

Notes on Macroeconomic and Institutional Convergence of the Economies of Western Balkans Countries

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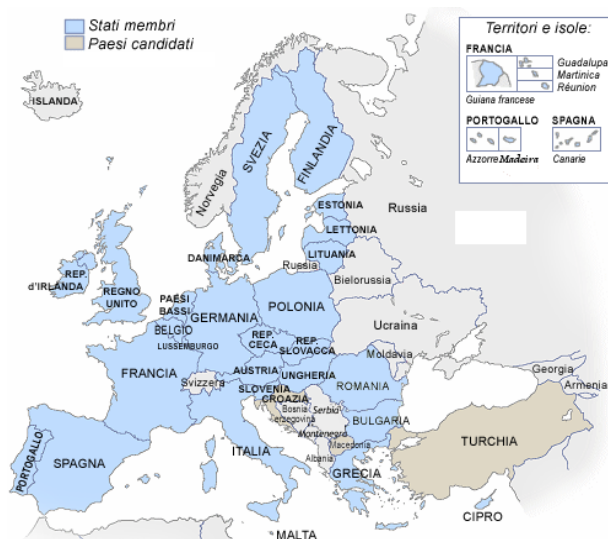
Abstract

The purpose of this contribution is to discuss the economic performance of non-EU Balkans countries compared to the European Union and some selected other countries of the Mediterranean Basin over the period 1999-2008. The idea is to highlight different paths of convergence to the European Union of different groups of countries interacting with the EU for different purposes (access versus partnership). We also try and make an attempt to assess roughly the different policy strategies to evaluate the stimuli and obstacles to endogenous growth given to Balkans countries through the Process of Stabilisation and Association.

Introduction

Anyone looking at a map of Europe and bearing in mind who the Member States of the European Union are cannot fail to note the existence of two *enclaves* in the territorial continuum of the Union.

Figure 1. Map European Union to 27 members



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The first of the two *enclaves* presumably will last forever, because the Swiss Confederation has always been a useful free zone of politics and international finance; the second encompasses all the Western Balkans states (WBs): Albania, Bosnia-Herzegovina, Croatia, Macedonia, Montenegro, Serbia (and now Kosovo). These states are characterized by reciprocal relationships that have experienced deep conflicts in the past not fully redeemed. It is also a group of countries that have all set up processes necessary for their eventual accession into the EU.

The paths to enter the EU have essentially the character of institutional policy choices for WBs. As it is noted in the second and third paragraph of this paper, individual processes to institutional convergence are not all at the same stage. Yet, they all have a common characteristic: they are Balkans countries which, challenging a process of deep transformation of their institutions, converge (at an institutional level) to the European Union.

This process of institutional convergence occurs in a period in which the economic literature contains several signs for the worsening of economic distances between countries. Should this trend apply also to the evolution of gaps between the Western Balkans and Europe, then this would be in contrast not only to the expectations of the people of those countries, but also with the rationale itself of the accession policies they put in place .

Accordingly,, in the fourth and fifth paragraphs of this paper we will attempt to verify the convergence currently occurring in the dynamics of GDP per capita of the economies of Western Balkans and to envisage a possible trend in the nearest future. In this work, our term of comparison will rely mainly on the value of GDP pc in \$ PPP (1990)², through which we will assess the dynamics of growth of WBs and those countries at their Mediterranean European border, such as Italy, Slovenia and Greece.

² We chose to use the Total Economic Database issued in June 2009 by the Conference Board and Groningen Growth and Development Centre, www.ggdc.net.

Some Considerations on Institutional and Macroeconomic Convergence of WBs

The measurement and evaluation of the convergence of countries constitutes a substantial strand of the literature on economic growth, characterized by a lively and controversial debate, still, and understandably, not resolved. In an era of global growth, the rate, the speed and the way of catching up are of paramount interest. The recent performance shows that international growth rates not only differ between countries and more or less homogeneous geographic areas, but the results in terms of income inequalities between countries and within countries, describes the convergence in terms of greater or lesser desirability (Barro and Sala-i-Martin 1992, Mankiw et al. 1992; Quah, 1996, Ravallion, 2003; Islam, 2005).

The Balkans are not immune to the attention of analysts and scholars, especially since the beginning of the millennium - which marked the end of a tragic era - both in terms of economic activity and -especially - in social and humanitarian terms for all countries in the region.

On the basis of what was agreed for the first member countries within the European Economic Community in the aftermath of World War II to redeem disputes and avoid resurfacing of destructive conflicts - and also of what has recently been implemented for the last wave of enlargement for the countries of Central and Eastern Europe (CEEC) - the EU, even in its latest role as single international player, inspires and supports the transformation of the Balkans economies towards a peaceful and market economy through the Stabilization and Association Process (SAP).

Somehow differently from what has taken place with the Eastern enlargement (2004 and 2007), in this new strategy the transformation of the institutions in each country plays a key role in managing time and mode of transition, and also in the coordination between internal stabilization and progressive association to the EU. On the other hand, the international global crisis threatens to slow down, even if not to cancel, the efforts made by both the EU and the WBs to achieve a peaceful economic prosperity.

In this context, the analysis of recent institutional and macroeconomic developments within the convergence process of WBs towards EU contributes both

to the scientific debate on measurements and success of convergence and to the political debate on the effects of European conditionality upon the wellbeing of the region and the EU with an eye to the prospect of a further enlargement.

The basic idea of this research is to highlight the paths of development, both in terms of institutional adaptation and in terms of dynamic growth in real terms, to verify whether institutional convergence, a necessary step in the process of EU accession, yields convergence in living standards and the pace of development.

The Principle of European Conditionality: The Convergence of Democratic Institutions as a Necessary Step in the Process of EU Accession of WBs

The "new" regional approach, which dates back to 1997³, ¹ in the wake of the tragic events that happened in the Balkans, includes a set of countries - by then known as a new geopolitical entity with the name of the Western Balkans - which range from the countries of South East Europe, not yet members of the EU, mainly the countries of the former Yugoslavia (except Slovenia) and Albania.

In exchange for financial assistance, trade preferences and agreements for enhanced cooperation, the EU links every chance to progress in bilateral relations to "democratic conditions", conditioning, thus, international relations and more specifically of economics and international trade, to the *democratization* of the institutions of the country. These main priorities were identified by the European Council (1997): 1) democratic principles, 2) human rights and rule of law, 3) respect and protection of minorities, 4) reforms to the market economy. This principle of European conditionality has really paved the way for a new EU Strategy in the WBs, along with several incentives to be granted in response to "appropriate" behavior and a common regional policy⁴, become over time a pre-requisite among the criteria for association and cooperation.

The key instrument of this enhanced regional policy has become the *Stabilization and Association Pact*, containing the dual purpose of 1) promoting

³ European Council, 1997.

⁴According to a shared practice in other conflictual areas, such as the Mediterranean Basin, EU promotes a bilateral together with a multilateral dimension, with the ultimate view to set up a spontaneous cooperation (cfr. Patimo, 2006).

stability and regional cooperation and 2) promoting European integration, both economic and, eventually through a candidature for membership, political. The SAP may count on the following implementation tools:

- The promotion of economic relations and intra-and inter-regional trade
- The development and partial re-direction of the existing financial assistance
- The enhanced support for democratization, civil society, education and institutional development
- The cooperation in the field of Justice and Home Affairs
- The development of political dialogue, including at regional level
- The negotiation of the European Stabilization and Association Agreements and, more interestingly, especially the prospect of EU membership

It can be noted that there is a mix of institutional and economic instruments and objectives, which responds to a well known principle in the history of European integration, namely that economic cooperation precedes - and facilitates - the political cooperation, with a view to a lasting stability. The novelty of the approach to WBs consists of rendering economic cooperation – already preliminary to the political cooperation (the Association) - conditional to institutional convergence towards democratic targets, essential to both kind of cooperation.

Over the last decade both criticisms and appraisals have been raised upon the new EU Balkans strategy. The former have mainly focused on the existence of an “overloaded agenda” (see Elbasani, 2008), tolerated only in the prospect of the near future (the so called approach of "carrot and stick" Bechev, 2006). On the other hand, one cannot ignore criticisms based on the skepticism created by the scenario of further – accelerating – enlargement. The history, the different development stages in the enlargement and deepening of European integration have required long time in order to reach the current scenario. Times have changed, globalization and ICT era advent will surely make integration in the SEE relatively faster, but targets and schedules have to be respected, particularly in terms of institutional convergence, more than ever necessary in a territory which experienced nationalism and

destructive conflicts. Similarly to what had happened at the origins of the EEC in the aftermath of World War II.

Many stakeholders have also praised the integration process of the WBs, also supported by the analysis made on the macroeconomic convergence (see *below* par. 4-5). These appraisals concentrate primarily on the climate of peace and stability established not only the EU but also among WBs, although, as discussed in the next section, there are a number of issues that must be solved in the short period. The following paragraphs are intended to highlight the features of this convergence taking place on a double track.

The State of Institutional Convergence in the Western Balkans

In order to describe the current state of institutional convergence, we analyzed the official documents that individual countries must produce annually in cooperation with the European Commission, in the aim of a joint assessment of progress within the SAP (the so called Progress Reports), along with the document of the EC Enlargement Strategy and Main Challenges for the period 2009-2013⁵.

With the following synthetic boxes we attempted to separately evaluate the institutional and macroeconomic variables, without trying to build a composite index (Sepulveda & Mendez, 2006) for reasons of scope. We did so without ignoring the close link between the two categories of variables, which is, on the contrary, precisely the assumption of this research.

Box 1 shows that, to date, the status of candidate or potential candidate country officially does not produce a sharp cut on the evolution of the progress of the institutions in WBs. Moreover, the signature, or the entry into force, of the Stabilization and Association Agreement, has not yet made significant differences in the progress towards the institutional priorities of the SAP. In fact, *good* progress has been recorded in Bosnia-Herzegovina and Serbia in some priorities without the Agreement having entered into force. On the other hand, the EU has allowed visa exemption for Serbia, Montenegro and Macedonia, mainly because of some improvements shown in different institutional aspects.

⁵ Communication of the Commission to European Parliament and to Council, COM(2009) 533 def.

Box 1 - Institutional convergence of WB within SAP with EU										
COUNTRY	EU-WB relations	SAA	Regional cooperation	regional problem	Visa regime with EU	NATO member	progress in entrenchment of Rule of law	progress in Property rights	progress in PA Reform	Main issues
ALBANIA	PC	2006 signed 2009 in force	SEECF CEFTA CCR	none	under discussion	yes	light	limited	some	rule of law, bribery, judicial power independency
BOSNIA-HERZEGOVINA	PC	2008 signed	SEECF CEFTA CCR	impunity; war crimes	under discussion	no	insufficient political commitment	good	little	institutional reforms; acquis
CROATIA	CC	2001 signed 2004 in force	SEECF CEFTA CCR	Slovenian borders; ICTY	under discussion	yes	further efforts needed	partial	some	judicial reform; bribery;
FYROM	CC*	2001 signed 2004 in force	SEECF CEFTA CCR	name controversy with Greece	exempt since 19/12/2009	no	further efforts needed	partial	some	bribery
MONTENEGRO	PC	2007 signed 1st May 2010 in force	SEECF CEFTA CCR ReSPA	none	exempt since 19/12/2009	no	further efforts needed	limited	some	judicial reform; bribery
SERBIA	PC	2008 signed	SEECF CEFTA CCR	impunity; war crimes	exempt since 19/12/2009	no	further efforts needed; eulex in Kosovo	partial	good capacity	
KOSOVO	PC (under UN Res 1244)		SEECF CEFTA CCR			no	limited; eulex with Serbia	limited	some	minorities; reconciliation

Source: Own elaboration from individual WB country Progress Report 2009 and Enlargement Strategy and Main Challenges 2009-2010, EC

There are still some regional problems within the WBs (primarily concerning boundaries and denomination), but main issues persist on matters of no lesser interest. The Commission, through the Progress Report, highlights the importance and urgency of the solution of fundamental issues such as reform and independence of the judiciary power on the one hand, and corruption, a *sine qua non* for the smooth functioning of the institutions and the successful functioning market economy. Interregional cooperation in the WBs is formally initiated even if, with a view to a creation regional free trade area, it cannot do without a substantial boos of productive activities, before the creation of any kind of trade.

From Box 2, we can highlight the efforts on macroeconomic convergence made by countries to keep the *fundamentals* within the EU parameters, albeit with different outcomes. Again, notable differences cannot be recorded between, for example, the candidate and potential candidate countries.

Inflation seems to be a common problem, except for Albania and Bosnia-Herzegovina (which indeed shows a negative value for 2009). The deficit/GDP ratio seems to be under control, although, due to increased public expenditure in infrastructure last year, Albania and Bosnia-Herzegovina just exceeded the

threshold. As expected, the debt/GDP ratio is not a problem and it can be assumed that the criteria for the association process can play a role in limiting its growth. Progress in the four fundamental freedoms, seen as necessary for the accession to a common market, are still limited, though positive signals come from the right of establishment in WBs, promoting thus the attraction of businesses and establishments from EU and other foreign countries in general.

COUNTRY	Inflation rate	deficit/ GDP	Debt/GDP	Exchange Rate stability	Activity rate	Unemployment rate	CEFTA (2006) in 2010	progress in free movt of capital	progress in free movt of people	progress in free movt of goods & services	progress in establishment right
<i>Standard EU</i> (from Treaty on EU and 2009 data)	(2010) 1%	-3%	60%	(2 years)	70.8%	9.4%		free	free	free	free
ALBANIA	2,0%	-5,5%	36,7%	stability	67,4*%	12,7%	2007	some	little	good	good
BOSNIA-HERZEGOVINA	-1,2%	-4,0%	16,8%	stability	53,5%	23,4%	2007	no significant	little	limited	no significant
CROATIA	6,1%	-1,4%	33,5%	stability	63,2%	8,4%	2007	some	good	good	good, but improvement needed
FYROM	8,3%	-0,9%	21,4%	stability	63,5%	33,8%	2007	limited	little	some	some
MONTENEGRO	7,4%	0,5%	28,0%	n.a.	51,9%	16,8%	2007	some	limited	limited	limited
SERBIA	13,5%	-2,4%	25,3%	depreciation, then stability	62,7%	13,6%	2007	some	some	good	none
KOSOVO	9,4%	n.a.	46,8*%	43,6%	2007	limited	limited	limited	none

Source: Own elaboration from individual WB country Progress Report 2009 and Enlargement Strategy and Main Challenges 2009-2010, EC

The labor market indicators are still unsatisfactory, but allow for positive expectations in the future, if we hold that employment has sound opportunity for growth. This also leads us to reflect on the accuracy of GDP pc as an antenna indicator of growth. Should we use GDP per employed worker (Checchi and Bucci, 2006), we would have a measure of productivity that leads to expectations for growth more realistic than those estimated in the following paragraphs, though we would need good estimates for employment growth as well. Yet, amid an international crisis, we prefer to be cautious, while considering the idea of future research that would take into account these aspects.

The Rationale for a Common Economic Convergence Through a Gap Reduction of GDP Per Capita PPP

As mentioned in the introduction, the economic literature of the last decade reports repeated signals to the aggravation of the gaps, as measured by GDP pc ppp (Daniele, 2010) between the living standards of different populations.

As repeatedly stated by the literature, the sore point is that this trend appears to be in stark contrast with what indicated by the promoters of the gradual opening up process of all economies to international trade (globalization) and, accordingly, with the growth theory's assumption on catching-up.

The catching up between economies is due to take place gradually, as the effect of the reduction and elimination of barriers to international economic relations, the strengthening of freedom of movement of both goods and production inputs, such as labor and capital (Barro 1991, Barro and Sala-i-Martin, 1992, Acocella and Sonnino, 2003). Therefore, should this trend also refers to the evolution of gaps between the Western Balkans and European Union countries, then this would be in clear breach of both the expectations of peoples of those countries and of EU and individual countries' policy makers, shadowing any chance of economic optimism.

However, if current trends were to show a "reasonable" convergence between the WBs economies and the economies of neighboring Mediterranean countries (Italy, Greece and Slovenia), then, from our point of view, not only the EU-WB integration would be regarded as "Pleasure Island", but this would also a strong signal of the validity, for WBs, of the efforts they have undertaken.

The existence of differences in living standards between different peoples is one of the dominant features of modern economic history. According to Pritchett, for example, between 1870 and 1990 the ratio in per capita income between the richest and poorest has grown by five times (Pritchett, 1997). What we can understand, then, by "convergence" and how can we measure it?

Generally, by *convergence* **between** the economies it is meant the reduction of relative distance in living standards as measured by the average *per capita* income (GDP per capita at purchasing power parity). When only two economic systems are involved, then the relative distance between the two economies is measured by the ratio of their GDP per capita: if this tends to decline, then there is

convergence⁶.⁴ When the countries involved are more than two, appropriate statistical indicators are used to measure the degree of dispersion of single values around the average: if the dispersion decreases, then there is true convergence⁷.

In the analysis of convergence-divergence of countries, we use GDP per capita in Purchasing Power Parity (also said, GDP in international \$, but henceforth referred as GDP pc PPP) to take into account differences due to exchange rate fluctuations. Moreover, we used GDP pc at constant 1990 international \$ to deflate the values across the period considered. The data used here are taken from the Total Economic Database issued in June 2009 by the Conference Board and Groningen Growth and Development Centre. The database covers the period 1990-2008.

From our point of analysis, the possible convergence of Balkans hides all the distribution problems that exist within each country. Actually, in this study, we were forced to ignore all matters relating to distribution problems linked to several domestic imbalances such as sectoral, spatial, functional and personal. Having made this choice, we will eventually refer to existence of convergence - and so reduction of income reduction - without implying any positive effect on the distribution of income within the countries. Namely, given convergence among countries, we cannot say anything about improvement in the individuals' situation in the single WBs.

The Empirical Evidence on the Convergence of the Western Balkans Countries and Its Trend

In the following analysis, the (eventual) convergence of non-EU countries of WBs is discussed comparing the WBS' macroeconomic dynamics to that of Italy, Greece and Slovenia, the three EU Adriatic countries, bordering the region on the North, South and West⁸.

⁶ We say *beta* convergence exists if poorer economies grow faster than richer economies (Sala-i-Martin, 1996).

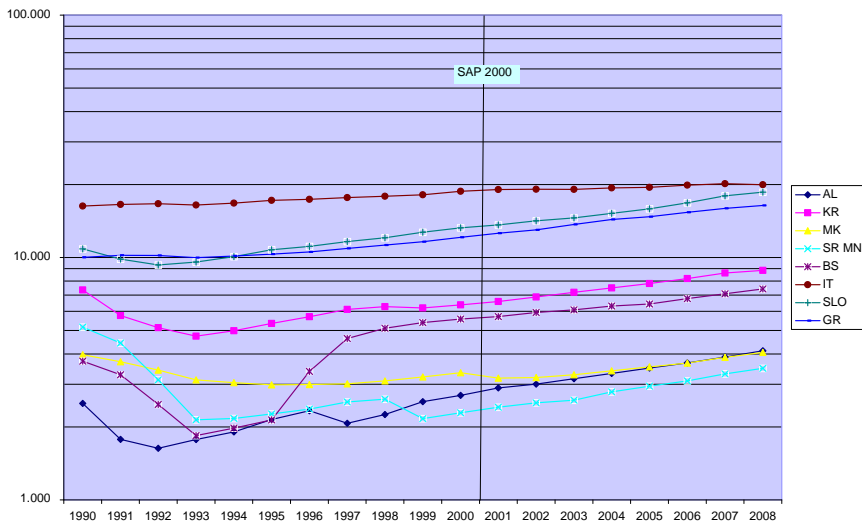
⁷ This is said *sigma* convergence: it occurs when standard deviation of real GDP tends to decrease over time.

⁸ The term of comparison chosen is not the only one possible. The criterion of choice has been relatively simple and has been affected by proximity relations.

It should be first noted that the overall experience of the last thirty years is not on the idea of convergence of the group of countries considered: the processes of political and social transformation resulting from the fall of the Berlin Wall (1989) and the process of disintegration of the former Yugoslavia have certainly affected this performance of lacking convergence.

However, since the surge of the Stabilization and Association Pact signed between the EU and WB, it seems that the process of convergence has started (see Figure 2).

Figure 2. Dynamics of GDP per capita (in 1990 PPP \$), 1990-2008

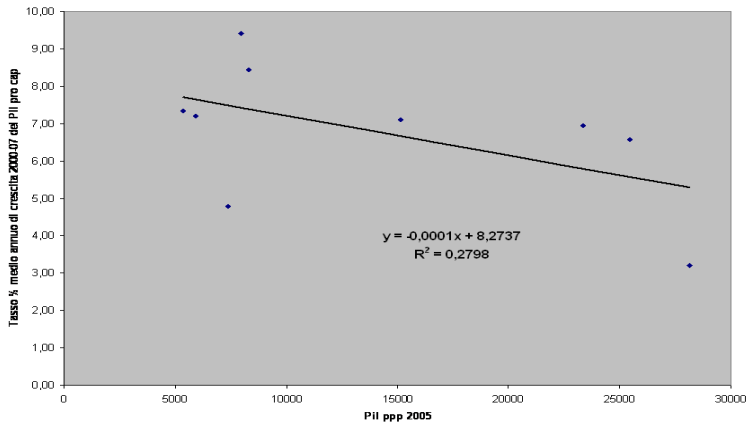


Source: Own elaboration on data from the Conference Board and Groningen Growth and Development Centre, Total Economy Database, June 2009.

However, we should consider that, with a view to reach a unique convergence of multiple economies, we definitely need at least a close inverse correlation between growth rate and level of development of departure (Barro, 1991).

In our target group of countries, such a correlation exists but is, unfortunately, not much significant for both the limited extent of regressor and for the lack of significance of the coefficient of determination R^2 (see next figure 3). The process of convergence seems to exist, but it is certainly weak and is not certain is deemed to persist.

Figure 3. The regression between GDP level and average annual growth



Source: Own calculations on data from IMF, World Economic Outlook Database, October 2009.

Finally, in order to test for the medium-term outlook of the convergence process, we have built an exercise of projection of trends, holding constant the current trend (see tab. 1).

The exercise is simple and is based on the assumption of permanence, in the near future (2010, 2015 and 2020), of the same pace of development that characterized the recent past (2000-08). The weighted variation coefficient decreases across years. This allows to say that expectations in the medium term, assuming the persistence of the actual trend lines, are not against the idea that the economies of the countries considered converge, as far as consideration on GDP per capita ppp are concerned.

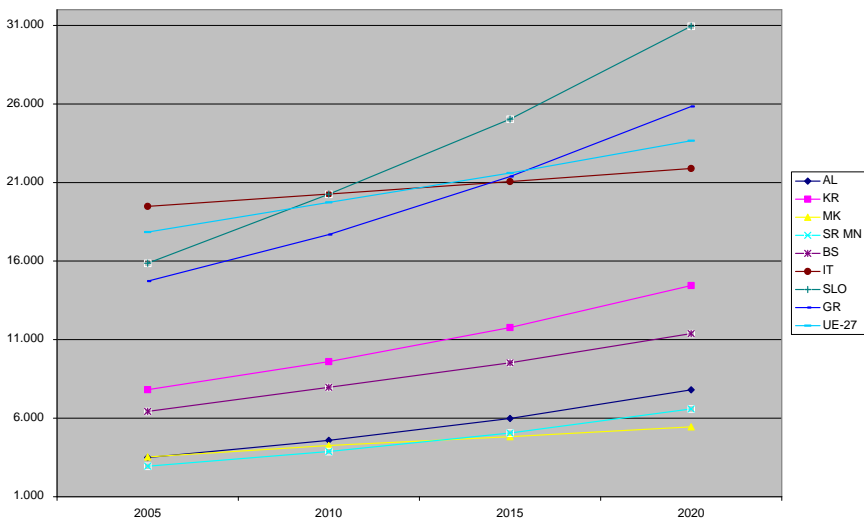
Table 1 - Expected level of GDP per capita ppp under the hypothesis of maintaining constant the recent average growth rates

Country	2005	2010*	2015*	2020*	Average annual growth rate 2000-08
Albania	3.500	4.587	5.982	7.802	5,5
Bosnia-Herz.	6.431	7.967	9.526	11.391	3,6
Croatia	7.813	9.597	11.772	14.441	4,2
Macedonia (FYRM)	3.538	4.263	4.820	5.449	2,5

Serbia Montenegro	2.945	3.880	5.055	6.587	5,4
Greece	14.726	17.689	21.381	25.844	3,9
Italy	19.487	20.267	21.063	21.891	0,8
Slovenia	15.869	20.256	25.039	30.953	4,3
UE-27	17.846	19.732	21.606	23.658	1,8

Source: Own elaboration on data from the Conference Board and Groningen Growth and Development Centre, Total Economy Database, June 2009.

Figure 4. Estimated trend of GDP pc growth and convergence of WBs under hp of growth rate unchanged at the average 2000-2008



Source: Own elaboration on data from the Conference Board and Groningen Growth and Development Centre, Total Economy Database, June 2009.

Conclusions

For the period 2000-2007 and the immediate prospects (2010, 2015 and 2020) the convergence of GDP per capita is enhanced in the light of the indicators used in paragraph 5 above. This convergence is certainly a new fact with respect to last decades of the twentieth century and suggests - at least - that the institutional changes needed to the path of accession are not slowing down the upward trend of

the Balkans economies and not hampering the process of convergence between countries.

The above statement should not mislead in embracing expectations of quick and painless gap reduction in the region: some further exercises to estimate the timing of a possible *catching-up* indicate that this cannot be short and that it will not be simultaneous.

Moreover, the whole process is also affected by the uncertainties caused by EU and European single governments economic policies to smooth the effects of the international financial crisis, the speculative attack the euro, the Greek crisis, the heavy manoeuvre budget set out at the Italian Government, etc..

Those contractionary policies will surely slow down the pace of growth in those European countries who have implemented them, but more regrettably will surely slow the pace of growth of the Balkans economies, since they are all deeply linked to Europe.

We cannot currently foresee whether the general downturn is to affect the convergence process or generate centripetal forces capable of deepening the gap between countries.

The link between the convergence of development paths of countries bordering the Adriatic and decisions and dynamics strictly relevant to EU is very strong. Much could be done to make the convergence faster and easier . A reconsideration and a reduction of European agricultural policy, for example, (also claimed within some parts of EU) would help in making less severe the balance of payments constraint for the weaker economies of the Eastern shore of the Adriatic.

Also, developing countries bordering the Mediterranean, including the WBs, rely heavily on economic and political stability of countries that are formally unrelated to the Mediterranean.

Sometimes these are countries that are close to the Mediterranean countries (think of the countries bordering the Black Sea) or even remote (i.e.: USA), but they eventually generate strong interference on the events, the tensions and harmonies that the Mediterranean expresses.

An example is valid for all: Albania has not yet acquired the *status* of candidate country (Turkey is since ever), but has already acquired the *status* of NATO member countries. This can be seen as a clear sign that *external* interests and

events affect a process that should be *internal* to the club of countries that gamble and work for unity.

The ability of the Balkans economies to stabilize their growth and see the gradual affirmation of the forces of convergence on the forces of divergence depends on the dynamics of these forces outside the Balkans area.

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