



## THE BALKANS: BETWEEN ECONOMIC CRISIS AND EUROPEAN INTEGRATION

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### Rezumat

Regiunea Balcanilor (cunoscută și sub denumirea de „butoiul cu pulbere al Europei”) a constituit dintotdeauna o problemă Europeană, a Europei Occidentale, după cum menționa Arnold Toynbee, în 1922. În prezent, Uniunea Europeană se confruntă cu al cincilea val de extindere, cunoscut și sub denumirea de „extinderea post-conflict” – integrarea statelor Balcanice. Bulgaria a aderat la Uniunea Europeană în 2007. Croația a semnat Tratatul de aderare la finele anului 2011 și va deveni membru în 2013. Celelalte state Balcanice se află în diferite stadii ale integrării europene. Acest proces de integrare europeană a țărilor Balcanice prezintă o serie de provocări și dileme, atât pentru Uniunea Europeană, cât și pentru enclava Balcanică. Principala provocare a acestui val de extindere constă în reconcilierea construcției statelor-națiune și integrarea europeană.

Din punct de vedere economic, regiunea Balcanilor este subdezvoltată. Printre factorii principali care determină această situație economică se numără: lipsa resurselor naturale, situația politică de-a lungul secolelor (conflictele militare) și factorii culturali. În prezent regiunea resimte consecințele celei mai severe crize economico-financiare mondiale de la finele celui de-al Doilea Război Mondial.

### Abstract

The Balkans region (also known as the „Powder keg of Europe”) has always been an European question, a Western question, as underlined by Arnold Toynbee, in 1922. At present, European Union is confronted with the fifth enlargement, also known as the “post-conflict” enlargement – the integration of Balkan states. Bulgaria joined European Union in 2007. Croatia signed the Accession Treaty

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in 2011 and is expected to become an EU member in 2013. The other countries encounter in different stages of European integration. However, this process presents several challenges and dilemmas, either for European Union, or for the Balkan enclave. The main challenge in the case of this enlargement is to reconcile the nation-state building and the European integration.

From the economic point of view, the Balkans region is underdeveloped. Several factors determined this stance of the region: the poor endowment in terms of natural resources, the political situation over the centuries (the military conflicts) – impeding the economic development, the cultural factors. At present, the region is confronted with the consequences of the worst economic and financial crisis of global economy since the end of World War II.

**Keywords:** The Balkans, economic crisis, European integration

**JEL Classification:** P51, G01, G32, F15

### **Introduction**

Situated in the South-Eastern of Europe, the Balkans region is a small one, with an area of around 500 000 km<sup>2</sup> and with a population estimated at 50 millions. It is a border of Europe, a link between Europe and Asia, between the Central Europe and the Middle East. The region is generally poor in terms of natural resources (however, there can be mentioned the fertile soils on the plains and some deposits of metal ores). From the economic point of view, the Balkans region is underdeveloped. Several factors determined this stance of the region: the poor endowment in terms of natural resources, the political situation over the centuries (the military conflicts) – impeding the economic development, the cultural factors. At present, the region is confronted with the consequences of the worst economic and financial crisis of global economy since the end of World War II. However, this region has an important geostrategic position, as during the past centuries, the great powers (Ottoman Empire, Russian Empire and Austro-Hungarian Empire) crossed their interests in the Balkans. At the same time, from the ethnic, linguistic and religious composition is a complex region, a rich one – the result of millenniums of changes. The Balkans region (also known as the „Powder keg of Europe”) has always been a European question, a Western question, as underlined by Arnold Toynbee, in 1922. At present, European Union is the main international actor in this area.

Croatia signed the Accession Treaty in December 2011. The other countries encounter in different stages of European integration.

The rest of the paper is structured as follows: the first part reviews the economic evolution of the Balkan economies before the worst world economic and financial crisis since World War II; the second part presents the main consequences of this crisis; the last part underlines the economic challenges for these countries in the process of European integration.

### **1. The Balkans before the crisis**

The countries in the Balkans present several common economic characteristics: they are small-open economies (their evolution is highly dependent on the global and European business climate and the sentiment on the international financial markets), underdeveloped, with a very high dependence on external financing and a poor functioning of labour markets.

On the other hand, there are some important differences, especially in terms of **economic openness** – some countries are more integrated with European Union economies (for instance Bulgaria, FYR of Macedonia, or Montenegro), but also in terms of **exchange rate regime**. Thus, the euro is adopted unilaterally in Kosovo and Montenegro; in Bulgaria and Bosnia is a currency board regime; in Croatia and Serbia is adopted a managed float exchange rate; in FYR of Macedonia is a hard peg exchange rate and a floating exchange rate regime works in Albania).

At present, GDP/capita (calculated on the base of purchasing power parity, in US dollars) for these countries, is below one third of the European Union level (except for Bulgaria and Croatia).

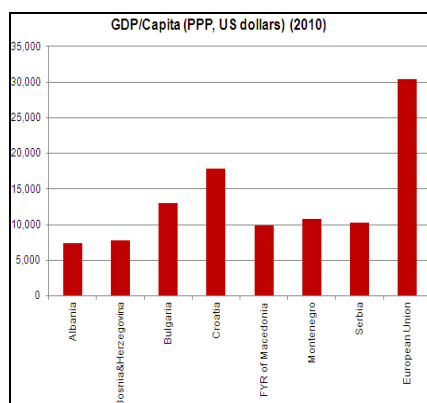


Figure 1. The GDP per capita in 2010

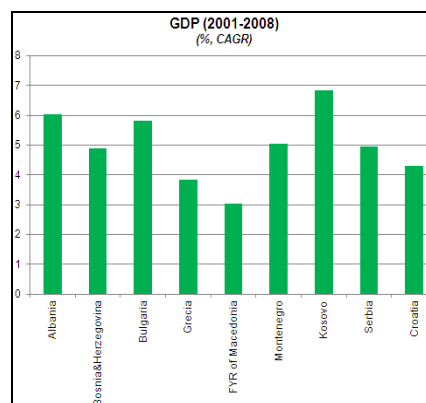


Figure 2. Evoluția PIB, 2001-2008

The region embarked on a period of economic growth at the end of the 1990s. This evolution was determined by political and international economic factors. In this context, we have to mention the political stability achieved after the end of Kosovo War (1999), when the European Union tried to promote regional cooperation in the Balkans, launching two institutional arrangements (“The Stability Pact for South East Europe” and “The Stabilisation and Association Process”). At the same time, the region benefited from the international macroeconomic context before the crisis (The Great Moderation period, with low risk aversion) and the spillover effects generated by the enlargement of European Union towards Central and Eastern Europe.

The countries in the region grew at an average annual rate of 5% during the period 2001-2008 (see Figure 2). The growth model of the region during this period was common for all the countries and was based on four pillars: exports towards European Union countries; private credit expansion; foreign direct investments; labour force migration. The evolution of these pillars over the past years (before the crisis) suggests the convergence of the area towards the European Union (we can say that, from the economic point of view, these countries are increasingly becoming *de facto* members of EU). For instance, private credit grew sharply in the region during the period 2002-2008, financing the private consumption and the investments. The generally expansion of credit (by the foreign banks) was determined by the decreasing risk aversion (on the global and European level), but also by the underdevelopment of the region

(potential growth on medium-long term, the process of convergence). As mentioned, the credit was provided by foreign banks, which dominated the banking sectors in these countries.

Also, foreign direct investments fuelled the growth of the region during this period (which seemed sustainable before the start of the crisis). As can be seen on the Figure 3, these countries received net Foreign Direct Investment of at least 5% (of their GDP) every year during the period 2001-2008.

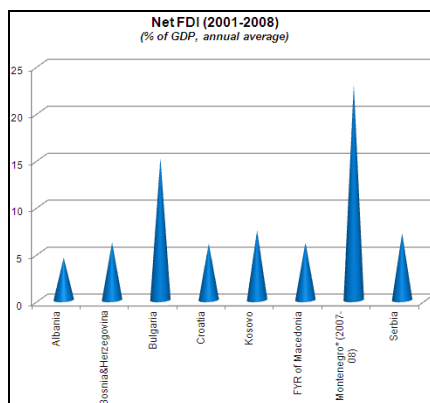


Figure 3. The Net FDI, 2001-2008

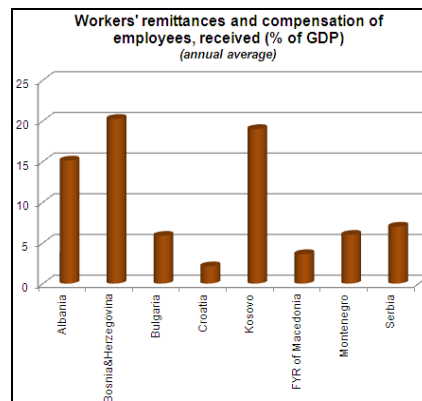


Figure 4. Workers' remittances and compensation, 2001-2008

At the same time, another important source of financing the growth process (especially for Bosnia and Herzegovina, Kosovo and Albania) is represented by the remittances of the population working in the European Union member countries (see Figure 4).

However, this growth model determined the accumulation of macroeconomic imbalances in the region before the start of the crisis. We mention the huge current account deficits. For example, in 2008, this is generally above 10% of GDP, with a value record in Montenegro (see Figure 5).

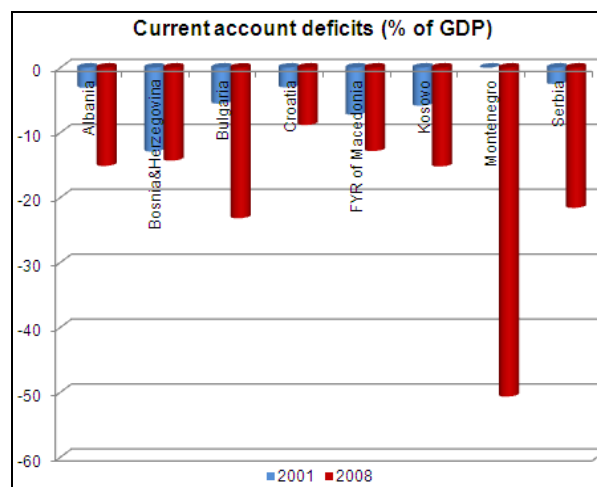


Figure 5 Current account deficit, in 2001 and 2008

The worst financial and economic crisis in decades transformed this model into a failure (the “successful” stories turned into vulnerable economies during the crisis). All the countries in the region were affected by the **sudden-stop** of foreign capital. The crisis (its first wave and now the second wave) affected the population: the unemployment increased; the import prices rose; the access to credit was restricted; the poverty level in the region turned higher.

## 2. The impact of the financial and economic crisis

The Balkan region felt the first wave of the worst financial and economic crisis of global economy since the end of World War II. All the countries in the region faced economic contraction in 2009, except for Albania and Kosovo. In the case of Albania the recession was avoided given the flexibility of exchange rate. On the other hand, Kosovo grew in 2009, given the low level of integration with the international economy, but also the embryonic state of the banking system.

Severe contractions (deeper than 4% y/y) were registered by Bulgaria, Montenegro and Croatia. In fact, the Croatian economy also contracted in 2010 (see Figure 6). As mentioned above, the crisis hit the region through the main channels of the economic model: trade channel, capital flows and workers’ remittances.

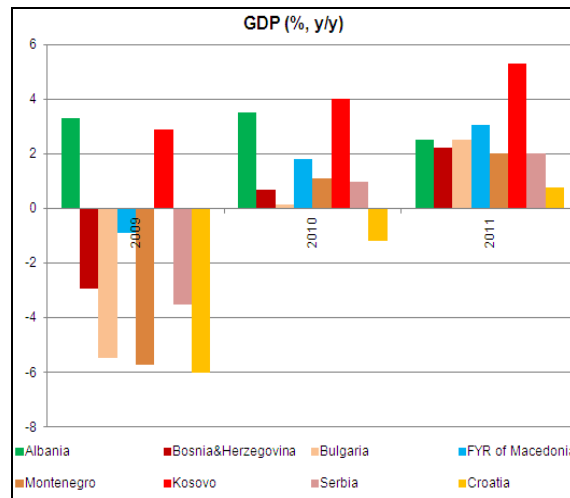


Figure 6. The annual growth rate of GDP in Balkan countries

The arrival of the crisis was forecasted by the evolution of stock exchanges in the region. Although in the case of Balkans economies the capital markets are less developed (frontier markets), the predictive power of the evolution of the stock exchange indexes is strong. The evolution of these stock exchanges is dependent mainly on the foreign capital flows. The deep decline of market capitalization of listed companies in the region during 2008 was a strong signal of the crisis in 2009.

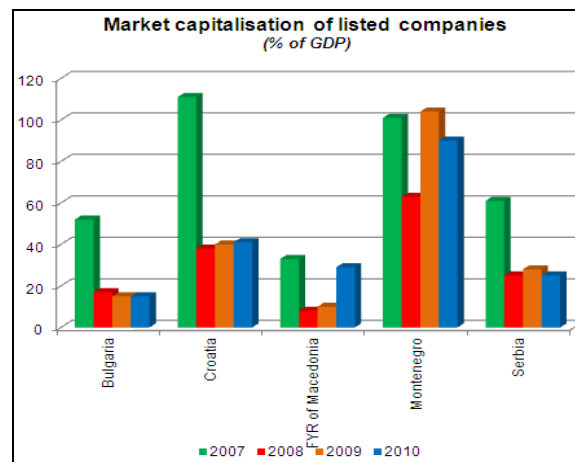


Figure 7. Market capitalization of listed companies

As can easily be noticed in the Figure 7, all stock exchanges in the region registered severe falls during 2008, when the international financial crisis intensified (the Lehman Brothers moment, in September 2008). This evolution expressed the fact that foreign capital was leaving the region, a strong signal for the sudden stop of capital in the real economy that followed afterwards.

In terms of exports, the most affected countries in the region by the contraction of European Union in 2009 were Bulgaria and FYR of Macedonia (with a higher exposure of exports to EU). On the other hand, the countries less affected by the fall of foreign demand were Croatia and Serbia (a lower openness degree).

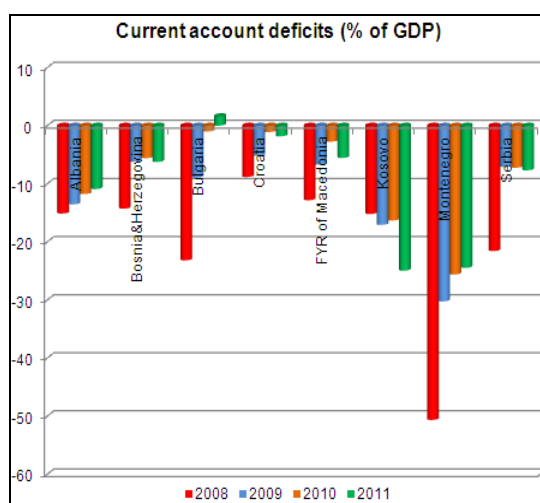


Figure 8. Current account deficits, in 2008-2011

However, the financial crisis hit the region through the phenomenon of sudden stop in capital inflows (as the region is dependent on foreign financing), due to several reasons: high level of external debt (especially in Croatia, Bulgaria and Serbia); high level of external financing needs (as mentioned earlier, all the countries in the region had a current account deficit in excess of 10% of GDP); the heterogeneity of international reserve adequacy to cope with such situations of sudden stop of capital.

After hitting the financial sector, the crisis transferred to the real economy in the region. The access to financing became difficult, as foreign capital was either leaving the region, or access to financing was restricted. It can be noticed in the Figure 9, the evolution of broad money in 2009 (strong deceleration, or even contraction in some



countries, when compared to 2008). The evolution of this indicator continued to be affected by the crisis also in 2010, given the risk aversion, the arrival of the second wave of the crisis (public debt crisis in Europe) and the dependence on foreign banks financing.

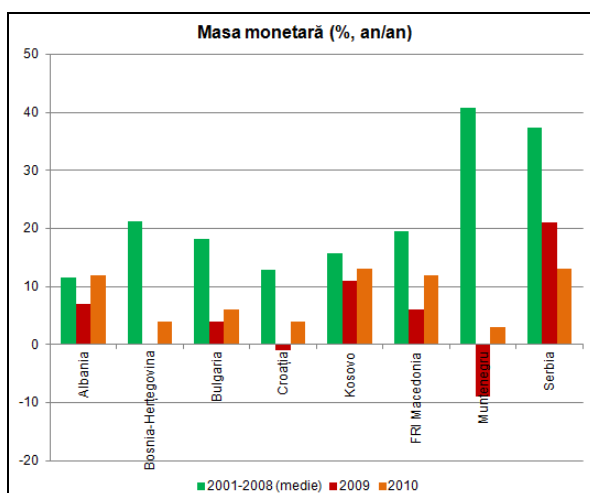
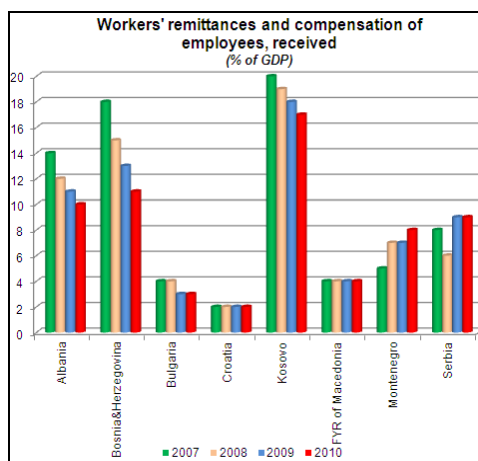


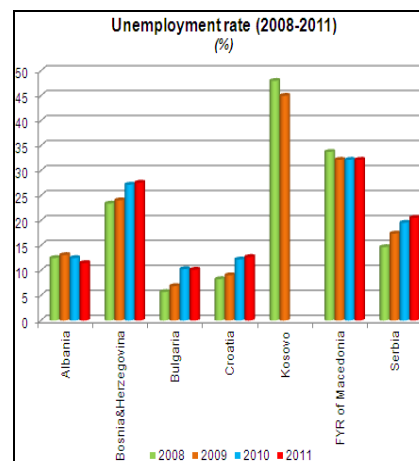
Figure 9. Broad money in Balkan countries ă

Another factor that affected the region was the decline in workers' remittances. In the context of the economic crisis in European Union, the migrant population of the Balkans in EU confronted with the deterioration in labour markets conditions: high level of unemployment and a decline of wages. Consequently, the remittances declined in the region during the quarters of the first wave of crisis, especially in Albania, Bosnia and Herzegovina and Kosovo.

The main consequences of the first wave of the world financial and economic crisis were: a higher unemployment rate; macroeconomic adjustment (lower current account deficits); the increase of non-performing loans rate; deterioration of public finance positions.



**Figure 10. Workers' remittances and compensation of employees, received**



**Figure 11. Unemployment rate in 2008-2011**

The deterioration of the macroeconomic context in the region (economic contraction or deceleration) determined tougher conditions on labour markets. The unemployment rate increased in the region, generally above the level of 10% in 2009 and 2010. Actually, unemployment rate almost doubled in Bulgaria and Croatia; rose to almost 20% in Serbia and 25% in Bosnia and Herzegovina and maintained over 30% in FYR of Macedonia.

After the financial crisis hit the region, the macroeconomic adjustment process began. There can be noticed in the Figure 9, a decline of current account deficits in the region, from the unsustainable level of 10% of GDP (in 2008). For instance, in Bulgaria the current account deficit declined from above 20% of GDP in 2008 to only 1% of GDP in 2010. At the same time, current account deficit decreased in Montenegro from above 50% of GDP in 2008 to 25% of GDP in 2010. On the other hand, current account deficit increased in Kosovo during the period 2008-2011, from 15% of GDP to above 20% of GDP.

Overall, the external imbalances remain high in the region, especially in countries like Albania and Serbia, but also Kosovo and Montenegro. In the context of financial and economic crisis the public finances stances deteriorated in the region. This evolution was determined either by the decline of budgetary revenues (given the economic contraction or deceleration), or by the increase of

budgetary expenses (expansionary budgetary policies to cushion the impact of the economic crisis). For instance, Bulgaria passed from a budget surplus of almost 3% of GDP in 2008 to a budget deficit of about 4% of GDP in 2010. Also, Montenegro passed from a budget surplus of 1.8% of GDP in 2008 to a budget deficit above 6% of GDP in 2009.

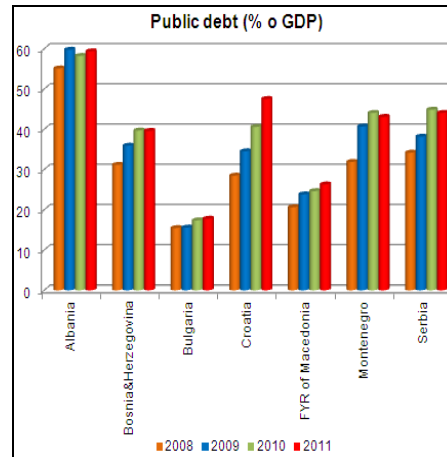
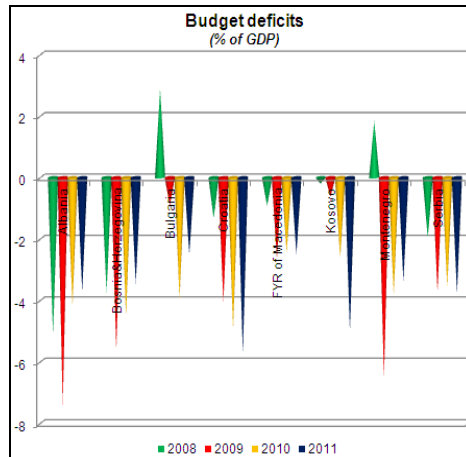


Figure 12. Budget deficit in 2008-2011      Figure 13. Public debt in 2008-2011

At present, in 2011, according to IMF estimates, all countries in the region present budget deficits, generally above 3% of GDP (except for Bulgaria and FYR of Macedonia), the highest are registered in Croatia (5.7% of GDP), Kosovo (5% of GDP), Serbia (3.8% of GDP) and Albania (3.7% of GDP). Consequently, the public debt (as a weight of GDP) increased in the region significantly over the past years. At present, public debt represents about 60% of GDP in Albania and around 40% of GDP in Bosnia and Herzegovina, Croatia, Montenegro and Serbia. The public debt is lower in Bulgaria, with 18% of GDP, and FYR of Macedonia, with 26.3% of GDP (see Figure 13).

### 3. The main challenges of European integration of the Balkan States

At the present, European Union is confronted with the fifth enlargement, also known as the “post-conflict” enlargement – the integration of Balkan states. Bulgaria joined European Union in 2007. Croatia signed the Accession Treaty in 2011 and is expected to become an EU member in 2013. FYR of Macedonia and Montenegro

have EU candidate status. Serbia was refused the candidate status in 2011, given the problem with Kosovo (this status is conditioned by finding a solution to this aspect). Kosovo cannot start a dialogue for European integration until it reaches an agreement with Serbia. And the progress of Albania and Bosnia and Herzegovina towards EU membership is questioned by the political and social crises in these countries.

However, this process presents several challenges and dilemmas, either for European Union, or for the Balkan enclave. The main challenge in the case of this enlargement is to reconcile the nation-state building and the European integration.

On the one hand, we have to mention the enlargement fatigue and the deep economic crisis in the European Union. The Balkan area is a European affair, but until now the integration of this enclave into European Union is perceived mainly as a necessary, unpleasant duty (a burden).

On the other hand, we mention the accession fatigue in the Balkans, but also the long distance of this area towards the European Union, from several points of view (including the economic one). The Balkan countries have to irreversibly consolidate their democracies. These countries confront with several democratic issues: high level of corruption, influential organized crime structures, defects of democratic structures, bureaucratic burdens on the economy, unresolved internal and external political problems, persisting ethnic cleavages. In this respect, the Balkan countries must meet the **good governance** criteria: the rule of law, an independent judiciary system, an adequate administrative capacity and an efficient anti-corruption strategy.

Overall, the region presents some assets for the European Union: the most secularized and pro-Western Muslim communities in the world; multi-religious nations composed of Muslims and Christians; two relatively efficient multiethnic states; high level of Roma integration in some states; know-how of political and economic transition.

From the economic point of view, a deeper integration with the European Union seems the only feasible economic policy solution on the long run in the Balkans. However, a successful economic integration of these countries within European Union is dependent on the implementation of structural reforms, in order to promote

sustainable economic growth, important for institutional strength, but also to avoid asymmetric shock after the European integration.

Among the main economic challenges for these countries in the European integration process there can be mentioned: finding a new growth model (develop more domestic sources of investment); addressing the slow pace of reform; boosting the low innovation capacity; reposition in the European constellations. The strategy “**Europe 2020**” should be an anchor for the reform in the Balkans – deep economic integration with the EU will continue to drive economic growth, while providing an anchor for political and structural reforms.

In this context, the countries must address the problem of human capital development, as sustainable economic growth cannot be attained through low labour costs and by commodity exports. The labour markets do not function properly in this region (the unemployment rate presents very high levels), given not only the cultural reasons (a high proportion of Muslims), but also the huge gaps between the skills demands of the market and the education coming out of schools. Consequently, there is the need to focus on education and vocational training.

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## APPENDIX

<b>Albania</b>									<b>Bosnia and Herzegovina</b>								
<b>Challenges</b>									<b>Challenges</b>								
<ol style="list-style-type: none"> <li>1. High level of unemployment</li> <li>2. Current account deficit</li> <li>3. Dependence on remittances</li> <li>4. Fiscal consolidation</li> <li>5. Informal economy</li> <li>6. Greek crisis (Greece is an important economic partner)</li> </ol>									<ol style="list-style-type: none"> <li>1. High level of unemployment</li> <li>2. Social security system</li> <li>3. Dependence on remittances</li> <li>4. Fiscal consolidation</li> <li>5. Competitiveness</li> </ol>								
<b>Albania</b>									<b>Bosnia&amp;Herzegovina</b>								
<b>Indicator/year</b>	<b>2006</b>	<b>2007</b>	<b>2008</b>	<b>2009</b>	<b>2010</b>	<b>2011</b>	<b>2012</b>		<b>Indicator/year</b>	<b>2006</b>	<b>2007</b>	<b>2008</b>	<b>2009</b>	<b>2010</b>	<b>2011</b>	<b>2012</b>	
GDP (USD, bil.)	9.0	10.7	13.0	12.2	11.9	13.3	14.2		GDP (USD, bil.)	12.4	15.2	18.5	17.0	16.5	18.3	19.4	
GDP (% , y/y)	5.4	5.9	7.5	3.3	3.5	2.5	3.5		GDP (% , y/y)	6.0	6.2	5.7	-2.9	0.7	2.2	3.0	
Inflation (% , y/y)	2.4	2.9	3.4	2.2	3.6	3.9	3.5		Inflation (% , y/y)	6.1	1.5	7.4	-0.4	2.1	4.0	2.5	
Unemployment rate (%)	13.8	13.5	12.5	13.1	12.5	11.5	11.0		Unemployment rate (%)	31.1	29.0	23.4	24.1	27.2	27.6	27.0	
Budget deficit (% GDP)	-3.3	-3.3	-5.1	-7.4	-4.2	-3.7	-4.5		Budget deficit (% GDP)	2.2	0.2	-3.8	-5.6	-4.5	-3.5	-1.9	
Public debt (% GDP)	56.7	53.8	55.1	59.8	58.2	59.4	59.2		Public debt (% GDP)	21.8	32.9	31.2	35.9	39.7	39.6	38.4	
Current account (% GDP)	-5.6	-10.4	-15.1	-13.5	-11.8	-10.9	-9.8		Current account (% GDP)	-8.0	-10.7	-14.3	-6.2	-5.6	-6.2	-5.6	
<i>Source: International Monetary Fund, 2011</i>									<i>Source: International Monetary Fund, 2011</i>								

<b>Bulgaria</b>								<b>Croatia</b>							
<b>Challenges</b>								<b>Challenges</b>							
<ol style="list-style-type: none"> <li>1. Unemployment</li> <li>2. Brain-drain</li> <li>3. European funds</li> <li>4. Structural reforms</li> </ol>								<ol style="list-style-type: none"> <li>1. Long-term unemployment (over 50%)</li> <li>2. Fiscal consolidation</li> <li>3. Institutional reforms</li> <li>4. Banking sector risks</li> <li>5. External debt</li> </ol>							
<b>Bulgaria</b>								<b>Croatia</b>							
<b>Indicator/year</b>	<b>2006</b>	<b>2007</b>	<b>2008</b>	<b>2009</b>	<b>2010</b>	<b>2011</b>	<b>2012</b>	<b>Indicator/year</b>	<b>2006</b>	<b>2007</b>	<b>2008</b>	<b>2009</b>	<b>2010</b>	<b>2011</b>	<b>2012</b>
GDP (USD, bil.)	33.2	42.1	51.8	48.6	47.7	54.3	57.7	GDP (USD, bil.)	49.9	59.4	69.9	63.4	60.8	64.2	66.9
GDP (% y/y)	6.5	6.4	6.2	-5.5	0.2	2.5	3.0	GDP (% y/y)	4.9	5.1	2.2	-6.0	-1.2	0.8	1.8
Inflation (% y/y)	7.4	7.6	12.0	2.5	3.0	3.8	2.9	Inflation (% y/y)	3.2	2.9	6.1	2.4	1.0	3.2	2.4
Unemployment rate (%)	9.0	6.9	5.7	6.9	10.3	10.2	9.5	Unemployment rate (%)	11.1	9.4	8.3	9.1	12.2	12.7	12.2
Budget deficit (% GDP)	3.3	3.3	2.9	-0.9	-3.9	-2.5	-2.2	Budget deficit (% GDP)	-2.6	-2.1	-1.3	-4.1	-5.0	-5.7	-5.1
Public debt (% GDP)	23.4	18.6	15.5	15.6	17.4	17.8	20.5	Public debt (% GDP)	34.8	32.3	28.5	34.5	40.6	47.5	50.0
Current account (% GDP)	-17.6	-30.2	-23.2	-8.9	-1.0	1.6	0.6	Current account (% GDP)	-6.6	-7.2	-8.8	-5.2	-1.1	-1.8	-2.7
<i>Source: International Monetary Fund, 2011</i>								<i>Source: International Monetary Fund, 2011</i>							



<b>Kosovo</b>									<b>FYR of Macedonia</b>													
<b>Challenges</b>									<b>Challenges</b>													
1. Current account deficit 2. Competitiveness 3. Unemployment (long-term unemployment – 80%) 4. Dependence on remittances									1. Unemployment rate 2. Greek crisis (Greece – an important economic partner)													
<b>Kosovo</b>									<b>FYR of Macedonia</b>													
<b>Indicator/year</b>	<b>2006</b>	<b>2007</b>	<b>2008</b>	<b>2009</b>	<b>2010</b>	<b>2011</b>	<b>2012</b>		<b>Indicator/year</b>	<b>2006</b>	<b>2007</b>	<b>2008</b>	<b>2009</b>	<b>2010</b>	<b>2011</b>	<b>2012</b>						
GDP (USD, bil.)	3.9	4.7	5.7	5.4	5.6	6.7	7.3		GDP (USD, bil.)	6.6	8.2	9.9	9.3	9.2	10.3	11.0						
GDP (% y/y)	3.4	6.3	6.9	2.9	4.0	5.3	5.0		GDP (% y/y)	5.0	6.2	5.0	-0.9	1.8	3.0	3.7						
Inflation (% y/y)	0.6	4.4	9.4	-2.4	3.5	8.3	2.6		Inflation (% y/y)	3.2	2.3	8.4	-0.8	1.5	4.4	2.0						
Unemployment rate (%)	45.0	46.0	48.0	45.0	n.d.	n.d.	n.d.		Unemployment rate (%)	36.0	34.9	33.8	32.2	32.2	32.2	32.2						
Budget deficit (% GDP)	2.5	5.0	-0.2	-0.6	-2.6	-5.0	-3.5		Budget deficit (% GDP)	-0.5	0.6	-0.9	-2.7	-2.5	-2.5	-2.2						
Public debt (% GDP)	n.d.	n.d.	n.d.	n.d.	n.d.	n.d.	n.d.		Public debt (% GDP)	32.0	24.0	20.6	23.8	24.6	26.3	28.2						
Current account (% GDP)	-6.7	-8.3	-15.2	-17.1	-16.3	-25.0	-20.5		Current account (% GDP)	-0.9	-7.0	-12.8	-6.7	-2.8	-5.5	-6.6						
<i>Source: International Monetary Fund, 2011</i>									<i>Source: International Monetary Fund, 2011</i>													

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<p><b>Challenges</b></p> <ol style="list-style-type: none"> <li>1. High current account deficit</li> <li>2. Banking sector problems – high level of non-performing loans</li> <li>3. Economic restructuring</li> <li>4. Competitiveness</li> </ol>	<p><b>Challenges</b></p> <ol style="list-style-type: none"> <li>1. High level of inflation</li> <li>2. Unemployment rate</li> <li>3. Fiscal consolidation</li> <li>4. Public sector reform</li> <li>5. External debt</li> </ol>																																																																																																																																																
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