

Point One: The Adjustment

Current Structure

Table 1 summarises the relevant demand and supply data for Bosnia and Herzegovina (B&H), Macedonia, Montenegro, and Serbia as it stood in 2014. On the demand side, consumption is quite high, that of the households rather than of the governments, investment is low as are exports, while trade deficit is high.

So, some rebalancing between consumption and investment with smaller trade deficits is needed.

Table 1: GDP by sectors

Structure of GDP (demand, shares 2014):

| | Serbia | Montenegro | Macedonia | B&H |
|-------------|--------|------------|-----------|-----|
| Consumption | 93 | 100 | 88 | 110 |
| Households | 75 | 80 | 70 | 90 |
| Government | 18 | 20 | 18 | 20 |
| Investment | 15 | 20 | 25 | 20 |
| Exports | 45 | 40 | 50 | 30 |
| Imports | 55 | 60 | 63 | 60 |

Structure of GDP (supply, shares, 2014)

| | | | | |
|----------------|----|----|----|----|
| Industry | 20 | 12 | 15 | 15 |
| Manufacturing | 15 | 7 | 10 | 10 |
| Energy, mining | 5 | 5 | 5 | 5 |
| Agriculture | 8 | 10 | 9 | 8 |
| Construction | 5 | 5 | 5 | 5 |
| Services | 67 | 73 | 71 | 72 |

Sources: wiiw, Eurostat, The World Bank

On the supply side, the share of manufacturing is small, and indeed the overall share of tradable goods and services is relatively small, which is in part the reason that these are rather closed economies (in terms of the share of exports in GDP). This has started to change since 2009, with export growth and import stagnation, but it will take some time before the appropriate level of openness is achieved. Particularly due to small share of manufacturing in GDP that has hardly increased in the last decade or so. Agricultural production does not contribute too much to value added, though not much less than manufacturing, and to exports (Serbia is an exception for the latter). Tradable services are primarily tourism and transport, the Balkan being a transit region.

So, some industrialisation, i.e. increased significance of manufacturing and of services connected with it needs to happen.

Target Structure

The Balkan growth model after the crisis needs to be based on investment and export growth. This is due to financial constraints (foreign, public, corporate, households). What needs to happen, on the demand side, is:

- (i) investment increases to about 25 percent of GDP,
- (ii) final consumption of government stays in 18 to 20 percent range,
- (iii) household final consumption settles around 65 percent, and
- (iv) trade deficit declines to less than 10 percent (all in percent of GDP).

On the supply side:

- (v) manufacturing needs to increase (to between 15 and 20 percent of GDP; except in Montenegro) while
- (vi) the share of services and agricultural production need to decline (the former not in Montenegro).

This is some kind of transitional change, which has already been accomplished in the Central European countries in transition (though not necessarily in the other Balkan countries – so this is a Balkan delayed transition as it were).

Trend: Forget the Past

The crisis has introduced a break, so the past trend growth of output is not necessarily relevant: e.g. 3 percent growth would be low if the period 2000-2008 is averaged, while it would be high if last 25 years are considered or the average growth rate since around 1980 is taken. So, in a sense, expected trend growth is what matters.

In the medium run, financial constraints will be binding, so assuming that household consumption increases by about 1 percent yearly and government consumption does not increase as a share of GDP (growth tracks the growth of GDP), with somewhat faster increase in capital outlays at the expense of slower growth of current expenditures, investment growth of e.g. 6 percent and net export improvement of 3 or so percentage points would give an output higher by about 15 percent (e.g. in Serbia, while that may be more or less in the other countries) by the time the structure is transformed, e.g. over a five year's period or a bit longer. Macedonia has a shorter way to go when it comes to the structure of demand, but not when it comes to the increase in the share of manufacturing and tradable services.

If it is realistic to turn things around in about 5 years that would imply a trend growth rate of 3 percent in that period. Currently, growth is below 3 percent, which can be seen as potential growth rate, except in Macedonia and Montenegro, so current output gap is, depending on the country, between 3 and 1 percent, i.e. potential output is that much higher than the actual one currently.

Output Gap

This adjustment in the structure of GDP is pushed by financial constraints (private, government, foreign). Assuming that those are relaxed in the medium run, i.e. in about 5 years, potential growth rate could be higher and the slack in the labour markets can start to be reduced quicker. Assuming that, as in most transition countries, growth is primarily driven by productivity, let us assume that two percent growth gives 1 percent increase in employment (this may be the so-called optimal rate of unemployment reduction), that would mean that with 15 percent higher GDP in five years, there would be a significant reduction in the rate of unemployment. If unemployment rates are between 18 and 27 percent, additional 15 to 25 percent higher GDP would be needed too. So, looked at it that way, output gap, the shortfall of actual GDP to the potential one, is 25 to 40 percent in this group of countries currently.

So:

Current output gap (in the next couple of years or so difference between the actual and the potential output) is between 0 in Macedonia, less than 1 in Montenegro, about 1 in B&H, and between 3 and 2 in Serbia.

In the medium term, i.e. 3-5 years, this output gap should be closed, i.e. GDP should be about 15 percent higher than currently at the end of the, more probably, 5 year period or perhaps a bit longer (because of underperformance in the first couple of years and still significant constraints afterward).

The overall output gap could take a decade or so to eliminate with trend growth rate above 3 percent as the constraints are loosened.

Closing the Gap

What needs to happen? The structure in Table 1 needs to be transformed to something like Table 2. On the supply side, there is a relatively low share of tradable goods in the overall production, which is seen from the share of industry or manufacturing in GDP. Indeed, it is manufacturing that matters, as energy and mining will have to decline due to current high share in overall production. Assuming that exports need to increase to 50 percent of GDP (e.g.

current share in Macedonia; less for B&H), manufacturing output would probably have to increase to between 15 to 20 percent of GDP (except for Montenegro). That means that growth of manufacturing will have to be faster than that of GDP. In this respect, the foreign debt constraint, that is significant in countries like Serbia and Montenegro, may put the onus of development on local entrepreneurs, which are in short supply when it comes to manufacturing. A somewhat better state of affairs is in tradable services, although outside of tourism probably only in the sector of information technologies. So, it may prove hard to close the long term output gap from the supply side.

Table 2: GDP by sectors: medium term (current in brackets)
Structure of GDP (demand, shares 2014):

| | Serbia | Montenegro | Macedonia | B&H |
|-------------|---------|------------|-----------|----------|
| Consumption | (93) 80 | (100) 85 | (88) 80 | (110) 90 |
| Households | (75) 62 | (70) 65 | (70) 60 | (90) 70 |
| Government | (18) 18 | (20) 20 | (18) 20 | (20) 20 |
| Investment | (15) 25 | (20) 25 | (25) 25 | (20) 25 |
| Exports | (45) 50 | (40) 50 | (50) 60 | (30) 45 |
| Imports | (55) 55 | (60) 60 | (63) 65 | (60) 60 |

Structure of GDP (supply, shares, 2014)

| | | | | |
|----------------|---------|---------|---------|---------|
| Industry | (20) 25 | (12) 15 | (15) 20 | (15) 20 |
| Manufacturing | (15) 20 | (7) 8 | (10) 16 | (10) 15 |
| Energy, mining | (5) 5 | (5) 7 | (5) 4 | (5) 5 |
| Agriculture | (8) 6 | (10) 6 | (9) 7 | (8) 6 |
| Construction | (5) 6 | (5) 7 | (5) 5 | (5) 7 |
| Services | (67) 63 | (73) 72 | (71) 68 | (72) 67 |

Production Gap

Looked at the gap from the growth perspective, i.e. in terms of the production function, there is slack in the labour market while capital is scarce. Assuming that human capital endowment is in fact better than it is revealed in the output produced, institutional and infrastructural deficiencies in the total factor productivity are problematic. Realistically, those cannot be solved in short to medium run. So, the closing of the output gap in the sense of reaching the level of production with full employment is going to be hard. So, trend or potential growth rate is probably such that ambitious sustained growth of investment and of exports is also going to be hard.

In any case, potential growth rate is about 3 percent in the medium run, actual growth rate is still below it due to slow post-recession recovery, but could speed up in the second half of e.g. 5 years period due to recovery of investment and exports with some improvement in household consumption. Assuming that constraints are loosened after that period and there is

improvement in institutional and the infrastructure set up, growth could speed up to around 4 percent and the slack in the labour market could be eliminated in the next 5 years, i.e. in 10 years altogether from now.

Balances and Prices

To transform the current structure into the potential one, balances need to be sustainable and prices need to adjust. Assuming that government spending sustains its share in the GDP suggests that no significant fiscal adjustment is needed. This is because government spending is already low and probably cannot be cut given the social and demographic as well as development needs. External balances are one important constraint. As nominal exchange rate adjustment is not possible (except in Serbia, but probably not to a significant extent), real exchange rate needs to adjust which is why household consumption needs to decline. As investment has to increase with current account adjusting significantly, savings have to increase which implies lower discount rate on future consumption and also lower real interest rate so that the former reflects increased savings and the latter increased investments.

Now, given that consumption needs to decrease by 10 to 20 percentage points, that recessionary influence needs to be counterbalanced by combined increase of export and investment growth in the medium term. Once the structure is in place, consumption can resume growth with the GDP, so potential growth rate can speed up, as assumed.

Conclusion: Risks of the Past Returning

Risks are on the down side. For two main reasons: discount rate on future consumption depends on the change in total factor productivity which grows quite slowly (i.e. overall uncertainty is still high); and entrepreneurial capacity is limited. That is in part the explanation for the low long term trend growth in the region in the last at least 40 years or so.

Point Two: Legitimacy Crisis

Currently, not unlike, in periodically in the past, the Balkan countries are undergoing one legitimacy crisis after another. Those have to do both with the dissatisfaction with the governments, but also with the doubts about the adopted or evolving political strategy. The way to settle the legitimacy issues and settle the policy discussion is elections, early ones if needed. Those have been held in a number of countries, e.g. Serbia, Montenegro, and Macedonia, but the issue of their regularity has been raised in the latter two countries. In the case of Bosnia and Herzegovina, the issue of legitimacy is not just an electoral, but also a

constitutional one. In Albania, concerns with legitimacy have been put aside, though they chronically arise due to the divided political space. In Kosovo, there is the crisis of legitimacy of the government and of the overall political strategy. Finally, in Serbia there are growing doubts about the pro-EU strategy of the government.

So, taking these two dimensions i.e. legitimacy of the government and the legitimacy of the political strategy, the ongoing legitimacy crisis in these countries can be characterised thus:

Serbia: growing doubts about the EU integration strategy, though the government commands widespread support. The latter may erode if the former develops into a full-blown legitimacy crisis (because the Serbian public does not feel comfortable in the current territorial and political distribution of the region).

Kosovo: the government has slim legitimacy for reasons of corruption and incompetence, while the strategy of normalisation with Serbia that involves the creation of the autonomous association of Serbian counties is quite unpopular. Full blown crisis of legitimacy is not improbable.

Montenegro: the government faces complaints that it has been rigging the elections, which requires that upcoming early or regular elections are closely monitored. However, there is also an attempt to delegitimise the political strategy of EU integration, NATO accession, and of the secularisation of the state. There is, in addition, the succession problem due to the long reign of the current prime minister (over 25 years, but perhaps more realistically since the independence, that is from 2006 on).

Macedonia: the government has lost legitimacy, though this is somewhat of a complex claim given the multi-ethnic configuration of the public space. Also, government's strategy of not pushing for EU integration is losing support. The upcoming elections can lead to stabilisation only if there is a change in government, which is uncertain without fairer elections, which government is not ready to agree to.

Bosnia and Herzegovina: the legitimacy of the government's on all level is practically non-existent. This is a feature of the constitutional system, not a bug of ongoing politics. This crisis of legitimacy in the Serbian Republic in particular has the makings of a state crisis as the current President is determined to hold a referendum that would be the first step to secession – in order for him and his party to retain the control of power.

So, the legitimacy of the current set up in most Balkan countries is clearly contested, to put it mildly.

Point Three: Collapsing Region

There are two influences that is a way work hand in hand to push the region into a collapse. On one hand, the EU has proved unable and not ready to speed up the process of Balkan Enlargement. It has substituted a more ambitious approach with the regional approach, which has proved to be slow in delivering results. Also, in part, it is inconsistent with the hub-and-spoke strategy of the Balkan Enlargement. Finally, EU has proved unable and disinterested to act in one case in which it is an obstacle to integrative ambitions of a candidate country. i.e. in the case of Macedonia. EU is destabilising rather than stabilising actor in that case. But it has also proved to lack ideas and initiatives when it comes to Bosnia and Herzegovina.

In the last few years, EU has staked its Balkan strategy of achieving success in Serbia. The premise seems to be that if Serbia is ready to join the EU and assume a stabilising role in Bosnia and Herzegovina and Montenegro and most importantly in Kosovo, the whole region can move forward and the country specific problems will be easier to solve, and indeed may solve themselves on their own.

This strategy was unlikely to work, as it did not work in the past. The reason is clear: Serbian government, independently of which party is in power, can be expected to demand concessions if they are to do EU's job in the region. If those are not forthcoming, as they are not, public dissatisfaction is bound to increase, as indeed it is. And then there is the alternative.

Russia is openly opposing EU Balkan enlargement. Up until recently the opposition was only to NATO Enlargement, but with the more assertive role that Russia is assuming in Ukraine and in the Middle East, Balkan legitimacy crisis are instrumental to the goal of weakening the EU, which is facing taxing challenges anyway. So, Russia is openly supporting Montenegrin protests, Serbian nationalistic opposition, and the secessionists in the Serbian Republic in Bosnia and Herzegovina. The operative word here is openly. This is in part due to also the loss of the indirect means after the collapse of various gas pipeline projects that should have increased Russia's influence in the Balkans.

So, at the moment, the Balkan region is in a state of near collapse.

Concluding Comments

The economies throughout the Balkans are facing the adjustment or transition problem both on the demand and on the supply sides, with unimpressive growth performance during the transformation period of up to 5 years.

The countries in the region are facing legitimacy crises both in terms of governance and in terms of political strategy. It is not a given that those will have democratic resolutions.

EU Balkan Enlargement has stalled due to the inadequate strategy on which it has been based, while there is now one big power, Russia, which is working actively and openly against the remaining Balkan countries joining the EU.