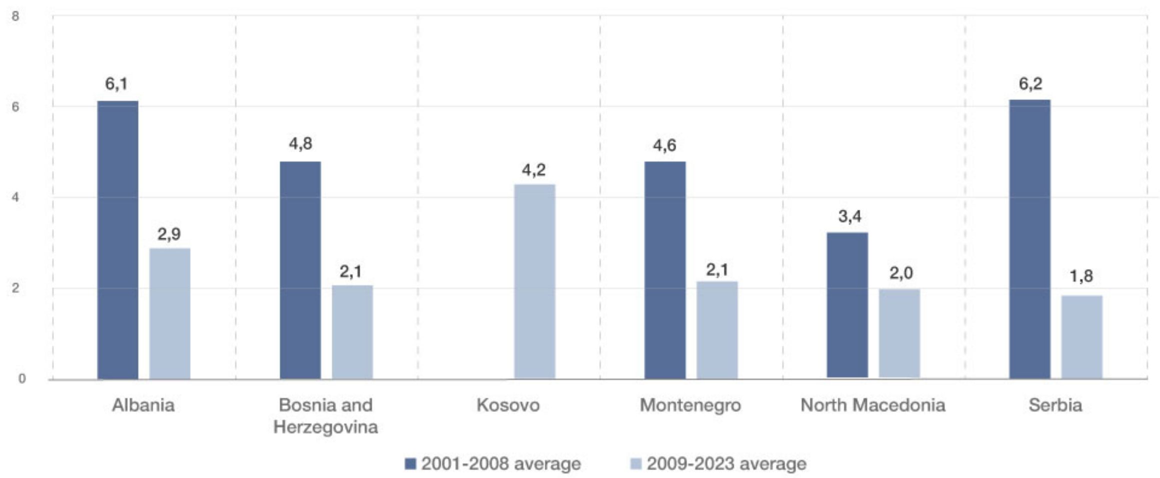
Graph 1. Real GDP growth rates (in %), 2009–2023



Source: compiled by the author based on International Monetary Fund (IMF) statistics.

Therefore, there was a notable slowing down of economic development in the Western Balkans after 2009. Comparisons of pre- and post-global economic crisis GDP growth rates indicate that most countries have had two to three times lower average growth rates in 2009-2023 than in 2001-2008 (see Graph 2).

Graph 2. Pre- and post- 2008 global crisis real GDP average growth rates (%)



Source: compiled by the author based on International Monetary Fund (IMF) statistics.

These trends explain why the Western Balkan countries' current level of economic development is relatively low. By 2022, GDP per capita with respect to the EU27 average (in Purchasing Power Standards) ranged from 34% in Albania to 50% in Montenegro. The poorest country is Kosovo, for which Eurostat does not have accurate statistics, but the World Bank estimates its GDP per capita at 28% of the EU27 average. During the past ten years, there has been only very limited convergence of the Western Balkan countries towards average EU income levels, a problem stressed in many recent studies.

Key structural problems of the Western Balkan economies

The global financial and economic crisis brought to the surface a number of long-term structural problems of the Western Balkan economies that had been accumulating for several decades. The acceleration of transition-related economic reforms since 2000 has not been sufficient to alleviate many problems that emerged during the previous decade. In the early 2000s, the Western Balkans were not starting their economic reforms from scratch; rather, they struggled under a heavy burden of weak institutions inherited from the 1990s, ruined by wars, criminality, corruption, smuggling, informal activities and absence of rule of law. Governments gave priority to economic liberalisation, macroeconomic stabilisation and privatisation, disregarding many important institutional reforms that were necessary to raise the efficiency of government and non-government institutions.

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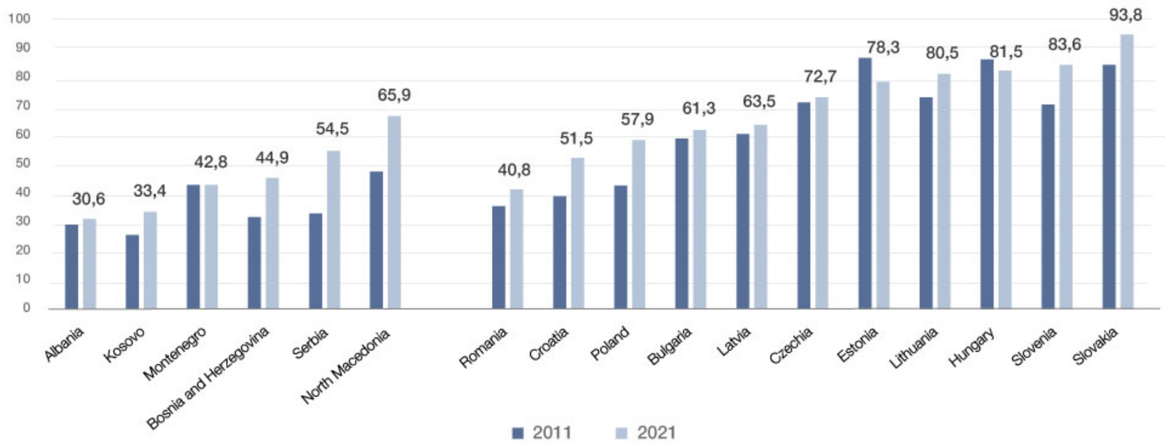
The emphasis on liberal market-oriented reforms and policies has not delivered more permanent economic development. Strong economic growth after 2001 was sustained by foreign capital inflows that played an important role as a supplement to low domestic savings and investments, but with the first effects of the global economic crisis, most sources of foreign capital were sharply reduced, pushing the region into stagnation. A number of structural problems became evident, including high imbalances on external accounts, slow adjustments of labour markets, rapid structural changes and specific features of FDI.

Firstly, the Western Balkans have registered high imbalances in their external accounts. Trade liberalisation after 2001 facilitated a rapid increase in the Western Balkans' foreign trade, but their exports have generally been far lower than their imports, leading to rising trade and current account deficits. Although most countries have increased their exports to international markets over the past decade, their export/GDP ratios in 2021 were still relatively low in comparison to those of most Central East European countries (see Graph 3), suggesting limited competitiveness of their products on international markets.

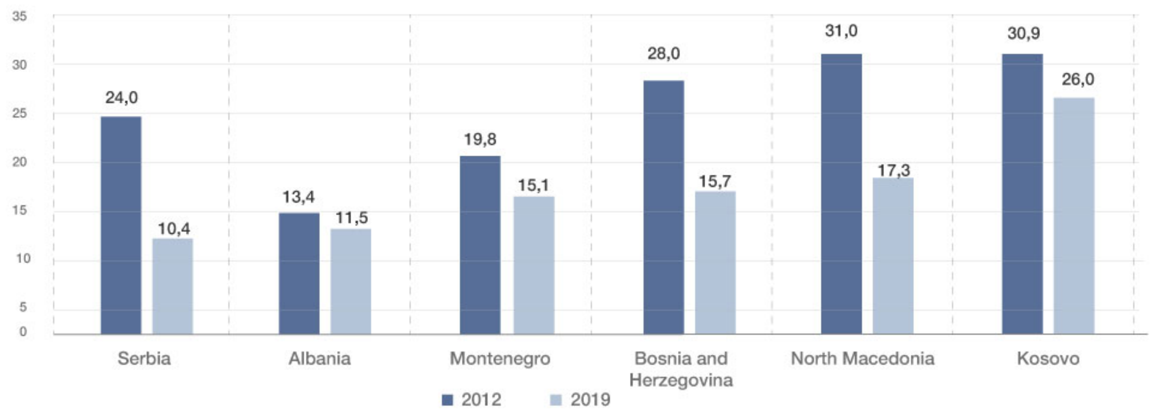
Graph 3. Exports of goods and services / GDP (in %)



Source: compiled by the author based on World Bank Development Indicators.

Secondly, the Western Balkans' labour markets have been characterised by very slow adjustments. The countries of the region witnessed the phenomenon of jobless growth in the early 2000s, when high growth rates were not sufficient to create new jobs for workers being laid off. There have been persistent problems of very high unemployment (especially long-term and youth) and low employment rates, leading to a widespread informal economy. Insufficient employment opportunities have led to continuous brain drain, as many young people and the best experts have left their homelands, and brain waste, since graduates are often unable to find suitable jobs in their professions. Although most labour market indicators have somewhat improved over the 2011-19 period, unemployment rates in Kosovo, Bosnia and Herzegovina, and North Macedonia remain extremely high (see Graph 4).

Graph 4. Unemployment rates in the Western Balkan countries

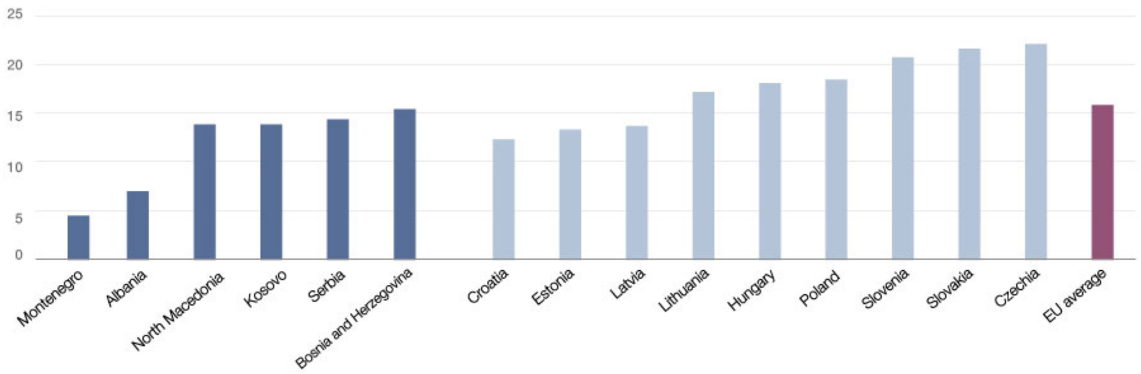


Source: compiled by the author based on International Labour Organization (ILO) statistics.

Thirdly, the Western Balkan economies have experienced very rapid structural changes, primarily due to continuous deindustrialisation. Serbia's economy underwent an extreme process of deindustrialisation in the 1990s and its industry recovered only marginally after 2001, so that its industrial production in 2008 was only 51% of the level recorded in 1990. [6] Similar processes of deindustrialisation have also taken place in the other countries. [7]

Today, the Western Balkan countries are more deindustrialised than those of the EU-27, where the manufacturing sector on average contributes 15% of value added, and even more in comparison to the new EU Member States, where manufacturing has retained an important role in most countries (see Graph 5).

Graph 5. Manufacturing value-added (% of GDP), 2022



Source: compiled by the author based on World Bank Development Indicators.

Fourthly, FDI has had specific features in the Western Balkans. [8] Foreign investors arrived in the Western Balkans as recently as the early 2000s, after the political situation had stabilised, and when many industries had been destroyed by war, disinvestment or unsuccessful privatisations. Foreign investors have thus mainly invested in the more profitable service sectors – retail and wholesale trade, banking, telecommunications and real estate – rather than in manufacturing. Until 2010, the largest part of FDI has gone into the service sector, ranging from 51% of total FDI stock in Macedonia to 73% in Serbia. [9] These features explain the limited impact of FDI on the restructuring and modernisation of many industrial sectors and the stronger process of deindustrialisation in the Western Balkans compared to Central Eastern Europe.

A study of FDI in five Western Balkan countries has shown that FDI has not had positive spillover effects in the manufacturing industries. [10] One of the reasons for the absence of positive economy-wide effects of FDI are the limited links between domestic firms and foreign investor companies, who often continue to rely on import input from their countries of origin. [11] Despite many government incentives to attract foreign investors, the remaining barriers to more and better quality FDI – derived from the small size of the Western Balkan economies, fragmentation, lack of economies of scale and inadequate infrastructure – will not easily be overcome.

A migrant washes himself and takes refuge in an abandoned warehouse behind the train station closest to the construction site of the 'Belgrade Waterfront' project in Belgrade, Serbia, winter 2016. Photo: Mitar Mitrovic

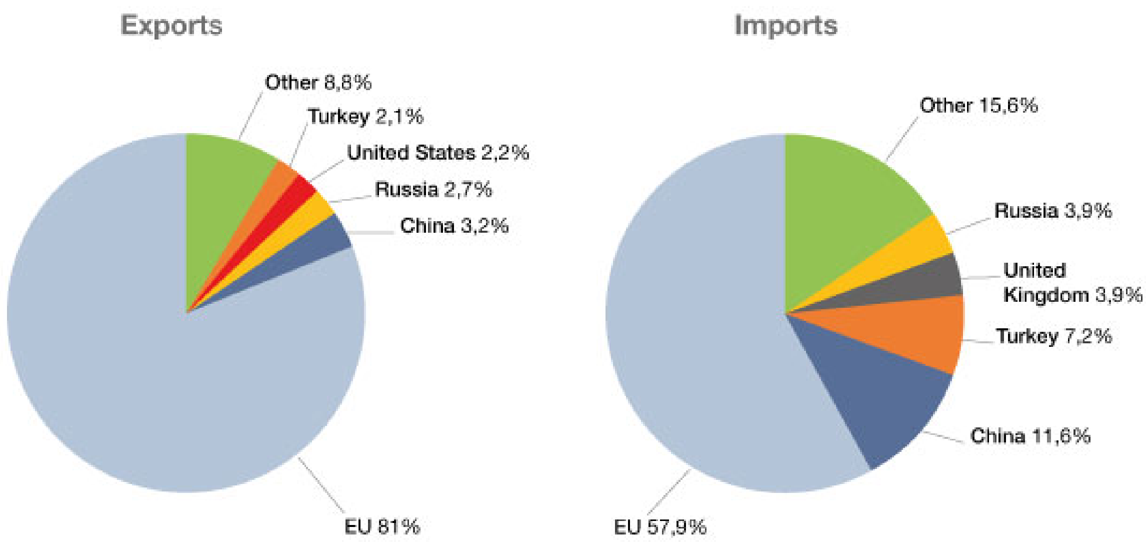
Integration of the Western Balkans with the European Union

The disintegration of SFR Yugoslavia has also delayed the integration of most of its successor states with the EU. During the 1990s, EU policies towards these countries were hesitant, directly shaped by the ongoing dramatic political events. Despite some selective and ad hoc measures of support, Slovenia was the only country included in EU programmes sustaining the transition and integration of Central Eastern Europe with the EU.

It was only after the end of the Kosovo conflict in June 1999 that the EU adopted a comprehensive and long-term strategy for the Western Balkans – the Stabilisation and Association Process (SAP) – with the aim of sustaining the region's political stabilisation, economic reconstruction and integration with the EU. European Union measures included trade liberalisation; financial assistance through the Community Assistance for Reconstruction, Development and Stabilisation (CARDS) programme, adopted in 2000 and replaced in 2007 by the Instrument for Pre-Accession Assistance (IPA); gradual legal harmonisation through the adoption of laws in conformity with the Acquis Communautaire; and the establishment of contractual relations through the signing of Stabilisation and Association Agreements, signed between the EU and all the Western Balkan countries during the sixteen years from 2001 to 2015. The SAP also offered the Western Balkan countries, for the first time, the prospect of EU membership, confirmed at the EU-Western Balkans Summit in Thessaloniki in 2003.

The Stabilisation and Association Process has greatly facilitated the economic integration of the Western Balkans into the EU economy. The EU has become their most important trading partner, representing 81% of Western Balkan exports and 58% of their imports in 2021 (see Graph 6). Within the EU, most trade is conducted with Germany and Italy. Foreign investors have also been mainly from the EU: by 2021, more than 60% of FDI stock in the Western Balkans, on average, was held by EU Member States. Thanks to the process of privatisation of the banking sector, between 65 and 90% of banking assets in the Western Balkans are owned by foreign banks, mainly from the EU. The euro is already used in Kosovo and Montenegro (where it was adopted for political reasons), while the national currencies of the other countries are either officially or unofficially pegged to the euro. There is a high degree of “euroisation” in the region, since savings holdings of enterprises and private citizens are mainly held in euros.

Graph 6. Western Balkans exports and imports of goods, by trading partner, 2021



Source: compiled by the author based on Eurostat data.

Non-EU countries have also increased their economic presence in the Western Balkans in recent years, but their role remains marginal when compared to the EU. The main non-EU actor in the region is China, which has increased its investment in the region to become the second most important investor in Serbia and Montenegro after the EU. Still, China is a much less important trading partner of the Western Balkans, representing only 3.2% of their exports and less than 12% of their imports (2021). All the Western Balkan countries have growing trade deficits with China, since trade is highly unbalanced.

Despite the increasing economic integration of the Western Balkans with the EU, political integration has been very slow. After 24 years of the SAP, only Croatia has been able to join the EU. Not even the optimistic expectations of economic integration with the EU from the early 2000s have fully materialised. In the Western Balkans, the blame for unsatisfactory economic performance is often attributed to economic dependence on the EU, rather than on domestic factors, including inefficient government policies or structural economic problems. [12]

> In 2021, the EU accounted for 81% of the region's exports and 58% of its imports. The main current economic challenge for the countries of the Western Balkans is to achieve faster economic growth and to converge towards EU living standards

There are many reasons for the slow accession of the Western Balkans to the EU, but they are primarily linked to political rather than outstanding economic problems. The EU has applied stringent political conditionality in the Western Balkan countries, imposing complicated procedures, methodologies and accession conditions: in addition to meeting the "Copenhagen criteria", they have to implement regional cooperation with other countries in the region and respect all international treaties, including cooperation with the International Criminal Tribunal for Former Yugoslavia. On the part of the Western Balkans, the countries of the region have faced frequent political crises, backsliding of reform processes and a tendency towards authoritarian regimes. The still unresolved relations between Serbia and Kosovo have also greatly delayed the EU accession process, [13] despite continued international pressure to reach mutually acceptable solutions over the last ten years.

Conclusions

The main economic challenge for the Western Balkan countries today is to achieve faster economic growth and converge towards EU living standards. Given the strong dependence on the EU economy, some issues are beyond the direct control of Western Balkan governments, but a lot more could be done by implementing more adequate economic policies. In particular, a more variegated pro-growth industrial policy would be desirable: to stimulate investment, not only foreign but also domestic; raise awareness of the importance of human capital (education, R&D expenditure and innovation); influence the sectoral structure of FDI, channelling investments towards higher value-added sectors; facilitate the creation of local networks between foreign and domestic firms; and implement the dual digital and green transition.

The Western Balkan countries also need more efficient government institutions to enforce laws, collect taxes, fight corruption, implement transparent public procurement procedures and increase public administration efficiency. Without improved governance, efforts to accelerate economic development will not lead to the desired results.

REFERENCES AND FOOTNOTES

1 — Although Croatia was also part of the Western Balkans, it will not be considered since it became an EU Member State in 2013.
2 — However, Kosovo has still not been officially recognised by five EU Member States (Cyprus, Greece, Romania, Slovakia and Spain), or by about 45% of UN members (including Russia, China and India).
3 — The European Commission first used the term "Western Balkans" in 1996 in reference to all the successor states of former Yugoslavia (except Slovenia, considered part of Central Eastern Europe). Albania was added to the group in 1997, after the political and economic crises produced by the electoral fraud and the collapse of the pyramid schemes.
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