GROWTH AND THE FUTURE OF SOUTHEAST EUROPE

After a decade of remarkable growth rates, the region of Southeast Europe was severely affected by the euro area fiscal and economic crises. The decreased international interest in this region does not depend entirely on the lack of global finances, rather on the structural problems of these small economies. The answer to this vicious cycle of economic recession, unemployment, and poverty lies in a new growth model based on regional economic integration, to enhance sustainable, inclusive, and smart growth. With a strong political will of all parties, the next 10 years can bring about a free regional economy, an interoperable new economic reality that would project collective financial stability, attract "qualitative" foreign direct investment, raise competitiveness and support innovative industries for long-term growth and development. Good governance, economic rule of law, and structural reforms are imperative for achieving these challenging objectives.

Valbona Zeneli*

TURKISH POLICY
QUARTERLY
Summer 2013

* Valbona Zeneli, Ph.D. is a Professor at the George C. Marshall European Center for Security Studies. This paper reflects the views of the author and is not necessarily the official policy of the U.S. or German governments.

In recent years, the world economy, and particularly the euro zone, suffered one of the most severe economic crises since World War II, which was accompanied by a huge decline in trade and investments. Much likely, recovery will not be faster than three percent of growth pace. The well-known factors for this sluggish recovery are: the job crisis, the sovereign debt crisis in the euro area and the fiscal austerity measures affecting both developed and developing countries.

The region of Southeast Europe (SEE)[1], outside the euro area itself, was indirectly affected by the crisis through the trade and finance spillover channels and because of the linkages and dependence on the European Union markets.[2] According to the World Bank's Southeast Europe Regular Economic Report,[3] perhaps no other region in Europe appears more vulnerable to the euro crisis as does SEE, opening up to serious vulnerabilities and challenges for these small economies. Real GDP contraction for the SEE economies was 5.9 percent in 2009, continuing to struggle with a double dip recession in the last two years, with GDP to have shrunk by 1.2 percent in 2012.

Global Economic Crisis' Contagion Channels in Southeast Europe

The most significant of the contagion channels in SEE has been the fall of foreign direct investment (FDI), experiencing the sharpest decline of any other emerging market in 2009, with a contraction of more than 30 percent on average compared to only eight percent in the global context.

Such a decreased level of FDI in recent years does not depend entirely on the lack of global finance resources, rather on the confidence crisis. Foreign investments have been mainly market seeking, related mostly to the privatization process, concentrated in manufacturing and the financial sector, and very rarely export oriented. The quality of the investments did not stimulate strong industrial growth through positive spillover effects, due to the absence of a serious presence of green field investments.[4]

1 The countries taken in consideration are according the European Bank for Reconstruction and Development (EBRD) definition of Southeast Europe: Albania, Bulgaria, Romania, Croatia, FYROM, Bosnia & Herzegovina, Serbia, Montenegro, and Kosovo.
2 Marios Efthymiopoulos and Valbona Zeneli, "From Transition to Opportunity: Security through Economic Development & Institutional Strengthening," *Research in the World Economy*, *Sciedu Press,* Vol.2, No.2 (September 2012), http://www.sciedu.ca/journal/index.php/rwe/article/view/1725
3 "South East Europe Regular Economic Report: From Double Dip Recession to Accelerated Reforms," *The World Bank,* No.3 (18 December 2012), http://www.worldbank.org/content/dam/Worldbank/document/SEERER_3_Report_FINAL_eng.pdf
4 Greenfield investment involves establishing a new plant with its own production abroad. There are different definitions of FDI given from different scholars, in this case the definition of OECD is considered: FDI is generally defined as an investment by a firm from one (home) country in another (host) country, where the foreign investor owns at least 10 % of the company in which the investment is made (OECD 1996).

Although the SEE region offers unique opportunities in terms of strategic position, proximity to Western markets, natural resources, and relatively cheap labor costs, it still attracts less than three percent of the global investments. Montenegro had the highest level of FDI stock per capita in the region in 2011 with 9,178 dollars and Albania and Kosovo had the lowest, with 1,462 dollars and around 1,200 dollars respectively.[5]

The reluctance of the foreign investors to seriously commit in this region is related to various political and economic concerns such as: weak growth rates, structural problems of the economies, pervasive corruption and labyrinthine bureaucracy, governance issues, political risks, skill deficiencies, and inexperienced institutions. The quality and performance of the institutions is what worries investors the most when they consider entering a new foreign market. In the case of SEE this has been also statistically proven.[6]

"Southeast Europe (SEE), outside the euro area itself, was indirectly affected by the crisis through the trade and finance spillover channels and because of the linkages and dependence on the EU markets."

Another negative spillover effect was the decline of exports and trade in general, especially to the euro area, although the trade performance of these countries was disappointing even before the crisis hit the region.

Also, the decrease of remittances from expatriate workers had negative consequences for these small economies. These remittances had a very important role in the transition period from centrally planned to open market economies, for consumption and the financing of small enterprises.

One of the main factors fuelling the continuing recession in the region is the credit crunch; mainly because of the strong dependence on the euro area due to a large portion of foreign ownership of the banking sector in SEE, which is above 80 percent of the market. Foreign banks have been very important strategic investors in the region helping the attraction of other FDI.[7] But on the other side, the reliance on external

5 "Data on FDI in SEE," *UNCTAD (United Nations Conference on Trade and Development) Statistics*, p. 5, http://unctadstat.unctad.org/ReportFolders/reportFolders.aspx?sRF_ActivePath=p,5&sRF_Expanded=
6 Valbona Zeneli, "The Determinants for the Attraction of FDI in Southeast European Countries: The Role of Institutions, *Ph.D. Thesis, University of Bari* (2011).
7 Valbona Zeneli (2011), p. 4.

funds has created liquidity issues by lowering the much-needed credit supply in these countries, therefore becoming a major problematic factor for domestic firms. Yet, under the influence of the economic crisis and sluggish recovery of the region, the country risks have increased and thereby the interest rates of foreign credit as well.

The serious impact from the Greek economic and political crisis is not to be underestimated too, due to its continuing negative effects for the future, as Greece is a strategic investor in the region, mainly in the banking sector, and one of the main trading partners.

Because of the abovementioned reasons, the region is experiencing a sluggish recovery and continuing to battle a further decline in economic output, accompanied with increased unemployment (only a few other economies in the world have unemployment rates above 25 percent such as some countries in the region) and dangerous public debts.

The Need for a New Growth Model

After a decade of surging growth, with an average annual growth rate of above five percent and some catching up by the economies of SEE, the boom came to an abrupt end in 2009. For the moment the picture seems gloomy, and the high growth speed a nice memory. The economic crisis made the world economy suffer very challenging times; nevertheless it also showed some important lessons to be learned, that have profound effects on the way policies are being shaped everywhere.

The accentuated long-term shift in economic weight from developed countries to emerging markets is gaining universal acceptance. The financial crisis in particular, has boosted the role of governments in the economy, leading policy makers to reflect on a new development paradigm that places inclusive and sustainable development on the same footing as economic growth. Meanwhile, the crises have revealed that international economic cooperation and integration have become imperative, since no country can address the nature of the new challenges in isolation.

In SEE, from a growth theory model, high growth has been mainly based on domestic demand-led expansion, made possible by large capital inflows mainly through the huge privatization process of the state-owned companies, large credit growth, and private transfers. However, credit capital inflows were allocated mainly towards consumption and did not properly feed productive investment activities.

Development was mainly driven by the accumulation of physical and financial capital rather than human capital, fueling the sovereign debt and not upgrading the competitiveness of these economies to assure long-term sustainable growth. Various indicators showed that there was a significant lagging performance in well-developing the enterprise sector and creating strong competitive market conditions. Investments were fueled by the foreign savings while domestic ones were extremely low. Productivity has been low and growth, so far, has not been based on increased efficiency.[8]

But, as global liquidity is shrinking, the growth model in SEE appears to be dramatically challenged. The economic slowdown shows that the import-led and financial sector driven trajectory of economic development in SEE should be reevaluated.

"The crises have revealed that international economic cooperation and integration have become imperative, since no country can address the nature of the new challenges in isolation."

There is a generally accepted need in all these small economies for shifting patterns of growth towards a more export-oriented growth, which would be more labor intensive and more competitive in terms of productivity growth. Attracting "qualitative" FDI, meaning FDI that has positive spillover effects for the host country economy, would help accelerate this trend. Remodeling the economies of SEE should be done by changing the drivers of growth, creating a favorable business environment and exploring more effective cross-border linkages. To fully exploit its sustainable benefits, growth needs to be driven by investment, productivity, competitiveness, and economic integration.

The Vitalness of Regional Economic Integration

SEE countries are struggling to regain their economic stride, facing the double challenge of structural changes and the financial and economic crises. The answer to the vicious cycle of economic recession and unemployment is increased regional cooperation, which is vital for the significance of the SEE region in the global market. The starting point for any regional integration has to be the recognition by the countries that they can achieve more on the international stage collectively than they can as single actors. They are too small and too weak to generate sufficient scale and

8 "The Pre-Accession Economies in the Global Crisis: From Exogenous to Endogenous Growth?" *Occasional Papers, European Commission Directorate for Economic and Financial Affairs* (2012).

capacity to attract productive investment. They do not have the required number of skilled workers, local financial capacity, or ability to sustain economic clusters.

Countries should focus on regional integrated growth as an imperative step ahead, strengthening regional trade and investment cooperation. This strategic objective can be achieved through complete trade liberalization, with final elimination of tariffs and quotas, simplification of procedures, removal of the non-tariff barriers, and liberalization of trade in services. The economic integration through the harmonization of custom and trade regulations and the adaption of EU standards should be seen as excellent opportunities for SEE countries to harmonize institutions and national policies.

A new trade zone needs to be established in the region, a free regional market economy for creating an interoperable new economic reality, including not only the countries of SEE but also neighboring countries such as Turkey or Greece. Turkey, as an example, has an impressive growth potential, being part of the "Next 11" list of Goldman Sachs, replicating the development rates of the BRICS.[9]

Therefore, this deeper integration should be based on the common framework of possible deliverable projects, institutional and infrastructural reforms, with the strategic goal to project collective financial stability, prosperity, growth, and attract FDI capital.

Many infrastructure investments have been delivered in various countries of SEE in recent years. But, infrastructure projects alone are not enough; instead they need to be put in a much wider development context, which is centered on the advancement of human resources and overall development by strengthening the regional value chains and supporting the creation of transnational clusters and business networks.

This new economic SEE space would mean new opportunities in terms of resource exploitation, new markets, and new trade partners. It would give the countries the opportunity to explore the potential of international competitiveness in the current globalized world.

A good existing framework is already in place: the Central European Free Trade Agreement (CEFTA) has substantially lowered tariffs and eased administrative procedures. However, this framework is still very poorly implemented. Disappointingly, intra-regional trade levels in SEE are extremely low, very much below the actual potential, with only around 33 percent of trade with CEFTA countries. Yet, the

9 "When Giants Slow Down," *The Economist,* 27 July 2013, http://www.economist.com/news/briefing/21582257-most-dramatic-and-disruptive-period-emerging-market-growth-world-has-ever-seen

most problematic issues lie in non-tariff barriers: lengthy procedures, extensive corruption and absence of political will for cooperation.

"The economic slowdown shows that the import-led and financial sector driven trajectory of economic development in SEE should be reevaluated."

In order to boost economic development, real structural reforms for faster productivity growth and new measures for increasing competitiveness are imperative in SEE. The key issue in creating a more favorable investment environment is the need to strengthen institutions. New investment policies should assure a stable macroeconomic environment, fair treatment of foreign and domestic companies, a friendly business environment, and institutional support for private competitiveness by supporting particular small and medium enterprises.

It is important to develop policies to harness investment for productive capacity building and to enhance international competitiveness. Critical elements of capacity building include human resources and skills development, technology, know-how, infrastructure development and enterprise development. This is not an easy task, with austerity continuing unabated.

However, this is also in line with the EU 2020 growth strategy which talks about smart growth to be built on knowledge, education, and innovation.[10] The promotion of linkages between academia, industry, and policy makers is very important for promoting the free flow of talent throughout the region; encouraging brain gain, supporting private and public sector investment in R&D, and regionally coordinating policies that would enhance innovation and promote the knowledge economy. The potential for more creativity –as a new major driver of competitiveness– should be better explored in SEE, with the aim of developing creative industries as one of the priorities for future economic growth.

This deeper integration would better link the SEE economies with the enormous EU market, following the successful example of the economies of Central Europe. The good news is that EU membership, which was already realized for three of the countries of SEE (Romania, Bulgaria, and Croatia), continues to be recognized as a key strategy toward the economic development in the region. Simultaneously, it

10 "Europe 2020: A Strategy for Smart, Sustainable and Inclusive Growth, *European Commission* (March 2010), http://ec.europa.eu/eu2020/pdf/COMPLET%20EN%20BARROSO%20%20%20007%20-%20Europe%202020%20-%20EN%20version.pdf

represents a positive race to improve each country's economic performance and diminish the real convergence gap with Western European countries.

The economic growth model, which relies on a deeper integration with the EU, remains the first and best option in the long-term for the small economies of SEE. A strong priority is to further integrate in the supply chains feeding demand in Western Europe and generally increase cooperation with EU markets and simultaneously broaden the export bases in terms of products and markets also outside the EU.

This idea has been pushed and supported by the EU as a preparation step for these countries before they enter the common European market. Working with the EU in the accession process has been of crucial importance to build institutional capacity for these countries. However, in the future the region should support itself and carry out reforms for its own sake and without too much reliance on external actors. The SEE countries should better understand the European integration story. It is a history of coordination and integration, supra-nationalism and inter-governmentalism. This is a very important part of the integration process, a common path that the SEE countries are following.

Attracting "Qualitative" FDI - A Priority for Growth and Higher Competitiveness

Given the crisis and the huge financial gaps in the region, countries should collectively promote institutional development and develop a friendly environment for the attraction and targeting of "qualitative" FDI towards sectors that augment domestic investment, to be channeled into exports and lead to sustainable growth. FDI has been one of the main promoters of economic growth, and the Euro-Atlantic integration agenda made some the countries more attractive than the others to foreign investors. Today, there is a greater interdependency among countries of the region and greater need for cooperation in attracting investments from abroad, working for a "pooled" competition for FDI.

Creating a regional strategy for investment promotion and developing a single capital market would help the region's global competitiveness.[11] Along with the improvement of skills and overall productivity, increased investment in the region would contribute to employment creation by accelerating growth and helping the resolution of some of the social problems that the region is faced with.

This is in line with the international development agenda according to which, as a response to continued economic uncertainty, turmoil in the financial markets, and

11 *European Commission* (2010), p. 2.

slow growth, governments focus on increased cooperation and a new push for more liberalization. Countries worldwide continue to liberalize their economies and pursue a broader development policy agenda, while building and maintaining a favorable business climate to promote foreign investment as a means to support economic growth and development. As a response to the downturn, a new generation of reforms and partnerships is emerging worldwide.

"Remodeling the economies of SEE should be done by changing the drivers of growth, creating a favorable business environment and exploring more effective cross-border linkages."

Investment policy measures undertaken in the last two years were generally favorable to foreign investors, with various forms and incentives across the world. Some were targeted to specific industries, others to privatization policies and measures related to the facilitation of administrative procedures on foreign investments.

Regionalization for Globalization

As a response to the new perils, international investment policy making has increased significantly, with a declining number of new bilateral treaties and intensification of regional treaty making. Regionalism is on the rise everywhere. The worldwide agreements among countries reached 3,164, which include 2,833 bilateral investment treaties and 331 free trade agreements (FTAs), with investment provisions, economic partnership agreements, and regional agreements.[12]

The increasing weight and impact of regional treaty making is evidenced by some trade and investment agreement negotiations which are currently under way, two of which I will mention here. The Trans-Pacific Partnership Agreement, which will create investments and trade opportunities that link North and South America with dynamic markets across the Asia-Pacific region. The other very promising effort, which directly interests SEE countries, is the Transatlantic Trade and Investment Partnership between the United States and the EU. It would be the biggest bilateral trade deal ever negotiated, even though the transatlantic economy has already the largest bilateral trade relationship and enjoys the most integrated economic relationship in the world. Given the low average of existing tariffs (under three percent), the key to unlocking this potential lies in tackling non-tariff barriers that consist mainly

12 "World Investment Report 2012: Towards a New Generation of Investment Policies," *UNCTAD* (July 2012), http://unctad.org/en/PublicationsLibrary/wir2012_embargoed_en.pdf

of customs procedures, behind the border regulatory restrictions and other non-tariff measures, such as those related to certain aspects of security or consumer protection.

Economic agreements respond better to today's economic realities, in which international trade and investment are increasingly interconnected, bringing about the consolidation and harmonization of investment rules and creating a plain level field for competition. This should be the future also for SEE, by strengthening regional integration.

Regionalism is often misunderstood with a false debate concerning a choice between regional versus global integration. Regional integration is not about creating islands, but helping small and weak countries scale up supply capacity in regional production networks and access global markets. It means more than just preferential trade access between neighbors; it is a step toward real globalization (since all the countries of the region rank badly on the globalization index);[13] it is about regional infrastructure investments, liberalization of regional labor markets, and establishing common institutions.

Despite the fact that the SEE countries have become more prosperous in recent years, they still lag behind EU living standards, as demonstrated by the GDP per capita in each country compared to the EU average. Since the privatization process is almost finished and the gap between SEE and the EU related to incomes and technology are decreasing, there will be less room for catch-up growth in the years to come. With the nature of growth changing in the global economy it will become very difficult for the countries of SEE to return to the remarkable growth rates of the past years.

The question which is asked by many is where the region will be in 10 years. The SEE 2023 vision should take inspiration from the EU's Europe 2020 growth strategy, which calls for an integrated, smart, sustainable and inclusive growth that is based on good governance.[14]

Countries need to direct their reforms and policies towards sustainable growth, in order to raise competitiveness, develop entrepreneurship, and promote greener and more efficient technologies, integrating green development priorities into their long-term policies. Inclusive growth should be centered on skills development by monitoring and tracking skills at the regional level, developing mechanisms for regional dialogue between employees and policy makers, supporting vocational training and

13 "KOF Index of Globalization 2013," *KOF Swiss Economic Institute*, http://globalization.kof.ethz.ch/
14 *UNCTAD* (2012), p. 6.

promoting women's employment and entrepreneurship. Entrepreneurial and business learning should become a real priority in education reform.

Growth and development in the region would not be possible without good governance. The rule of law and governance should aim for sustainable growth as a basis for achieving the goals of smart, sustainable, inclusive and integrated growth. Synergies and complementarities should be found in the regional context for the effective implementation of existing legislation, including the improvement of judiciary capacities and giving high priority to enforcing the rule of law and anticorruption measures.

> *"The SEE countries should better understand the European integration story. It is a history of coordination and integration, supra-nationalism and inter-governmentalism."*

The biggest challenge will be for politicians in SEE whose performance will propel or delay growth and development. Internationally, lower growth is driving leaders towards increased cooperation and towards a push for liberalization.

Economic security and development in the region are also very important for helping end the long history of divisional lines between states, regional disputes, and mistrust among neighbors. Better cooperation would reduce instability and political risks in the region, which are among the main concerns of foreign investors. The regional players, more than anyone else, should recognize the advantages of cooperation over conflict in a rapidly changing world, where commercial and investment interdependence have significantly reduced the validity of scope of nationalistic perspectives.

This is easier said than done. As every good and challenging idea, a strong political will of all parties is required. The time is now. Economic crises usually trigger real reforms and partnerships, which would otherwise be very slow. A reinvigorated relationship in the region is a necessary prerequisite to meet the challenges of the 21st century. Leaders in the region working together in cooperation with other important players such as political, economic, and civil society actors and institutions finding agreement for strong economic partnerships, would be a key for a desperately needed success.