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ANALYSIS

A New Economic Agenda for Southeast Europe

Policy Recommendations

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- A new economic agenda for Southeast Europe calls into question the previous growth model in the region which is based on foreign direct investment, jobless growth and the continuing existence of patronage networks.

- We argue that a successful shift in the region's economic agenda must include higher wage growth, institutional innovation such as the advocacy of development banks and a renewed emphasis on regional industrial policy.

- The region's experimentation with low and flat income tax rates needs to be replaced by a more flexible set of taxation policies, including progressive income tax and the development of progressive property taxes.

- External actors are contributing to the narrative of a new economic agenda for Southeast Europe. Established partner institutions like the EU, EBRD and the Berlin Process, countries such as Russia and Turkey as well as newcomers, e.g. China and the Gulf states impact on this agenda setting process.

Introduction

The New Economic Agenda Working Group

This volume is based on the work and discussions of a working group that has gathered with the assistance of Friedrich-Ebert-Stiftung. Its aim was to describe the economic challenges and solutions towards more sustainable, qualitative and inclusive growth for Southeast Europe. The development gap towards Central Eastern Europe as well as towards the EU average remains huge. In order to bridge this gap, the Wester Balkans need to make better and more differentiated use of foreign direct investments, the EU has to devise its funds for the region in a more targeted and sustainable way, the governments of the region have to develop industrial policies for their respective countries as well as for the region as a whole, and, finally, the instruments of monetary and fiscal policy have to be revised.

This paper presents central insights of our deliberations and provides concluding policy recommendations which are based on the discussion this working group, a circle of economists, sociologists, and political scientists from Southeast Europe and Germany. This working group has met on several occasions since the end of 2015 until the spring of 2018 in Zagreb, Skopje, Ljubljana, Bucharest and Sofia on the invitation of Friedrich-Ebert-Stiftung. One important point of the project was that there is no 'one size fits all'-solution for the economic and social challenges of the countries in Southeast Europe, there is not one medicine that is the panacea for all problems of the region. We rather started from the insight, that the usual medicine of neo-liberal economic policy measures did not deliver the intended results in the respective countries.

Therefore, we decided to dig deeper empirically and recalibrate the conceptual emphasis. Five county studies with a focus on Bulgaria, Croatia, Macedonia, Serbia and Slovenia, as well as two regional studies, one for Southeast Europe and the other on Central Eastern Europe, have been written in the process; these studies are published together with this paper in book form by Friedrich-Ebert-Stiftung. This paper is not a manifesto of the New Economic Agenda-working group; it rather presents key findings, points out policy recommendations and wants to have an impact on the debate about European integration of Southeast Europe. It does not necessarily reflect the opinion of all the individual experts and authors involved in the project.

The Friedrich-Ebert-Stiftung would like to thank all the experts who have contributed to this process: Franz-Lothar Altmann, Mihail Arandarenko, Jurij Bajec, Jens Bastian, Max Brändle, Vladimir Cvijanović, Milan Cvikl, Gancho Ganchev, Vladimir Gligorov, Velibor Mačkić, Jože Mencinger, Jelica Minić, Paul Stubbs, Dušan Reljić, Zoltan Pogatsa, Anton Rop, Dragan Tevdovski, Josip Tica, Milica Uvalić, Michael Weichert, and Nenad Zakošek.

Sustainable, Qualitative and Inclusive Growth for Southeast Europe

Various countries in Southeast Europe are currently witnessing their fastest economic expansion for nine years. Romania grew 8.8 per cent year on year in the third quarter of 2017, primarily based on increased government spending on pensions and rising public sector salaries which stoked a boom in private consumption. Serbia's economy is projected to grow by three per cent in 2017. The economic growth forecast for Macedonia was 1.9 percent in 2017 and 3.2 percent for 2018. In Kosovo, annual output growth reached 4.4 per cent in the third quarter of 2017 and Bosnia and Herzegovina grew at 2.9 per cent. Montenegro grew at a robust 4.7 per cent while annual GDP in Albania was forecast at 3.5 per cent.

Still, as impressive as the quarterly GDP numbers appear, the economic recovery is fragile, constrained to specific sectors, while unemployment remains high and a lending recovery by commercial banks has yet to expand from large enterprises to medium and small-sized businesses. After a prolonged and difficult transition path from the late 1980 until the economic crisis, the countries in Southeast Europe are not yet on a development path which guarantees future socio-economic prosperity. Limited competitiveness on world markets, jobless growth, increasing social problems and the consequences of extreme deindustrialization remain key structural problems of the region.

Furthermore, economic growth is by no means a guarantee of social cohesion. Social protection systems across Southeast Europe are fragile and unable to offer an adequate safety net against risks such as unemployment, disability and again, let alone be a springboard to social and economic reintegration. Rather than just strive for increased economic growth, the countries of the region should aim for a more balanced model of development and implement redistributive policies that can combat mounting social problems and secure decent living standards. The good news is that growth is back in Southeast Europe. But this alone is not the solution to the economic and social challenges. What the countries in Southeast Europe, and especially the Western Balkan EU candidate and association countries need is sustainable, qualitative and inclusive growth.

Breaking the Power of Patronage Networks

After years of democratic stagnation in the Western Balkans, the new Macedonian government that took office in May 2017 constituted the first democratic transfer of power in the region after four years. It also represents a break with the success of autocratic rule. The Macedonian moment stands out and has the opportunity of setting an example. The subsequent improvement of the Bulgarian-Macedonian relations further nourishes this hope. New ideas, progressive leadership and genuine vistas for countries in the region need to come forward as a change of political culture in the Western Balkans. Without doubt, the transfers of power focus not only on individuals and their ability to deliver. Breaking the power of patronage networks is essential as they constitute the main transmission channels between politics and citizens across the region. Thus, structural change in politics is about making government more transparent and accountable. The renewal of democratic rule in various Balkan states remains a work in progress which will require joint efforts at the domestic level and EU mediation, social movements and protests as well as international efforts.

Re-Energize the EU-Enlargement Process

The European Commission presented a strategy paper in February 2018 which aims to jump-start the stalled EU-accession processes in the Western Balkans. EU enlargement has always been promoted as a driver of domestic reform capacity. The roadmap of accession now includes a timetable for 2025 - in the best case - for front running countries such as Serbia and Montenegro. This seems like a last chance for the EU to present a clear road-map for the European integration of the Western Balkans. It has to be a clear objective of the EU to leave no country behind.

The prospect of EU membership must not only be a driver for domestic reform, but also for more intensive regional cooperation, also in the areas of research and development, energy, transport, agriculture and for a regional industrial policy. The initiative for a Regional Economic Area is a step in the right direction. A failure of this path towards EU integration, or an excessively slow pace of enlargement raises the question of geopolitical competition in the region with Russia, Turkey, China and the Gulf Arabs as actors with their own interests in Southeast Europe.

It is encouraging to see that the EU's renewed enlargement policy is now based on three pillars, namely public administration, the rule of law and economic governance. The deterioration of democratic standards and attacks on the independence of the judiciary in some countries of the Western Balkans cannot be further ignored by policy makers in Brussels. But unless the new Enlargement Strategy can contribute to enhance fragile economic growth and improve social progress in the region, it risks being seen by many as yet another futile institutional exercise.

Policy Recommendations for Sustainable, Qualitative and Inclusive Growth

The Role of Foreign Direct Investment (FDI) in Supporting Sustained Growth

The economic recovery in Southeast Europe continues to be fragile and susceptible to pushbacks. It is therefore risky to merely assume that it is a matter of time until foreign investors will return to the region. FDI cannot per se be considered an investment in real assets. The track record of FDI (greenfield and privatization-related) is mixed at best. FDI can be a welcome supplement to the still low domestic savings, but it is unlikely to be sufficient for a faster and sustained economic development. Based on the experience of FDI during the past two decades, governments need to refine their investment promotion strategies and find a more balanced approach.

- Governments in Southeast Europe need to attract not only more, but also **better-quality investments** which facilitate a faster restructuring and technological upgrading of key industries on the basis of a systematic industrial policy, institutional reforms and taxation.
- The countries' investment policy should also influence the **sectoral distribution** and should extend across sectors of agriculture, energy, R&D, education and innovation. Such a targeted industrial policy will help to diversify and upgrade the production and export base. The targeting needs to be undertaken by investment promotion agencies to direct greater FDI flows into chosen sectors by the host economy and in higher unit-value exports.
- Countries in the region need to improve their export capacity and attract foreign direct investment. To the extent that **China, Russia, Turkey or Gulf states** are willing to provide such resources, many countries in the region will see therein opportunities and choices, while tending to downgrade the **perception of risks**. It is important to see that the growing trade deficits of countries in Southeast Europe with China and rising lending dependency from state-owned Chinese policy banks for infrastructure projects do not necessarily constitute a 'win-win' combination for all parties involved. Moreover, such a pivot towards Beijing must comply with rules and regulations that are based on the priorities of the European Union accession process for countries in the Western Balkans.

The Role of EU Funding and International Financial Institutions (IFI)

Foreign Direct Investment can only be one source of financing for Southeast Europe. Resources from the European Union and International Financial Institutions (IFI) will remain one of the most important instruments for the social and economic development of Southeast Europe. The focus on Economic Governance in the EU's enlargement strategies puts major importance on the problems of economic development which had been in the shadow of political issues for a long time.

- The recently introduced **Economic Reform Program** (ERP) can help to move West Balkan governments to adopt a longer (three-year) planning framework and to introduce prioritized structural objectives based on an impact analysis of desired outcomes. However, only few countries have for now the administrative capacity to actually undertake this type of longer-term policy planning. Here further assistance by the EU is needed.
- The Western Balkan countries should be supported with additional financial resources form the EU and its institutions before they actually enter the EU. **Access to the EU's structural funds** should be granted **before membership**. This will help the candidate and aspirant countries to boost their public investment and adopt a clearer development perspective. Eventually, this would be beneficial economically and geopolitically, not only for the Balkans but also the EU itself.
- For **EU member states** such as Bulgaria, Romania, Slovenia and Croatia the **utilization of EU funding instruments** may become more difficult under the newly established EFSI 1 and EFSI 2 arrangements of EU cohesion policy. The set of rules applicable to EFSI operations with the establishment of prior actions such as *Investment Platforms* and *National Promotional Banks* are complex and require institutional preconditions that are ambitious. Investment projects will require to be pooled with a thematic or geographic focus. The provision of EIB loans will require guarantees, counter-guarantees and capital market instruments as funding or credit enhancement. This conditionality, while appropriate in terms of risk management, presupposes a level of preparation and sophistication in financial engineering instruments that may prove challenging for participating ministries, banks and project applicants.
- The **role of International Financial Institutions** is critical in that respect, not only in terms of their operational mandate as a lending institution. The EBRD, World Bank, Central European Initiative (CEI), EU Delegations and the Regional Cooperation Council (RCC) can provide valuable input in the strategic advisory areas: (i) the promotion of good governance, (ii) public procurement transparency, and (iii) expanding the financial role and responsibility of the private sector in combination with the utilization of EU-related financial engineering instruments.

Providing Credit to the Real Economy

As a transmission channel to the real economy, the banking sector has an essential role to play with the provision of affordable credit at reasonable (time) maturities and sustainable yield levels. This responsibility has frequently been called into question in numerous countries of the region during the past decade, in particular since the outbreak of the financial crisis in 2008. Corporate financing still heavily relies on bank-centered lending. Given the elevated levels of non-performing loans in various countries of the region, credit availability remains difficult and the provision of quality collateral is a major challenge for many companies, in particular SMEs and start-ups.

The Western Balkan countries do not lack innovative business ideas or a risk-taking attitude. But they are frequently excluded from a funding pipeline that continues to focus on large enterprises, excessive-collateral requirements and short repayment maturities at high interest rates.

- The **pro-active involvement of the *European Investment Bank*** (EIB) in countries of the region is an important measure, but a revival in responsible lending will need more than the initiatives of the EIB, the EBRD or foreign-based micro-credit institutions. Stronger credit growth to the non-financial sector requires policy interventions to reduce NPL levels of SMEs. Targeted lending schemes for start-ups whose credit history with domestic commercial banks is insufficient need to be part of this conversation.
- The ***'Juncker Investment Program'*** (EFSI 1 and EFSI 2) **should be extended to accession and candidate countries**. The net capital inflow via EU structural funds can contribute to keeping growth rates in or closer to positive territory. But it is not a one-size fits all solution. Participation in the *'Juncker Investment Program'* should be open to public and private sector initiatives.

Industrial Policies with a Focus on Innovation and Human Capital

Policy-makers in the Western Balkans need to elaborate and implement a more efficient industrial policy, both at the national and regional levels. Industrial policies need to be country-specific, carefully prepared by its advocates on the basis of national priorities. The country studies of this project have shown that an explicit government-sponsored and targeted industrial policy does not even exist in several countries.

- A **regional industrial policy** calls for coordinating national policies in agreed priority areas, all the more since it can establish economies of scale and create a critical mass of initiatives. Greater regional cooperation in industrial policy-making should focus on the sectors energy, transport, tourism, agriculture, as well as on R&D and start-up companies.
- The **focus on innovation** is crucial for all countries of the region. The Bulgarian government, e.g. adopted the *Concept for Industry 4.0* in 2017. Innovation promoting strategies must become part of a wider policy framework that would include education, the development of skills for young people through vocational training, and close cooperation between higher education institutions and the business sector.
- The **Regional Cooperation Council** (RCC) in Sarajevo is a key institution to advance and promote such an industrial policy agenda. Its 'SEE 2020 Strategy' was adopted in November 2013 and represents the attempt to implement targeted regional cooperation initiatives in different sectors of the countries' economies, in particular transport and energy.
- Equally, the Berlin Process launched in 2014 includes the establishment of a **Regional Economic Area** in the Western Balkans. Such an emerging institutional architecture and the political will articulated therein represent opportunities to include the advocacy of industrial policy making for individual countries and the region as a whole.

Southeast Europe Needs a System of Well-Governed Development Banks

The debate about industrial strategy in countries of Southeast Europe needs to embrace innovative financial sector initiatives. One such avenue concerns the advocacy of development or promotional banks. Such financial institutions require a specific set of legal and regulatory conditionalities attached to their operational mandate. Revolving loan or credit funds have been used to support government operations across Europe. The *Juncker-Plan* at the European Union level or promotional banks such as the KfW in Germany, the CDC in Italy, the EIB in Luxemburg and the EBRD in London highlight an expanding architecture of development banks and strategic public investment funds across the continent. By contrast, such financial institutions are in high demand, but low supply in the region of Southeast Europe.

- The **Western Balkans need a system of development banks** as part of coordinated efforts to direct investments in Southeast Europe. Such national policy institutions seek to mitigate credit crunches, e.g. in sectors where access to loans from commercial banks is constrained by collateral requirements, high interest rates and short maturities, in particular for SMEs and start-ups.
- Engaging in building financial development institutions requires astute attention to its **governance mechanisms**. Key among promotional banks must be to ensure their **independence from political interference and cronyism**. The definition of these preconditions is all the more necessary as there is a legacy of past development banks that have frequently served as vehicles for rent-seeking politicians, were prone to corruption and provided political lending while ignoring the viability of applicants' business plans.
- The advocacy of promotional banks will also require **blending such financing instruments with private sector initiatives**, e.g. public-private initiatives (PPPs). The concrete instances and mechanisms of cooperation and hierarchies between promotional banks and PPPs will require detailed elaboration and attribution of legal accountability, e.g. to central banks and parliament. Constraining development banks by capital market actors or narrow political considerations is not the rationale for their advocacy.

Optimize Monetary and Exchange Rate Policies

The countries in Central, Eastern and Southeastern Europe illustrate a large mixture of monetary policies which they have implemented since the 1990s. Across this set of countries, every type of monetary and exchange rate regime can be identified. This multiplicity includes inflation targeting, floating regimes, currency pegs, membership in the euro area and the unilateral introduction of the euro.

At times the focus was on controlling runaway inflation, other periods and countries based their monetary policy on the management of income convergence with Western Europe and cyclical needs. But even flexible regimes in this region experienced their own boom-bust cycles during the period 2003-13. The continued existence of fixed-exchange rate regimes in some countries points to lasting credibility challenges for domestic currencies.

Central banks have little room for maneuver when ongoing pegs lead to high deposit and loan euroization. Tying the domestic currency to an anchor currency such as the Euro may provide stability in monetary affairs, but limits policy makers leverage for fine-tuning. Monetary policy is further disabled when economies in the region have high foreign currency exposure. Any depreciation of the nominal exchange rate risks increasing the accumulated debts of the corporate sector and private households, with subsequent knock-on effects on investment capacity, consumption and disposable income levels.

- The balance of benefits and risks of various **exchange rate regimes must take country characteristics into consideration**. It remains a huge challenge for countries with a fixed-rate regime to identify the appropriate timing and process to transition towards greater flexibility. Bulgaria is the obvious case in point. But similar challenges loom for policy makers in Serbia and Croatia. Uncontrolled shifts should be avoided, and any revised strategy must contain monetary and financial stability.
- In order to avoid monetary misalignments implementing a combination of counter-cyclical fiscal and macro-prudential policies will require the **close coordination of finance ministers and central bank governors** in individual countries of the region.

Inequality, Employment and Social Cohesion

Leave No One Behind

The good news is that growth is back in Southeast Europe, but growth alone by no means guarantees social cohesion. Past periods of growth have rarely undone the damage to the social fabric caused by the shocks of transition, conflicts and recession. Growth has often not only been jobless but contributed to increasing inequalities: between income groups, between regions, and between generations. Social protection systems across the region remain fragile. Inclusive and effective social policies have to be considered as a productive factor with a positive impact on economic growth and development. Repairing the social fabric across the region requires bold policies as part of a new social contract. No Economic Agenda for the region can be considered complete without an explicit focus on policies to reduce (income) inequalities, create quality employment for all, improve social dialogue, and reduce social exclusion.

Tackling Rising Inequalities

Rising inequalities across the region pose a serious and continued threat to social cohesion. Horizontal inequalities, including unequal access to opportunities for women, minorities, and people with disabilities add to the challenges. In addition, growth has tended to favour larger urban cities at the expense of peripheral and rural areas and some regions in the Western Balkans have become zones of exclusion. The following policies should therefore be considered to tackle rising inequalities:

- The region's experimentation with low and flat income tax rates, often combined with high taxes on consumption needs to be replaced by a more flexible set of taxation policies including **progressive income tax** and the development of **progressive property taxes** alongside takes on wealth and inheritance. The overall tax burden on the bottom quintile group can also be achieved by lower rates of VAT on essential commodities including food.
- Entrenched rural-urban and regional inequalities need to be reduced through **sustainable regional development policies** which target disadvantaged areas for a range of programmes including: subsidies for essential service workers in health, education, channeling of investments to disadvantaged areas, support for agriculture.
- Access to free or **affordable and quality pre-school education, education, and health services for the poorest** quintile of the population must be a priority. An extensive system of grants for those from poor families wishing to attend higher education is also important.
- **Increased opportunities for women**, national minorities, people with disabilities and LGBTQ identified persons needs to be part of the equality agenda both in terms of legal provision, the rigorous enforcement of anti-discrimination provisions and the development of inclusive labor markets.

A Work Agenda for the Future

Unfavorable labor market features are a challenge to inclusive economic growth, development and social cohesion in Southeast Europe. Employment and activity rates are low by EU standards and, with some exceptions, stagnating. Two main groups have dramatically low employment rates across the region: young people and women. The quality of employment is also a serious issue in a region marked by high rates of activity in the informal, and hence unprotected, real economy and in the emerging non-standard economy characterized by precarity and short-term contracts or a misleading definition of work as self-employment. Social dialogue is underdeveloped across the Western Balkans and Southeast Europe, not least as a result of the weakening of the bargaining power of trade unions and the proliferation of firm-level agreements.

- The countries of the region need to devote a significantly higher proportion of GDP to **Active Labor Market Policies** targeting disadvantaged young people, women, minorities, and older workers. Active Labor Market Policies need to become more flexible and responsive to diverging needs across the region, prioritizing skills enhancement and the building of human capital. To boost the employment of women, it will be necessary to change the regulatory environment and to invest much more in services and benefits which promote work-family life balance.
- **Trade Unions need to be key players in social dialogue** and economic governance in all key sectors. At the same time, the voice of civil society is needed to ensure that the interests of those not in formal employment are represented, and a sustainable balance between economic, social and environmental objectives is achieved. Social dialogue is crucial to ensure that leading companies operate across the region with a growing sense of corporate social responsibility and are committed to reduce their environmental footprints.

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