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Indexing
Abstracting

INTEGRATION IN THE EUROPEAN UNION AS A DOUBLE-EDGED SWORD FOR THE WESTERN BALKANS

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Abstract

By analyzing the impact of the economic crisis on the Western Balkan (WB) countries, the paper concludes that their export, inflow of remittances and FDI have suffered due to the crisis. Regarding the rapid credit growth in years before the crisis it spurred an increase in imports, which in context of relatively uncompetitive economies, led to increased current account deficits despite significant remittances and FDI inflows. The impact of the crisis in the region can be explained mainly by their degree of European integration. But, the European Union (EU) is more uncertain to embrace the economically weaker countries, causing loss of EU credibility. It seems that the EU integration is a double-edged sword for the WB: in good times EU delivers its prosperity, but at a time of crisis, it is creating instability.

Key words: economic crisis; transmission channel; Western Balkans; European Union

INTRODUCTION

Western Balkans is consisted of the following countries: Albania, Bosnia and Herzegovina, Croatia, Kosovo, Macedonia, Montenegro and Serbia. Economically, the whole region lags behind the economic growth and development of the Western European countries. Politically, the reform process towards modernization and democratization of their society is moving slowly. In addition, this region is characterized by past ethnic conflicts, current unstable ethnic relations, lack of the rule of law, violation of territorial integrity and economic systems that constitute poor bases for further economic development. Moreover, the global financial crisis was experienced as a huge external shock for the WB. As their banking systems were not directly exposed to "toxic assets", the crisis was transmitted to the region through a number of indirect channels. These included a contraction of international trade, a sudden stop of credit growth, a rapid fall in inflows of foreign direct investments (FDI), and a rapid fall in remittances from migrant workers, each reflecting the impact of the global crisis in financial markets, goods markets, capital markets and labor markets. It is notable that these mechanisms mattered to different degrees in different countries in the region (Barlette and Monstiriotis 2010, 3-8).

Since the countries from the WB are highly dependent from the EU countries in terms of trade, investment and finance, this paper will try to give further clarification of the interdependence in "good" and in "bad" times. The "good" tangible achievement is that most of the countries are on a path towards EU accession which resulted in rising incomes and living standards. Still, during this accession process countries missed the opportunities to complete the reform process of becoming a fully functioning market economy, to achieve macroeconomic stability and to become a democratic society. All of these factors affected negatively during the "bad" times – since the beginning of the economic crisis.

Having in mind that WB countries belong to a group of countries that have similar characteristics regarding the extent of EU integration, progress with transition, the business environment and the quality of governance, institutional factors are not included in the analysis. The exception is Croatia, which became a member state of the EU in 2013.

The paper will be presented in three sections. The first section provides an overview of the economic performances of the WB countries i.e. initial conditions at the start of the crisis. Section 2 identifies the variable extent of the transmission mechanisms across WB countries and finally section 3, discusses about the repercussions of the crisis on the region`s accession process and prospects. Even though we considered making panel data model for the purpose of this paper, we faced with problem of lack of data for these countries and different data sources that provide incomparable data. Additional problem was that the time series were too short; having in mind that Montenegro became independent country in 2006 and Kosovo became independent in 2008. Until their independence, these countries were part of Serbia, and the data is registered as part of Serbia`s indicators.

ECONOMIC PERFORMANCES OF THE WESTERN BALKAN COUNTRIES

The global economic crisis began in the second half of 2007, in the wake of financial and real estate speculation in the United States, which caused mortgage crisis. It came after a long period of international financial instability and trade imbalances. By late 2008, the crisis had spread to many countries all around the world (Japan entered into recession in Q2 2008, Germany Q3 2008, France Q1 2009 and the official recession in the EU was announced in Q2 2008).

The impact of the crisis on the WB countries came in two waves. The first wave was during 2008-2011, as a result of the negative repercussions of the economies in the world, hit by the economic crisis and the second one, by the end of 2011, caused by the Greek sovereign debt crisis and increasing problems in the Euro zone.

However, WB countries during the first eight months of 2008 still had positive rates of economic growth, rise in the FDI and available funds from the financial institutions. For most of the countries in the region, the period during 2003-2007 was characterized by high rates of economic growth: the average GDP growth was 5.38% (figure 1). The biggest problem of these countries in the referred period was the high rate of inflation due to the high prices of the oil and commodities on the world markets (figure 2).

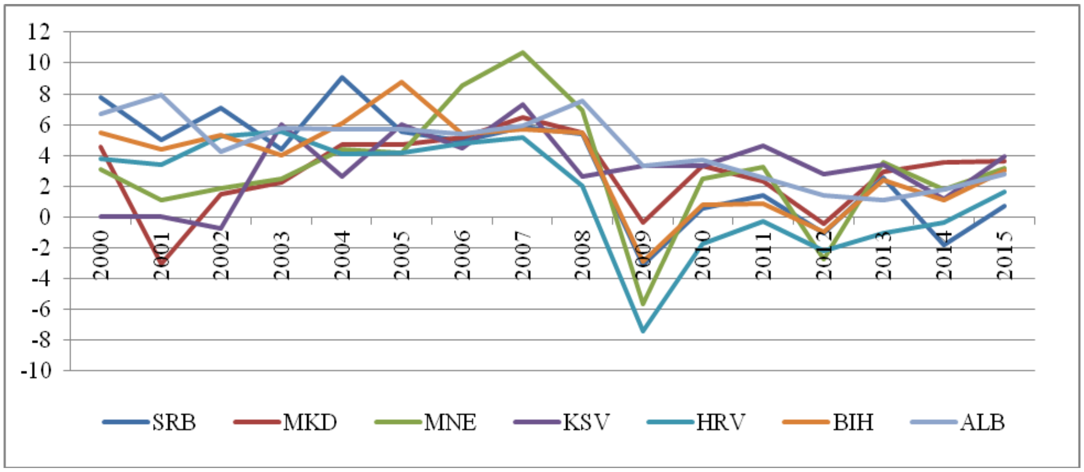

Figure 1. GDP growth, annual, in percentage (World Bank data development indicators)

Even though WB countries hoped that they would have mild effect of the negative trends in the world, the situation started to change dramatically in September 2008. After many of the major financial institutions have collapsed and stock prices have slumped, the ongoing turmoil in financial markets brought negative consequences for the real sector and the world entered into recession.

The WB countries were not isolated from the world and the crisis has not completely bypassed the region. The transmission effects, the speed, and the depth of the crisis took hold in various ways, owing in part to the heterogeneity of regional economic structures. Many of the crisis effects arrived through decreases in domestic demand and consumption, as a result of the tightening of available credit in the region, constricting the domestic demand which served as one of the principal factors in regional growth in recent years. Coupled with these shocks of tightened credit markets and decreased consumption, WB countries have been negatively impacted by downturns in many of the productive sectors of their real economies, through slumping trade and investment partners in WB (Shrera, Shahini and Dosti, 2015). The trade openness of the region was generally high at above 50%. This along with downturns in important commodities such as metals has negatively affected industrial production, and export performance has weakened considerably in several sectors. These factors have contributed considerably to the declines in GDP growth experienced by many countries in the region in 2009.

Dramatic change happened around September and October 2008. The annual data show that the growth started to slow down, but remained positive for the whole 2008. By the end of 2009, the rates of economic growth were negative for all of the WB countries, with the highest annual slump of 7.4% for Croatia (figure 1).

The second wave of the crisis was felt during the period 2011-2012, when the problems of the Greek sovereign crisis became evident. For most of the WB countries (Albania, Montenegro and Macedonia), Greece is significant trade partner and one of the key investors. These countries once again registered negative rates of economic growth, even though the fall of the GDP was milder than in the first wave.

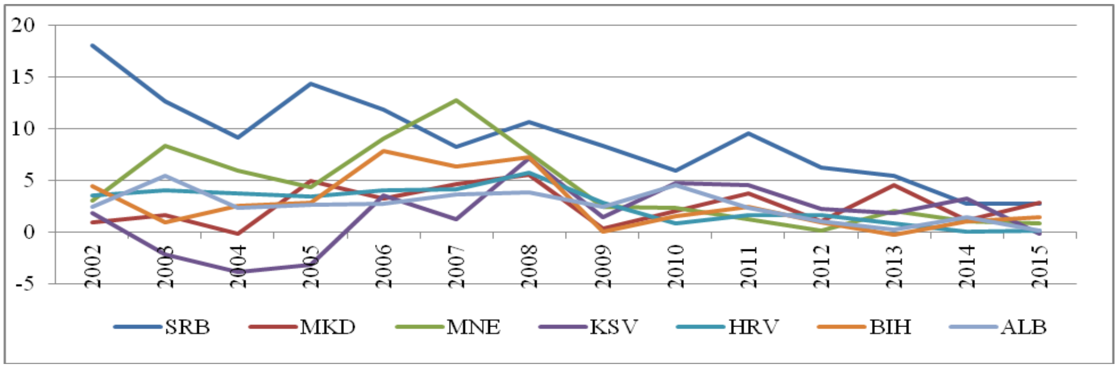

Figure 2. Inflation rate, GDP deflator, annual, in percentage (World Bank development indicators)[1]

The drop in economic activity had a significant impact on other macroeconomic variables, such as inflation and unemployment**.** Before the crisis, the inflation was threatening to become a serious problem for almost all of the countries in the region. Figure 2 shows that the rates of inflation were lowering dramatically under the influence of the fall in the domestic demand, steep drop in the oil prices and other natural resources in the second half of 2008. The inflation rates at the end of 2015 were around zero percent. Serbia had difficulty in keeping inflation under control but managed to put under control.

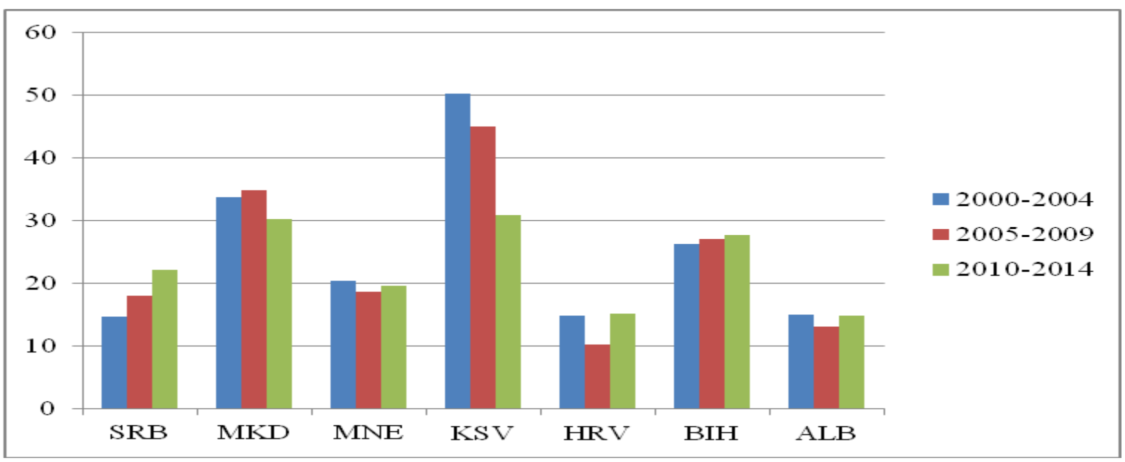

Figure 3. Unemployment rate, as percentage of total labor force (World Bank development indicators)

Rates of unemployment in WB were high even before crisis. The highest unemployment rate is registered in Kosovo, Macedonia and BIH (45%, 33% and 20% respectively for the whole period 2000-2014), so the crisis practically had neutral effect. On contrary, Serbia registered 8.3 p.p. increase in 2015, compared with 2008 (figure 3).

[1] Data for 2000 and 2001 are missing because of the extreme inflation rate in Serbia (79% in 2000 and 89% in 2001).

CHANNELS OF CONTAGION

We distinguish four main transmission mechanism of the crisis: export, remittances, foreign direct investments and banking credits to private sector. Since, economic crisis caused retraction in trade with EU, shrinking of private credit; and significant and rapid drop in FDI we first present these three channels as negative externalities from the crisis. Regarding remittances, they showed opposite tendency i.e. stayed on same level or even increased, since the beginning of the crisis.

The fall in the **export** in 2009 was evident in all of the observed countries, with the largest decline in Montenegro of 50.23% and Macedonia of 40.65%, compared with the previous year. Besides the fall in the export in absolute terms, total exports towards the EU in the value of total trade remained almost the same. The percentage remains the same in the years of recovery as well (the EU trade accounts for more than half of the total foreign trade of each country).

The reason is that right after signing of the Stabilization and Association Agreement with the EU, the trade exchange of goods from the WB countries experienced a strong trade diversion effect towards the EU trade partners (Kikerkova 2011, 844-854). That shows that WB countries did not find alternative markets to place their products during the crisis. On the other hand, the intra trade in the CEFTA-2006 is also decreasing, showing low and insufficient trade relations between the WB countries.

Also, intraregional trade is relatively concentrated, with the top six products representing 40% of total imports: mineral fuels, iron and steel, steel products, and aluminium, beverages and electrical machinery and equipment (Handjiski at al. 2010: 8). All of these industries have been particularly hit by the global recession, not only from the fall in demand of these products, but also because of the dramatic fall in price of the metals, especially copper and iron in 2008. In addition, the dispute between Russia and Ukraine in mid-2008 over the gas prices reduced the energy supply in the region that forced the heavy industry in the region to cut production.

Regarding the **financial channel of contagion,** it is important to mention that all of the WB countries experienced credit boom, four or more years before the crisis. Even though countries started with low levels, domestic credit to private sector growth has reached significant growth in the period 2003-2008. The credit amount reached 87% of the GDP in 2009 in Montenegro, and 67% of the GDP of BIH and 64% of the GDP of Croatia (figure 4).

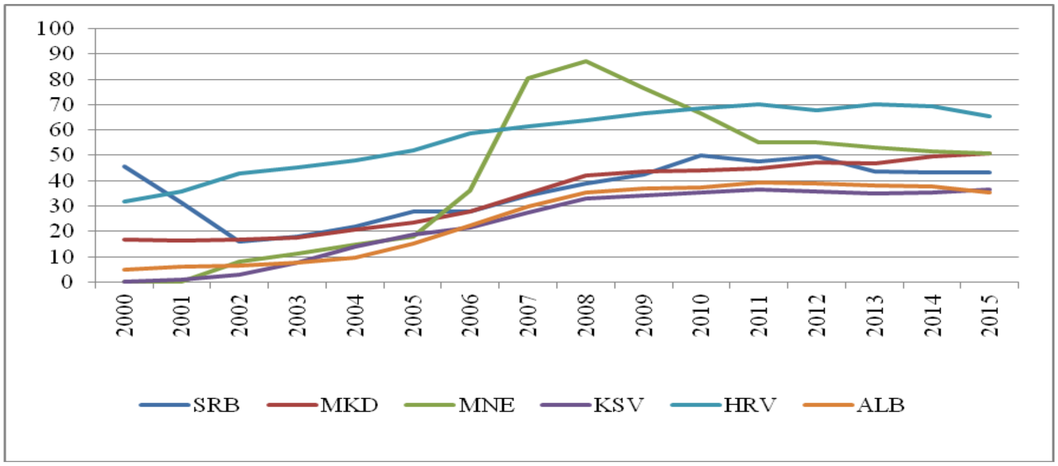

Figure 4. Domestic credit to private sector, % of GDP (World Bank data development indicators)

Credit boom was a result of two important factors: first, restructured banking and non-banking financial sectors which were largely placed in the ownership of foreign financial institutions and second, improved access to international capital markets. The foreign banks that largely controlled the banking sectors in the region, and therefore kept the banks on board in the crisis, have been one of the region's biggest concerns. According to the European Bank for Reconstruction and Development (EBRD), in 2007, European banks (mainly Austrian, French, Italian, Dutch, German and Greek) owned 94% of the banking system assets in Albania, 82% in Bulgaria, 86% in Macedonia, 79% in Montenegro, 87% in Romania and 75% in Serbia. The biggest fears was the Greek crisis, since Greek banks had accumulated a significant market share in the region, accounting for around 30% of total banking assets in Macedonia, 25% in Albania, 15% in Serbia by 2007 (Panagiotou 2012).

Even though the funding after 2009 decreased, the foreign banks did not exit the domestic economies and oriented towards domestic crediting. The first reason is that the banking sectors in the region are in relatively good shape (well capitalized and profitable) so, holding on to these portfolios are still attractive for foreign banks. Second, local portfolios are small relatively to the size of foreign parent banks (i.e. selling them will make only a small contribution to the broader deleveraging process). Third, even where asset sales are being contemplated, it is likely to be difficult in this environment for foreign parents to find buyers for their local subsidiaries (Burgess 2012).

Inflow of FDI played a very important role in the economic growth achieved in the region during the period 2003-2007. As in other emerging European economies, the peak of the inflow of FDI was achieved year or two before 2009, and then sharply fell. FDI flows to the region decreased by 34 percent between 2008 and 2009, with total flows declining from 12.6 to 8.3 billion dollars. The fall in the FDI was greater in countries that had large FDI inflows in the period before crisis (BIH and Croatia). Even though the FDI started to show positive trends during 2011, the recovery is far behind the pre-crisis levels.

Most of these investments came from Europe, with the Euro area accounting for about 70% of the total stock of inward direct investment in the region. The major investor is Austria (a top investor in all countries except Montenegro). Italy and Greece is present in the Balkans. Overall, by 2010, the Greek companies disinvested almost 1.3 billion Euros from the region, with the biggest withdraw in Serbia and Macedonia (Panagiotou 2012).

Remittances are very important source of income and for financing the balance of payments over the years for the region. The flow of remittances declined after 2008 in Albania and BIH, but with slow pace. In the rest of the countries, the value of remittances remained the same or even increase. Most of the remittance flows to Albania come from Greece and Italy, which are also an important source of flows for Macedonia. Germany is a major source of remittance flows to the region, particularly for Croatia, Macedonia, and BIH. Austria is a particularly important source of remittance flows to Serbia.

Table 1. Foreign direct investments and Remittances, as percentage of GDP (World bank development indicators)

	Remittance			FDI		
	2000-2004	2005-2009	2010-2015	2000-2004	2005-2009	2010-2015
SRB		5.489316	8.990085	3.212223	9.199472	5.565222
MKD	2.803882	3.96022	3.676651	5.822324	5.256678	3.118435
MNE		3.852987	8.570248	3.881578	25.95823	14.01468
KSV	17.05509	18.73325	16.47291	1.464027	8.357014	5.700927
HRV	3.871561	3.132551	3.679277	4.201407	6.110441	2.689416
BIH	23.70883	15.63913	10.85671	4.435417	5.971049	2.29287
ALB	16.31043	13.43945	8.856958	3.969923	6.7427	8.657303

Table 1 makes comparison between the flow of remittances and the FDIs (as percentage of GDP) in the period 2000-2015. The value of remittances has considerably exceeded the volume of FDI in BIH, Kosovo and Serbia. Only in Montenegro the FDI are more significant source of finance than remittances. The annual flow of remittances reached around 10 percent of GDP for Albania, BIH, Montenegro and Serbia, and above 15% in Kosovo. Even though, the remittances are considered as source of risk because of their instability and unpredictability, higher percentage of remittances in most of the WB countries helped in sustaining the balance in the current account and domestic demand. What is maybe more important is that inflow of remittances alleviate the social pressure in the countries.

THE IMPACT OF THE EUROPEAN CRISIS ON THE WESTERN BALKAN EU PROSPECTS

In the previous section we point to the fact that economies of the WB countries are very dependent and highly vulnerable from the economic situation in the EU. The regions problems are not only economical. There are political failures as well. There is indeed a silent pact between enlargement fatigued EU member states and rent-seeking elites in the WB who don't mind slowing the pace of transformation. It seems that countries does not know or want to sort their own problems, and are waiting for a solution from external actors. According to authors Bartlett and Prica, 2011 the benefits of EU accession are higher than the costs for EU accession, for most of the WB countries. Therefore a strategy of non-accession would most likely only be chosen by ruling elites which have much to lose from adopting EU rules.

But, accepting the situation in the WB is also a failure for the EU. If the EU cannot deliver transformation in the WB – a region that many see as its backyard – how it can expect other global players to see it as a credible actor in the Middle East, the post-Soviet space or East Asia? Putting enlargement on hold allows other actors to seize on business opportunities, score political points and carve out niches of influence – in part, free riding on the tremendous investment into stability already made by the EU. The United States still plays a decisive part in Kosovo and often has greater leverage over the government there than the EU. But ambitious powers such as Russia, Turkey and China are also beginning to fill the gaps (Bechev 2012).

Turkey for example is among the top three foreign investors in Croatia and Serbia and among the top five in Bosnia. The Serbian government is courting new loans from Russia and Asia as it needs to service its debt in 2012. A new bridge over the Danube in Belgrade and 140 km of highways in Serbia are being built by Chinese companies. Such diversification of investment partnerships, now common across the region, reflects larger shifts in the global economy.

Here comes the dilemma of whether EU is still an engine for convergence between Europe and its peripheries? After the Greek crisis and experiences with enlargements towards Central Eastern European countries, EU member states are more uncertain to embrace the economically weaker countries. Even though the accession of the WB countries is an official regional policy of the EU, the "wait-and-see" approach has been pursued for too long, causing loss of EU credibility in the region. It seems that the EU integration is a double-edged sword for the WB: in good times, the European core exported its prosperity towards its South-Eastern region; but now, at a time of crisis, it is exporting instability.

According to the official statements of president of the European Commission (Junker 2014), ongoing negotiations will continue, and notably the WB will need to keep a European perspective, but no further enlargement will take place over the next five years. Still, the question about future enlargement was not put aside. Besides Croatia accession in 2013, the rest of the countries experienced some kind of improvement in the accession towards EU. In June 2014, Albania was granted EU candidate status. The accession negotiations with Montenegro were opened on 29 June 2012, and the progress has been made so far. On 21 January 2014, the 1st Intergovernmental Conference took place, signaling the formal start of Serbia's accession negotiations.

The decision of the European Council to open negotiations was reached due to Serbia's progress in the reforms and its continued commitment to the normalization of its relations with Kosovo. Stabilization and Association Agreement (SAA) between the EU and Kosovo entered into force on April 2016. BIH, signed the SAA in 2008 and in June, 2015 the agreement entered into force. It seems that Macedonia had the lowest progress towards accession. The European Council granted the status of candidate country in December 2005, but dispute with Greece over Macedonia's name continues to hamper the country's bids to join the EU and NATO.

The accession of Croatia into the EU is a big test of the benefits for the WB. It is expected that the EU accession will bring higher FDIs to Croatia, create more growth and jobs. With good strategy and alliances inside the EU, Croatia can help and foster the enlargement towards the rest of the countries in the WB. It is in Croatia's interests to help its neighbors (among them its former enemies) to join the EU as soon as possible, but Croatia could also misuse its seat behind the EU table to score political points, reinforcing new divisions in the region and free riding on the huge credit and political investment behind its own EU membership (Nic 2013).

Still, the EU has its own instrument to restore the confidence of the accession process. The diplomatic initiative "The Berlin Process" is linked to the future enlargement of the WB towards the EU. This initiative aims at "converting" political commitment into further action, by using the best practices and international norms and mechanisms.

For the pre-accession countries the Instrument for Pre-accession Assistance (IPA) remains to be the key accelerator of reforms and a EU`s central policy instrument which is directly connected to economic development. Similar to Structural and Cohesion funds, the IPA is designed to mirror closely structural cohesion and rural development funds of the Commission in preparation for management of such funds upon accession. These pre-accession funds covering the period 2007-2013 (IPA I) and 2014-2020 (IPA II) are a sound investment in the future of the WB countries. However, it is still a challenge for the EU is finalizing the procurement of IPA I funds, setting medium and long term priorities that would accelerate the usage of the fund and sufficient and trained personnel in order to ensure sound financial management of the EU funds and greater visibility of the possibilities transmitted to the beneficiaries.

CONCLUSION

The countries experienced common external shock from the world economic crisis, but the impact of the crisis had varied across countries. In the first half of 2000s the economic growth of the countries was export and credit-driven. As the inflows began to decrease, the problems arise. Some countries, such as Albania have proven quite resilient to the weakening of international capital flows and reduction in export demand, while others, including Croatia and Montenegro have been harder hit. In very broad terms, the countries that were more open, more integrated with the European economy, tended to suffer the biggest loss in output following the crisis.

The general conclusions of this paper are: a) The fall in the FDI was greater in countries that had large FDI inflows in the period before the crisis; b) The remittances seemed to be resilient to the negative effect of the economic crisis and they helped to most of the WB countries to sustain the balance in the current account and domestic demand; c)

The countries experienced large reduction of the export performance, but the relative percentage of the total export towards EU remain the same, showing that countries did not find alternative markets to place their goods and services during the crisis; d) The credit growth affected negatively the economic performance in the WB countries. The reason is that the allocation of the assets before the crisis was in many cases biased towards consumption rather than productive or investment activities.

The countries from the region substantially depend on the EU trade and finance, and therefore indirectly they will start to gain as the Union will start to recover. Four member states play a particularly prominent role in trade: Germany, Italy, Austria and Greece. The EU's share will increase because Croatia is the third-most significant partner for the remainder of the Balkans.

Still, the EU does not have the capacity to continue to be an engine for convergence between Europe and WB. Even though the accession of the WB countries is an official regional policy of the EU, the "wait-and-see" approach has been pursued for too long, causing loss of EU credibility in the region. Putting enlargement on hold allows other actors to seize on business opportunities, score political points and carve out niches of influence, reflecting shifts in the global economy. There are two situation of unfolding the crisis in the Euro zone, and both are unfavorable for the region. First, if the Euro zones solve its problems, it might take a while until the new enlargements are on agenda, giving priority to economic stability and growth. Second, if it doesn`t solve the problems, EU disintegration might happen. In both cases the WB countries will have negative repercussions on their economies and will lose the external support for their modernization and democratic consolidation.

On the other hand, the WB does not have other options. Balkan citizens are not in love with the EU, rather, they see it as something inevitable. For all practical intents and purposes, the Balkans is already part of the EU. Since the 2007 accession of Bulgaria and Romania, the region is now encircled by the EU. Croatia's membership shrinks the geographical perimeter even further. Trade and financial liberalization between the EU and the region (as we previously explained) are already established.

Therefore, the EU needs to deploy its existent resources, as scarce as they may be, to bolster growth, competitiveness and employment. Instead of the question of the disaggregation of the Union, the question of the restructuring of the principles and means of the EU it is more important. EU should develop a more flexible and creative sets of instruments, such as making the IPA II more inclusive process and bringing closer to the citizens, utilizing all important assets of WB societies towards integration into the Union and strengthening the political will of the countries for implementing the necessary reforms and effective use of the granted funds.

The future outlook for the WB countries is that they must pursue further integration in the Union. In economical sense it would mean that the counties will take advantage of a future global upturn even though it is not expected that the rates of economic growth will be high as few years before the crisis. On political aspect, they will avoid pessimistic scenarios for the region. Otherwise, if the European perspective is lost, it is more likely that the region will be under the pressure of ethnic nationalism, which can cause tensions and jeopardize the political and economic stability of the region.

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