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Western Balkans and the European Union: political ties lagging behind economic ones

Despite regional conflicts, the 2007-08 financial crisis, and the 2009-11 eurozone crisis, Western Balkans countries[1] have developed a close economic proximity with the European Union via a number of regional and bilateral agreements. However, due to institutional, economic, and diplomatic obstacles, accession to the EU will be a long process. At the same time, due to the region's strategic importance and with the reinforcement of membership conditions, accession (or a pre-accession status) is likely to happen – especially as membership would divert the region from other interested parties (Russia, China).

After being disrupted by the 1990s wars, the relationship resumed

The severe ethno-nationalist conflicts in the Western Balkans (WB) began in 1991, accompanying the breakup of Yugoslavia, and only ended in 1999, following the intervention of the forces of the United Nations and the North Atlantic Treaty Organization, and with the promise of accession to the European Union (EU). The same year, the Stability Pact for South Eastern Europe (replaced in 2008 by the Regional Cooperation Council) was adopted by the WB countries, as well as by Moldova, with support from the EU, the United States, and other international organisations. Several agreements were adopted under this umbrella related to trade (Central European Free Trade Agreement in 2006), infrastructure (WB Infrastructure Framework in 2009, Online Regional Investment Platform in 2018), and energy (creation of the Energy Community in 2006), among other fields. In parallel, the EU adopted the Stabilisation and Association Process, allowing the signature of Stabilisation and Association Agreements (SAA) between the EU and individual WB countries, which include provisions for future Deep and Comprehensive Free Trade Agreements (DCFTA).

To overcome the slowdown in the relationship and the economic convergence caused by the successive financial and euro crises between 2008 and 2011, the EU made a push to accelerate road, rail, energy, and communication networking, both within the Western Balkans and between the region and the EU. This push saw the adoption of the Berlin Process in 2014 and the Connectivity Agenda in 2015. This subsequently resulted in the Transport Community Treaty in 2017. This treaty, like the others, obliges countries to adopt core EU legislation as defined by the *acquis communautaire*[2]. In February 2018, the European Commission's new enhanced WB strategy[3] set an indicative deadline (2025) for admission of the two most advanced candidates – Serbia and Montenegro – while flagging specific areas for improvement such as rule of law, security and migration, socio-economic development, digitalisation, and improving relationships with neighbouring countries. The EU-WB summit in Sofia, Bulgaria on the 17th May 2018, aims to reaffirm the EU's commitment towards the WB and the latter's vocation to adhere to the EU.

1 - Albania, Bosnia & Herzegovina, Kosovo, the Former Yugoslav Republic of Macedonia (FYROM), Montenegro, Serbia
2 - The acquis is the body of common rights and obligations that is binding on all the EU member states
Source: https://ec.europa.eu/neighbourhood-enlargement/policy/glossary/terms/acquis_en
3 - Com (2018) 65 final

WB economies are closely integrated with the EU

The EU is the Western Balkans' largest trade partner **(Chart 1)**. Their links have been boosted by the SAAs that progressively entered into force between 2004 and 2016. Since 2008, trade in goods between EU and WB[4] has increased by 80%: 89% for WB imports and 42% for WB exports. The EU accounts for 76% of the WB's total goods trade, for 83% of their exports, and 67% of their imports[5]. When intra-WB trade is added, the figures are even more impressive: intra-zone exports and imports represent between, respectively, 13% to 40% and 7% to 30% of the total, with Montenegro taking first place due to its historic and geographic proximity with Serbia. Nevertheless, goods exports only represent 37% of regional GDP (25% without intraregional trade), with Serbia and the former Yugoslav Republic of Macedonia (FYROM) having the highest percentage (44%) due to their significant manufacturing sectors **(Chart 2)**.

The WB's balance of goods with the EU has seen a regional deficit of over EUR 8 billion every year since 2006[6], ranging from 9% of GDP for Serbia to 45% for Montenegro, with the rest at over 20%. The main reasons are the market opening and economic integration with the EU, coupled with the narrow productive base and the low added-value – except for Serbia, which induces high imports of consumer goods and equipment. Their main exports are machinery, automotive products, chemicals, clothing, agricultural and food products, ores, fuels and electricity, metallic and plastic articles. Nevertheless, their deficit is high for some of these products: machinery, automotive products, food products, fuels (petroleum), while there is a balance for chemicals and agricultural products, and a surplus for clothing and ores. They import a lot to cover their needs in pharmaceuticals, textiles (yarn and fabrics), telecommunication and data processing equipment, non-ferrous metals, glass, and animal products.

High trade deficits are mostly financed by emigrant remittances **(Table 1)**, foreign direct investment, and services revenues sourcing overwhelmingly in the EU[4]. Emigrant remittances represent around 10% of GDP in Albania, Bosnia & Herzegovina, Montenegro, and Serbia, as well as 15% in Kosovo, but only 4% in FYROM. Due to the conflicts of the 1990s, lower income per capita, and high unemployment (especially among the young), a large proportion of the WB population emigrated to Western and Northern Europe from the 1960s onwards. Almost a quarter of the whole population lives abroad, ranging from 47% in Bosnia & Herzegovina to 11% in Serbia. Foreign direct investment stock, which represents over 40% of GDP in Albania, Bosnia & Herzegovina, and FYROM, 70% in Serbia and 113% in Montenegro, mostly (60 to 80%) originates from Western Europe, although Russia, Turkey, Canada, and Serbia constitute a significant share. The European (German, Italian, French, Austrian and Greek) presence is particularly significant in the banking system, as well as in telecommunications, energy, and tourism, and to a lesser extent in manufacturing. Exports of services account for a large share of the region's total exports of goods and services. Tourism receipts alone, predominantly from European visitors, represent 56% of total exports in Albania and 49% in Montenegro, but play a much lesser role in Serbia and FYROM.

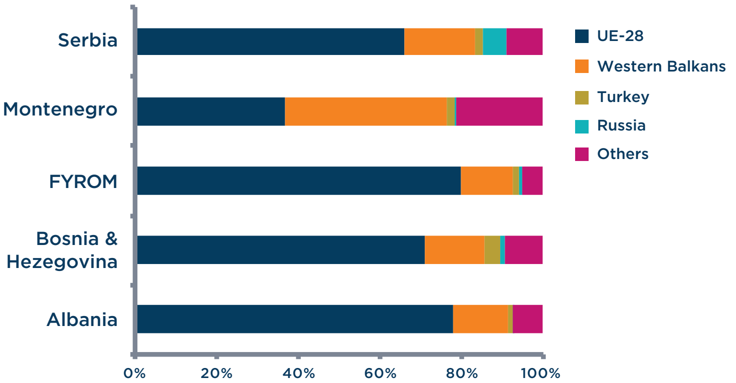
The WB economies are tied to the euro[7] and the eurozone's economic cycle[8]. The linkage is all the most important given the high degree of euroisation of their economies. Foreign-exchange (mostly euro) denominated deposits exceed half of the total, except in Serbia and FYROM (46%). FX-denominated loans constitute around 60% of the total in Albania and Bosnia & Herzegovina, 45% in FYROM and 69% in Serbia **(Table 2)**. Although considered by the European Central Bank as a weakness[9] because of potential cyclical misalignment and deep structural discrepancies with the eurozone, euroisation is diminishing very slowly due to memories of the hyperinflation and financial disorder in the 1990s, as well as a limited confidence in the current economic policy.

Applicants' numerous and serious deficiencies point to a long road ahead, as the EU reinforces its requirements

WB competitiveness is 60% of EU-28 level in the private sector

Deficiencies among WB countries have multiple causes. Some of these are related to the structure of the economy, such as emigration[10]: predominantly affecting the young educated demographic, this phenomenon results in both a brain drain and an aging and shrinking population, which is particularly detrimental to the economy. Public infrastructures[11] are still insufficient in terms of transport, utilities, communications, health, education, vocational training, and research & development, despite some recent acceleration partly linked to the sudden emergence of China in the wake of its Belt and Road initiative.

CHART 1
Geographical Structure of exports, % of total 2016



Source: ITC Trade Map; Kosovo data is unavailable

CHART 2
Exports of goods and services, % of GDP

Source: World Bank, World Development Indicators

4 - *The Western Balkans on the Road to the European Union, Marek Dabrowski and Yana Myachenkova, Bruegel Policy Contribution, Issue n° 04 February 2018*
5 - *The lesser share in imports is due to the importance of Russian gas & oil imports for Serbia, Bosnia & Herzegovina, and FYROM, as well as the growing share of imports from China and Turkey.*
6 - *European Commission Directorate-General for Trade: EU, Trade in goods with Western Balkans 6, 16-11-2017*
7 - *Kosovo and Montenegro use the euro unilaterally, in large part due to their short history, their tiny size, and, in Kosovo's case, its frail institutions. Bosnia & Herzegovina operates a currency board arrangement, by which the Bosnian convertible mark is pegged to the euro. Macedonia's denar is informally pegged to the euro. In Albania and Serbia, there is a managed floating rate that aims to follow euro fluctuations.*
8 - *IMF, Taking Stock of Monetary and Exchange Rate Regimes in Emerging Europe, Nazim Belhocine and others, EUR Special Report 2016*
9 - *https://www.ecb.europa.eu/press/key/date/.../ecb.sp170922.en.html; IMF Working Paper 2018/21, Euroization Drivers and effective Policy Response: An application to the case of Albania, Guido della Valle & others*

The limited fiscal space does not favour a catch-up. The level and efficiency of tax revenues and collection are limited by the prevalence of an informal economy[12] that remains widespread (with share of employed in the hidden economy reaching 26% in Albania, 30% in Bosnia & Herzegovina, 51% in Serbia, and 81% in Kosovo), extensive tax exemptions and incentives meant to attract foreign investment, and heavy energy subsidies. The average public debt reaches 55% of regional GDP (2016) and is rising within several countries. Moreover, budgeted capital expenditures, already dwarfed by current expenditures, are under-executed in most of the countries in the region. Finally, numerous state-owned enterprises remain inefficient and subject to government influence, especially in utilities. This is exemplified by the unstable regional energy supply (with the exception of Bosnia & Herzegovina and Serbia).

Although WB countries have performed reforms thanks to the prospect of EU accession, their institutional frameworks are still deficient. Corruption is commonplace among the whole public sector, from governments and political parties, to the legal system and public tenders. According to Transparency International (2017 data), WB countries rank at the bottom for perception of corruption in Europe (between the 64th and 107th ranks among 180 countries)[13]. These poor performances are corroborated by World Bank governance indicators **(Table 3)**. Poorly-established political stability, with the majorities showing little respect for minorities and the latter boycotting institutions, has recently been seen in Albania, FYROM and Montenegro, and still persists in Kosovo. This is not to mention the institutional fragmentation of Bosnia & Herzegovina, whose system is modelled after its three ethnic groups and is near-impossible to manage at the central level, leading to ethnic voting, strong polarisation, and political stalemates that are detrimental to reforms. Weak bankruptcy and insolvency regimes, added to uncertain property rights in connection with defective registering, do not favour credit by mostly foreign-owned banks, which have only recently recovered from the boom and bust linked to the global financial crisis.

Deficiencies concur with high unemployment[14] and low GDP per capita

Despite improvement in recent years, unemployment **(Chart 3)** is still at 16.2% in the general working population; 37.6% (29% in Montenegro and Serbia, 50% in Kosovo) among the young. Share of the long term unemployment is between 70% and 80%, even 90% in Bosnia & Herzegovina. Labour force participation rates remain low and stable, the lowest in Kosovo with 41% and the highest in FYROM with 56%. The regional employment rate for women is 43.2%, spreading from a low 13% in Kosovo to a high 52% in Serbia.

Unsurprisingly, WB average GDP per capita in Purchasing Power Parity **(Chart 4)** is barely above a quarter of the level in the EU-15, or half of that of the 11 Eastern European EU members. The convergence, which was well underway in the years following the regional conflicts, stopped suddenly with the financial crisis due to a lack of competitiveness. With the current GDP growth rates (just over 3% on average), the World Bank estimates that it would take about six decades for average per capita WB income to reach the EU average.

TABLE 1
Personal Remittances, received (% of GDP)

COUNTRY	2007	2016
Albania	13.7	8.9
Bosnia & Herzegovina	17.0	10.9
Kosovo	19.0	14.8
FYROM	4.1	2.7
Montenegro	5.4	9.1
Serbia	9.3	8.4

Source: World Bank, World Development Indicators

TABLE 2

	Foreign currency denominated loans to total loans (%)			Foreign currency denominated liabilities to total liabilities (%)		
COUNTRY	2010	2013	2016	2010	2013	2016
Albania	68.6	61.9	57.8	50.5	50.0	52.1
Bosnia & Herzegovina	70.0	68.8	62.6	67.0	63.8	57.4
FYROM	58.8	52.7	44.9	57.6	50.1	46.3
Serbia	n/a	71.6	69.4	n/a	76.7	71.1

Source: IMF Financial Soundness Indicators, except Serbia: IMF Country Report No. 17/397

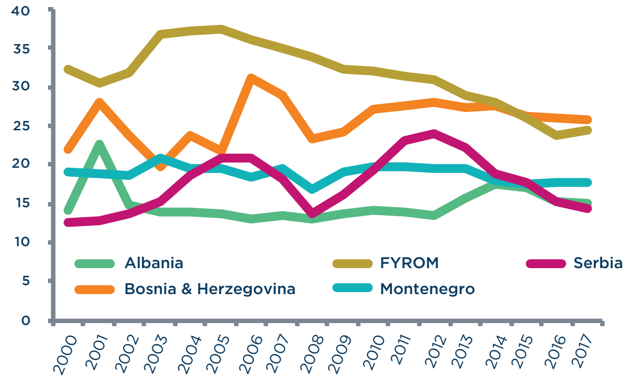
TABLE 3
World Bank, 2016 Governance indicators

COUNTRY	Voices & Accountability	Political Stability	Government Effectiveness	Regulatory Quality	Rule of Law	Control of Corruption
Albania	99	95	100	83	127	123
Bosnia & Herzegovina	121	142	130	108	118	132
Bulgaria	83	112	73	56	97	102
Croatia	73	68	64	72	72	79
Greece	64	123	79	86	86	91
Hungary	88	66	65	60	63	82
Italy	43	89	60	53	82	85
Kosovo	120	131	131	110	130	125
FYROM	126	143	92	67	122	112
Montenegro	104	104	89	79	98	96
Romania	75	94	109	62	81	88
Serbia	96	110	93	95	105	114

Source: World Bank, Ranking out of 209 countries

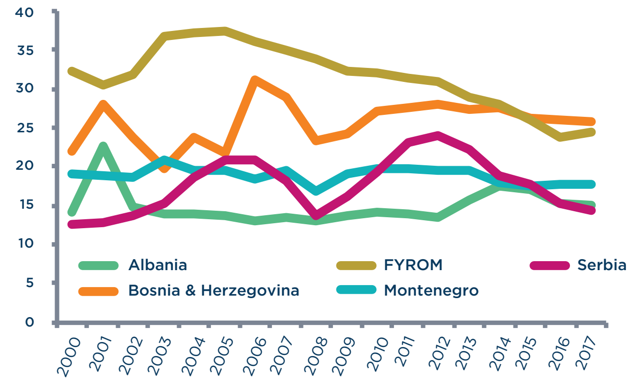
10 - Coface May 2017, Labour shortages in Central and Eastern Europe countries: a growing concern for businesses, Dominique Fruchter & Grzegorz Sielewicz
11 - IMF Feb.2018, Public infrastructures in the WB: opportunities and challenges, Ruben Atoyan & others
12 - IMF Working Paper 2018/17, Shadow Economies around the World: What Did We Learn Over the Last 20 Years?, L. Medina & F. Schneider; SELDI Policy Brief n°6, October 2016, Hidden Economy in SEE
13 - It is worth noting, however, that Bulgaria and Hungary are positioned below Montenegro (the WB regional champion), which itself is only slightly behind Romania and Slovakia
14 - World Bank and wwiiw Western Balkans Labor Market Trends 2018

CHART 3
Unemployment, % of labour force, modeled ILO estimate



Source: World Bank, World Development Indicators

CHART 4
GDP per capita in current international USD, PPP adjusted, Germany = 100%



Source: World Economic Outlook Database, IMF October 2017

On top of these domestic obstacles, conflicts between neighbours and with EU members[15] also slow the adhesion process. Due to its large Croatian and Serbian populations, Bosnia & Herzegovina has difficult relationships with Croatia and Serbia, who themselves are battling in front of the International Court of Justice over mutual accusations of genocide. FYROM is still in conflict with Greece over its name, which also refers to a Greek province. Kosovo is not recognized by Serbia and five EU members, including Spain. Albania is still suspected by its neighbours to long for a gathering of all Albanians in a "Grand Albania". International forces are still present in Kosovo and Bosnia & Herzegovina, while the EU and the United States exercise constant attention on regional political life. Moreover, progress has been made with the ratification of the demarcation line between Kosovo and Montenegro.

The Western Balkans will likely gain EU membership

The combined population of WB countries (18 million) represents 3.6% of the EU-28 population – but their output is only 1% of that of the EU. Only two Baltic countries have a smaller GDP than Serbia, the biggest regional economy. Moreover, membership would have limited extra financial cost for the EU.

Presently, financial assistance from the EU – mostly consisting of the Instrument for Pre-Accession Assistance and, to a small extent, of the Connectivity Fund – will amount to roughly EUR 7 billion over the 2014-2020 period, most of which is directed at supporting administrative and institutional reforms. As members of the EU, this figure could potentially quadruple, given that Bulgaria (a similar economy with 7.1 million inhabitants), will receive EUR 11.7 billion a year in structural funds over the same period. Over a year, the extra funds would represent 2% of the EU-28 2017 budget. The United Kingdom, favouring the future membership of the WB, would be expected to contribute, as would Norway and Switzerland. Moreover, WB countries have a high strategic importance for the EU, being a *passage obligé* between central EU and Greece, Bulgaria, and Romania, and a 'soft belly'[16]. Aggravated problems in the region could rapidly spill over to neighbouring EU countries – especially Croatia, which has a nested border with several WB countries and whose southern mainland is separated from the rest of the country by a stretch of Bosnian territory. Finally, membership would divert the region from foreign sirens. Russia has been using its historic and cultural proximity to keep a significant influence in Serbia which decided against sanctions over Ukraine and application for NATO. Russian interests[17] are estimated to represent 10% of the local economy, due to a strong presence in the energy and banking sectors. Russia has granted significant loans to Serbia, and the stock of Russian direct investment in Montenegro (some of which can be labelled Cypriot) represents 30% of GDP, mostly in real estate. It can also exert its influence in FYROM, which imports half of its energy needs, mostly from Russia. Chinese presence[18] has become significant in Montenegro, Serbia, and Albania, who are together receiving significant transportation investments aimed at connecting the Greek port of Piraeus, recently acquired by a Chinese shipping company, with Central Europe. This project is called the Land Sea Express Route and is considered part of the Belt and Road Initiative. Turkey is also becoming more active, both economically and culturally, in countries such as Albania, Kosovo, Bosnia & Herzegovina, and FYROM, which were part of the Ottoman Empire and are mostly or partly Muslim.

15 - Fondation Robert Schuman, Question d'Europe n°459 du 22 janvier 2018
Les Balkans occidentaux: entre stabilisation et intégration à l'UE, Pierre Mirel
16 - Bonomi, M. & Reljić, D. (2017). The EU and the Western Balkans: So Near and Yet So Far
Brussels: German Institute for International and Security Affairs
17 - Assessing Russia's economic footprint in the Western Balkans, Center for the study of Democracy, Sofia, 2018
18 - The Good, the Bad and the Ugly: Chinese influence in the Western Balkans, A. Lagazzi & M. Vit, Europeum Policy paper October 2017

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