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Can the Western Balkans converge towards EU living standards?

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1716: Can the Western Balkans converge towards EU living standards?

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Contents

Abstract

Standards of living in the six economies of the Western Balkans (WB-6) are well below those in the European Union (EU). The gap is closing gradually, but a full catch-up could, on current trends, take 70 years or more. The fundamental problem is low productivity in the economy, a result of many years of under-investment, weak institutions, unfavourable demographics and a difficult business environment. In this paper, we use the European Bank for Reconstruction and Development's (EBRD) assessment of transition qualities (ATQ) framework to identify areas where the region lags far behind EU comparators, and we propose a number of concrete policy improvements that, if adopted, would speed up the rate of convergence.

We suggest a three-pronged approach to reforms: better governance, enhanced openness and going green.

First, standards of public governance need to be improved, especially through reform of public administration and state-owned enterprises (SOEs), simplifying complex regulations, protecting media and civil society, and leveraging the digital revolution. Progress in this area would help reverse the brain drain from the region and enhance the skills and human capital of the labour force.

Second, greater openness to trade and investment can be achieved by increasing the role of the private sector in the economy (thus attracting investment) and making SOEs more efficient, strengthening regional cooperation, and using smart technology to reduce waiting time on the borders. The results would be more competitive economies with a greater degree of innovation and complexity of goods and services.

Third, the development of renewable energy capacity needs to be stepped up, accompanied by improved regulatory capacity and greater cross-border cooperation in the energy sector. Not only would this lead to lower levels of pollution and a greater likelihood of achieving decarbonisation targets, but it would also strengthen the region's resilience to future energy shocks and to the impact of the EU's forthcoming Carbon Border Adjustment Mechanism (CBAM).

The EU's new Growth Plan for the Western Balkans, announced in November 2023, can provide new impetus for much-needed reforms in line with the above-mentioned priorities, as such reforms will be part of the conditionality to access the enhanced funding envisaged under the Plan.

I. Introduction

Living standards in the Western Balkans are far behind those in the EU. All six countries of the WB-6 have a gross domestic product (GDP) per capita (adjusted for purchasing power parity (PPP)) that is less than half the EU average. The underlying problem is low productivity, a result of many years of under-investment, weak institutions, unfavourable demographics and a difficult business environment. The GDP gap between the WB-6 and the EU has narrowed in the past two decades, but the pace of convergence has slowed since the global financial crisis of 2008-09. On recent growth trends, it could be 70 years or more before the WB-6 catch up with their EU counterparts. The key question, therefore, is: what can be done to speed up the rate of convergence?

Reforms can make a difference. Everyone agrees that much needs to be done to make economies in the region more sustainable and well-functioning market economies. But which reforms are likely to prove most effective in accelerating convergence? To answer this question, we base our analysis around the EBRD's "six transition qualities" framework.[1] That is, we examine the extent to which the Western Balkans economies are competitive, well governed, green, inclusive, resilient and integrated. We then benchmark them against those EU members in central and eastern Europe that have a shared history of post-war socialism and the planned economy. Our analysis shows the WB-6 falling well short of their EU counterparts on all six qualities.

A three-pronged regional approach to reforms could deliver significant results. Policymakers in the WB-6 should exploit the region's potential by focusing on a few common challenges and recognising the complementarities among different qualities of market economies. Specifically, convergence can be accelerated by: (i) governing better, (ii) fostering cross-border linkages and (iii) going green.

Improving the quality of governance could help reverse demographic trends. The region has gone backwards in governance standards in recent years, widening the gap with peer countries in the EU and elsewhere. Areas that stand out as requiring particular attention include the general ineffectiveness of state institutions and the courts, the lack of protection for property rights and intellectual property, and the perceived high level of corruption. Cronyism and weak governance are not just major deterrents to investors, but also discourage labour force participation and skills acquisition, encourage young people to emigrate (and discourage emigrants from returning), and hold back efforts to address regional disparities. Improving governance can therefore go a long way towards addressing the region's skills deficit, by persuading talented people to stay or return and by promoting greater inclusion. The expansion of digital services can be an important tool in creating greater transparency and efficiency in the provision of public services, and in encouraging labour supply of excluded groups.

Greater openness to trade and investment will make the region more competitive. For the past three decades, the efforts of the Western Balkans economies to integrate more fully into regional and global markets have been hindered by the legacy of poor-quality and outdated infrastructure, barriers to trade across borders, and a lack of scale, know-how and sophistication that prohibits them from entering richer markets. The dominant role of SOEs in key sectors has also been detrimental to attracting new investment and reaching new markets. Increasing the role of the private sector, improving the quality of transport infrastructure and focusing on attracting foreign investors can strengthen the region's competitiveness and bring major growth dividends.

Going green will deliver jobs and faster growth and make the region more resilient to future shocks. Much of the existing energy infrastructure is old and outdated, and several countries still rely heavily on coal. This is highly problematic, not only because of the resulting pollution and damage to the climate, but also because the Western Balkans countries will be among those most affected when the EU introduces its CBAM. But recent years have seen encouraging developments in terms of significant investment in renewables such as wind and solar energy, the development of interconnectors that promote a genuine regional market, and the expansion of auction markets for energy supply. While the transition from coal to greener energy generation is a difficult

[1] The methodology underlying the ATQs is explained on the EBRD's website. See https://www.ebrd.com/economic-research-and-data/transition-qualities-asses.html (last accessed on 26 January 2024).

process that can raise unemployment temporarily and locally, it is worth starting it promptly and doing it in a planned and managed way, using the experiences of other successful regions, to reap the benefits earlier. Recent studies show that carbon-intensive regions are, on average, characterised by poorer economic and social conditions than non-carbon-intensive ones.[2] An acceleration of properly managed decarbonisation would help boost both green and sustainable growth, significantly improve air quality (helping reverse adverse demographic trends) and help the region withstand future energy shocks.

The EU's Growth Plan, announced in November 2023, can provide new impetus for much-needed reforms in line with the above-mentioned priorities, as such reforms will be part of the conditionality to access the enhanced funding envisaged under the Plan.[3] The Growth Plan, once approved, will provide €2 billion of grants and €4 billion of concessional loans for Western Balkans countries through a new Reform and Growth Facility for the Western Balkans. It will also allow conditional access to the EU market in the areas of goods and services, road transport, energy, electricity, customs cooperation, e-commerce and cashless payments.

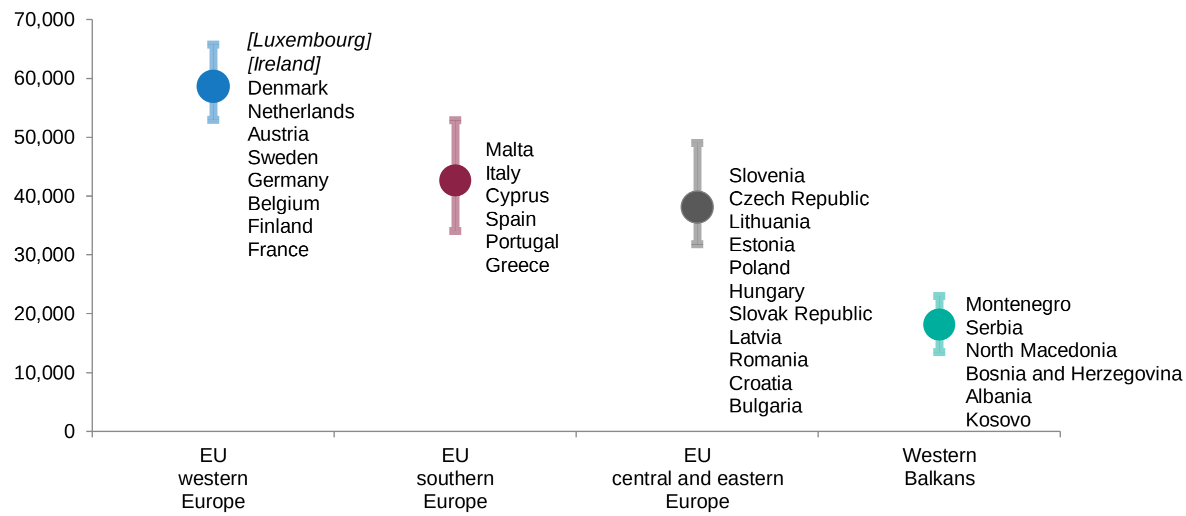
[2] See CINTRAN (2023).
[3] Details on the new Growth Plan are available on the European Commission's website. See https://ec.europa.eu/commission/presscorner/detail/en/QANDA_23_5605 (last accessed on 26 January 2024).

II. How long will it take the Western Balkans to catch up with the EU?

People in the Western Balkans are typically much poorer than their counterparts in the EU. We compare living standards across countries using an International Monetary Fund (IMF) estimate of annual GDP per capita in US dollars, adjusted for PPP. Using this measure, average GDP per capita in 2021 in the WB-6 was US$ 18,131 (€16,827), ranging from US$ 13,240 (€12,288) in Kosovo to US$ 22,787 (€21,148) in Montenegro. The average is around half that of the 11 EU member states of central, eastern and south-eastern Europe (EU-11), a little less than half the average among southern European countries, and just one-third of the most advanced European countries (Chart 1).[4]

Chart 1: The gap in living standards is large

GDP (PPP) per capita, current international dollars, 2021



Source: IMF World Economic Outlook (WEO), April 2023.

Note: Countries are ordered within subregions from highest to lowest. Luxembourg and Ireland are outliers in terms of GDP PPP per capita and are not included.

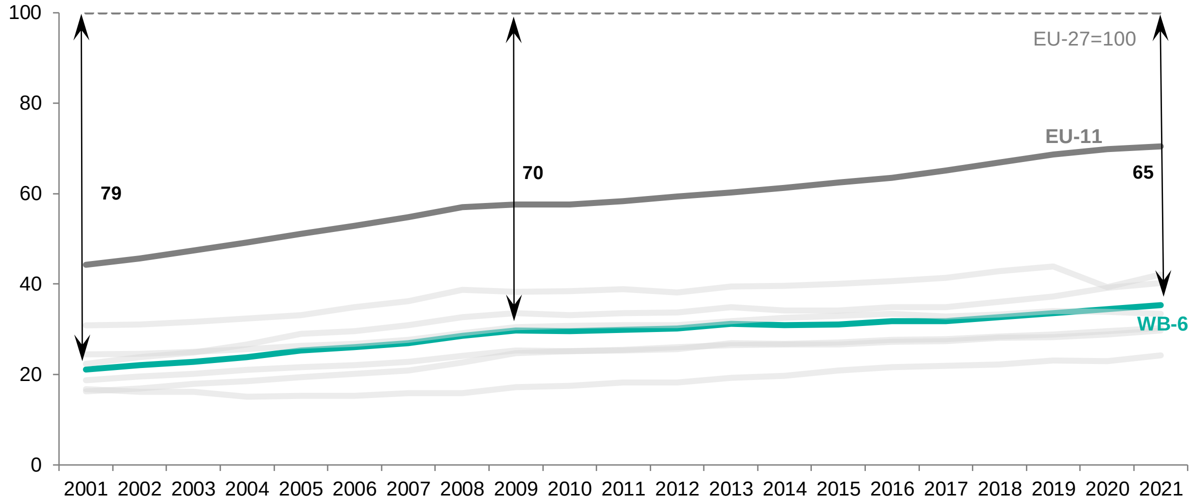
Some catch-up with EU living standards has taken place in the past two decades... (Chart 2). The (weighted) compound annual growth rate of the Western Balkans region between 2001 and 2021 was 3.6 per cent versus 0.9 per cent in those countries that now make up the EU (EU-27). As a result, the gap between the two regions has narrowed, with GDP per capita in the WB-6 moving from 21 per cent of the EU-27 average in 2001 to 35 per cent in 2021.

...but the speed of convergence has slowed over time. This period can be divided into two distinct phases: before the full impact of the global financial crisis (2001-08) and afterwards (2009-21). During the former period, compound annual growth (weighted average) in the WB-6 was more than four percentage points higher than in the EU-27 (6.0 versus 1.5 per cent). In the latter period, WB-6 growth was just 2.6 per cent, compared with 1.1 per cent in the EU-27.

[4] The EU-11 refers to the 11 former socialist countries from central Europe, the Baltic states and south-eastern Europe that joined the EU in 2004 or since then, namely: Bulgaria, Croatia, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, the Slovak Republic and Slovenia.

Chart 2: Convergence is happening, but the pace has slowed

GDP (PPP) per capita, constant 2017 international dollars, where EU=100



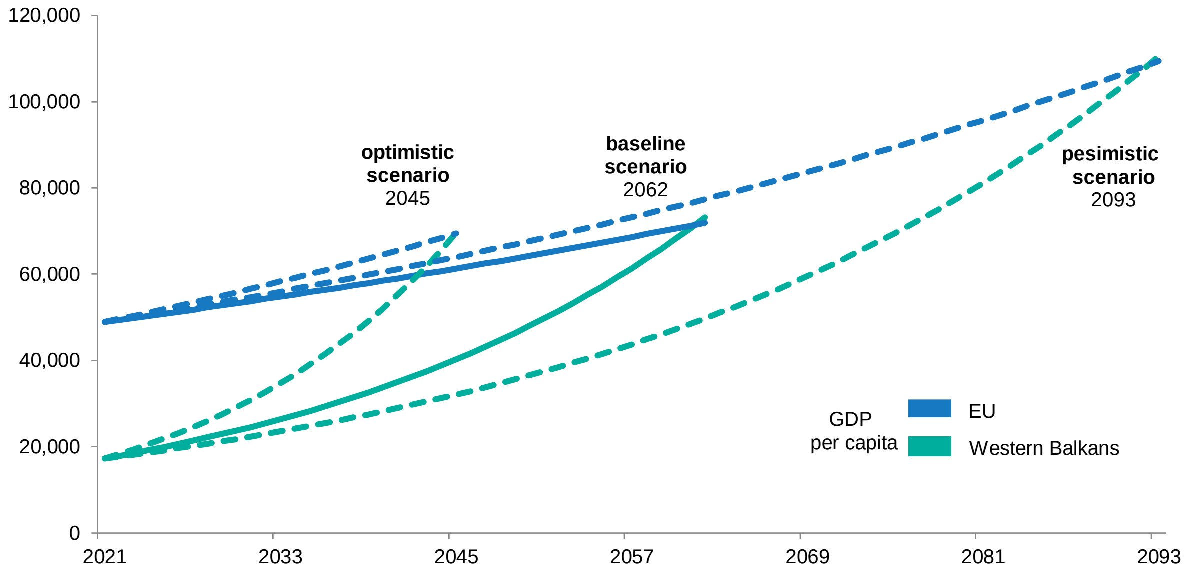
Source: IMF WEO, October 2022, and authors' calculations.

Note: The WB-6, EU-27 and EU-11 averages are weighted based on current values of GDP in 2021 at market exchange rates.

Catching up fully with average EU living standards will take several decades at least, and possibly 70 years or more. It is impossible to say with any certainty how long this catch-up process will last, or to be sure that the Western Balkans will one day converge fully on EU living standards. What we can do is construct some plausible scenarios and calculate how many years it would take under each one (Chart 3). In the best case, the growth differential between the WB-6 and the EU-27 returns to the level seen in the seven to eight years preceding the global financial crisis. Under this (highly) optimistic scenario, full convergence requires between two and three decades. A more realistic case is where the growth difference between the two regions is equivalent to the average over the period 2001-21. Then, the catch-up would be complete in some 40 years. And if, instead, the rather slow pace of growth seen in both regions since the global financial crisis is maintained year after year from now on, the WB-6 region would require around 70 years to converge in full with the EU-27. These illustrative calculations highlight the scale of the challenges facing the region.

Chart 3: Full convergence may take anywhere from a few decades to more than 70 years

GDP (PPP) per capita, constant 2017 international dollars



Source: IMF WEO, October 2022, and authors' calculations.

Note: Both Western Balkans and EU averages are weighted based on current values of GDP in 2021 at market exchange rates. The optimistic, baseline and pessimistic scenarios assume annual growth rates equal to the compound annual growth rates witnessed in the EU-27 and WB-6 for the 2001-08, 2001-21 and 2009-21 periods, respectively.

The fundamental problem facing Western Balkans economies is low productivity. The region has had decades of under-investment, most noticeably in infrastructure and the energy sector. Businesses face day-to-day problems, such as corruption, informality and a lack of public-sector administrative capacity that are deeply entrenched and therefore difficult to reform. Most countries in this region have also seen falling populations since the 1990s as a result of declining birth rates and large emigration outflows. The gap in labour productivity between the EU-27 and the WB-6 has barely changed since 2001, and not at all since 2009 (Chart 4), implying that the (limited) economic convergence that has taken place since then was driven by rising employment levels in the WB-6.[5]

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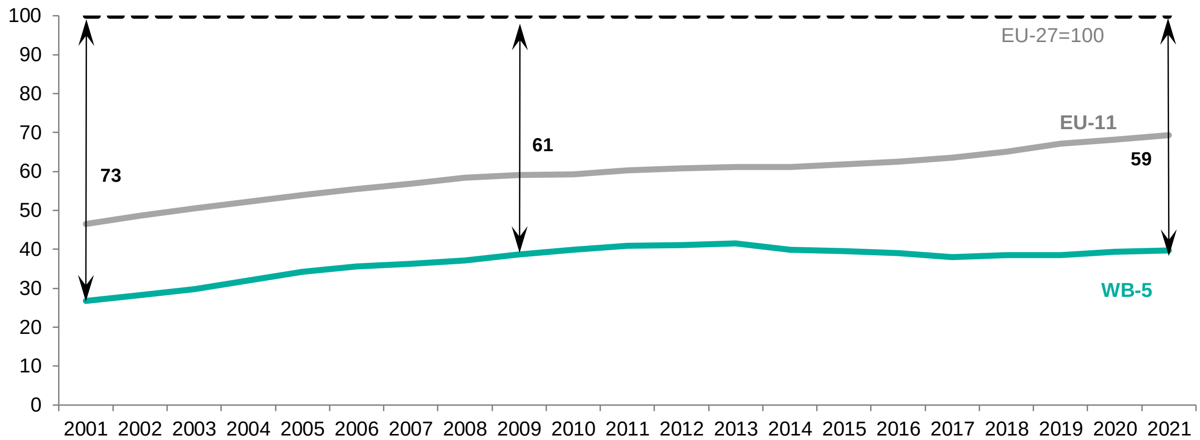
[5] Full incorporation of the recent (North Macedonia in 2021, Serbia in 2022, Montenegro in 2023) and planned population censuses may change the estimates of the productivity gaps as the number of workers may have declined more than estimated, but the trend is likely to remain similar. North Macedonia has already seen a big jump in measured productivity in 2022 due to this effect.

Chart 4: Labour productivity has flatlined relative to the EU since 2010

Output (GDP constant 2017 international dollars at PPP) per worker



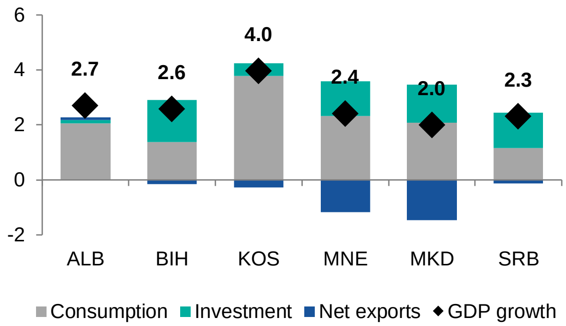
Source: International Labour Organization (ILO) and authors' calculations.
Note: The WB-5, EU-27 and EU-11 averages are weighted based on current values of GDP in 2021 at market exchange rates. The Western Balkans average does not include Kosovo due to a lack of comparable data.

A shift is needed from consumption towards private investment… The region has relied on private consumption as the main growth driver in the past decade (Chart 5). Investment levels are comparable to those in the EU as a per cent of GDP (Chart 6) but inadequate given the major needs of the region. Further private investment is needed for export-oriented firms and industries. The post-pandemic focus on geographic proximity and "near-shoring" could bring new opportunities for investors, provided the enabling conditions are in place. However, regional governments should be careful when using fiscal means to attract investment.[6] International evidence shows that these incentives are often costly for governments and cannot make up for the underlying deficiencies in investment conditions, including in the rule of law or public governance. They can also lead to competition among target countries that can heavily burden their respective budgets. Lastly, the uneven treatment of foreign and local companies can stifle investment by domestic entrepreneurs and lead to further emigration.

[6] For a recent comprehensive survey, see Columbia Center on Sustainable Investment (2022).

Chart 5: Private consumption has been the main growth driver in the past decade

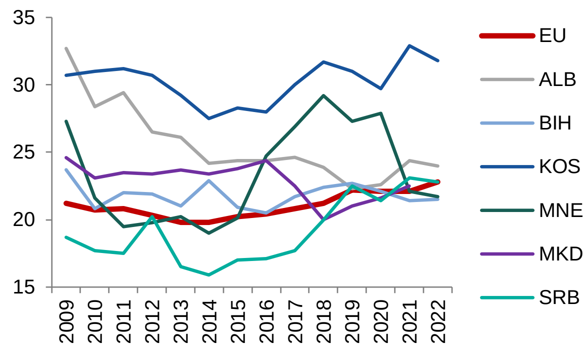
Contributions to GDP growth in 2012-22, average in real terms



Source: Eurostat and authors' calculations.

Chart 6: Investment as a percentage of GDP is low given the needs

In 2012-22, average GDP (per cent)



Source: Eurostat and authors' calculations.

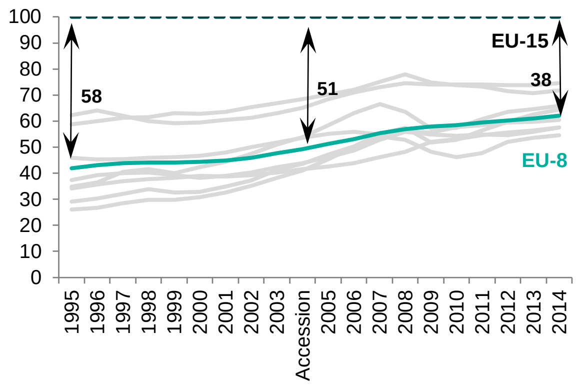
...but public investments are also important for short- and long-term economic growth. Public investments in infrastructure stood at 5.5 per cent of GDP on average in 2021, ranging from 3.5 per cent in Bosnia and Herzegovina to more than 7 per cent in Serbia and Albania. These investments have significantly increased over the past decade, although the region remains behind on the overall stock and quality of public infrastructure.[7] While the direct short-term effect on GDP is relatively modest, well-prioritised public investments can be effective in enhancing growth and employment in the long term, in particular at times of low growth, as they may stimulate additional private-sector investments in the medium term.[8,9] However, public infrastructure investment will be effective only if the necessary institutions exist to ensure the right projects are chosen; that is, those with high economic viability and careful allocation of limited public resources.[10]

Prospects of EU accession can accelerate convergence if accompanied by comprehensive reforms. To show this, consider the speed of convergence of the eight central and eastern European countries that became EU members in 2004 in the decade before their accession and in the following years in relation to the then 15 members of the EU (EU-15). Convergence was particularly rapid in the years immediately before and after accession, at a time when these countries were implementing a major reform agenda that was anchored by the prospect, and reality in 2004, of EU membership. Those countries, such as the Baltic states, that started from a lower base typically converged towards EU living standards more quickly, implying that they benefited most from the perspective of EU membership (charts 7 and 8).

[7] See Atoyan et al. (2018).
[8] See Bartlett et al. (2022).
[9] Recent estimates for the 10 central and eastern European countries suggest that at times of slow growth this fiscal multiplier is relatively large, at 1.46 over four years, with statistically significant effects on employment and private spending. See Petrović et al. (2021).
[10] See Bartlett et al. (2022) and Atoyan et al. (2018).

Chart 7: Convergence speeds up just before and just after joining the EU

GDP (PPP) per capita, constant 2017 international dollars, where EU=100

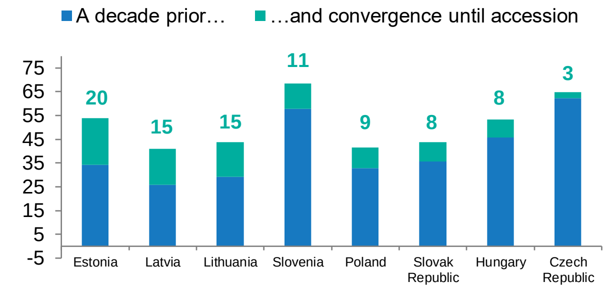


Source: IMF WEO, October 2022, and authors' calculations.

Note: EU-8 and EU-15 averages are weighted based on current values of GDP in 2021 at market exchange rates. The EU-8 comprises the eight central European and Baltic countries which joined the EU in 2004 – Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovak Republic and Slovenia. The EU-15 comprises the countries that made up the EU immediately prior to the accession wave in 2004.

Chart 8: Convergence tends to be more rapid for countries that started from a lower base

GDP (PPP) per capita, constant 2017 international dollars, where EU=100



Source: IMF WEO, October 2022, and authors' calculations.

Note: Due to data availability, a "decade" prior refers to nine years prior for the Czech Republic and Lithuania.

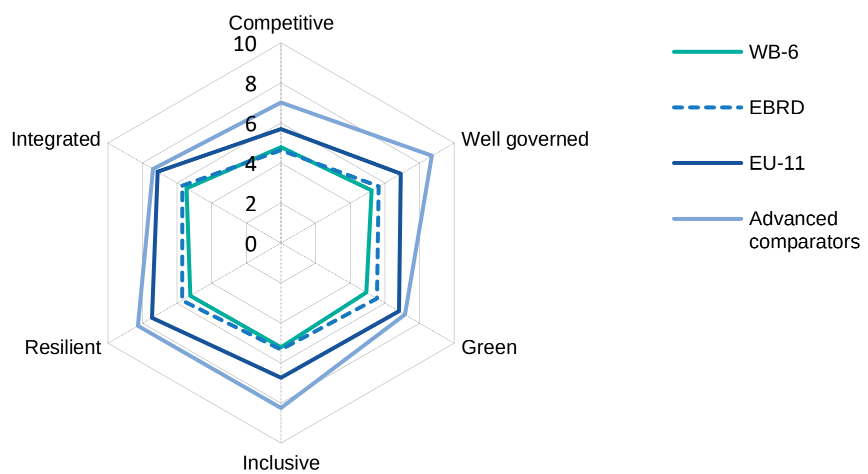
III. Which reforms are needed most? Introducing the EBRD's transition qualities

The Western Balkans region still faces a major reform agenda. Our assertion is based on an analysis of the EBRD's ATQs, a framework developed by the Bank in 2017 to judge the extent to which countries have moved towards well-functioning, prosperous and sustainable market economies. Each year, EBRD economists use a wealth of data and other information to measure progress in each country across six desirable qualities of a market economy: competitive, well governed, green, inclusive, resilient and integrated. The composite scores are calibrated from 1 (worst) to 10 (best) and are calculated not only for EBRD economies but also for selected comparators among the advanced Organisation for Economic Co-operation and Development (OECD) countries.

The WB-6 fall short on all six qualities. The region's average scores range from 4.79 for competitive to 5.46 for integrated, close to the overall average across the 36 EBRD economies in all six qualities but well below the averages for the EU-11, and even further behind when measured against the advanced comparator countries (Chart 9). The gaps are particularly large in the areas of governance, green and resilience, with smaller, although still significant, differences in competitive, inclusive and integrated.

Chart 9: Western Balkans countries lag behind the EU and other advanced comparators on all six transition qualities

1 (worst) to 10 (best)



Source: EBRD (2023) and authors' calculations.

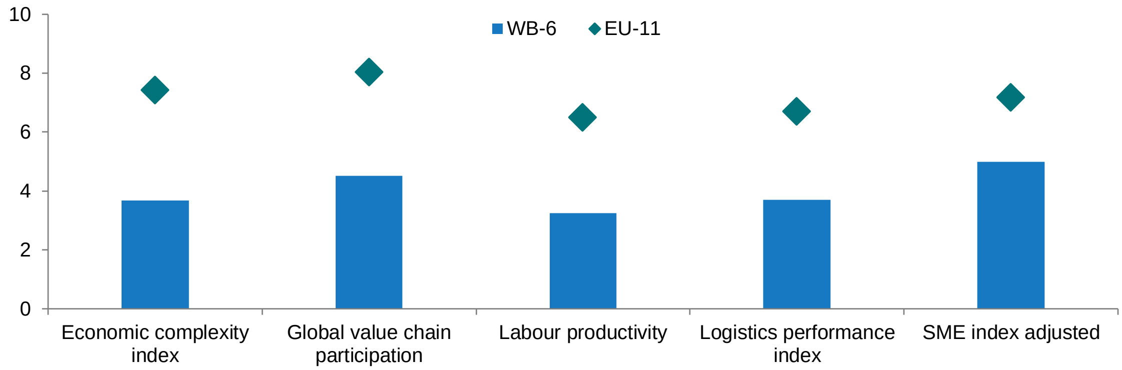
Note: Each quality is measured by the EBRD on a scale of 1 (worst) to 10 (best), according to a methodology described in EBRD (2023), with the latest scores available at https://2023.tr-ebrd.com/ (last accessed on 1 February 2024).

The region's low scores reflect a range of problems. Each ATQ is derived from a large number of indicators and data points. An inspection of the underlying data helps to reveal how the Western Balkans region is performing when set against the EU-11 (and against advanced comparators). In all six qualities, there are areas where the WB-6 countries score particularly poorly in relation to the EU-11, thus holding back convergence and sustainable growth.

Low competitiveness scores reflect weak labour productivity, a lack of complexity and logistics support, and a poor environment for small and medium-sized enterprises (SMEs). Labour productivity has been stagnant in the region for the past decade, implying that economic growth has come from higher employment rather than greater efficiency in production. In several countries, the state still plays an outsize role in the economy, and productivity in SOEs is typically well below that of private companies. Most exports from the region are low in complexity and value added, although this is improving gradually in some countries. Meanwhile, SMEs face pervasive and long-standing problems in doing business, such as unfair competition from the informal sector (the number one obstacle in many business surveys), difficulties in accessing finance on reasonable terms, and barriers to international trade and integration (Chart 10).

Chart 10: Selected indicators of the "competitive" quality

1 (worst) to 10 (best)



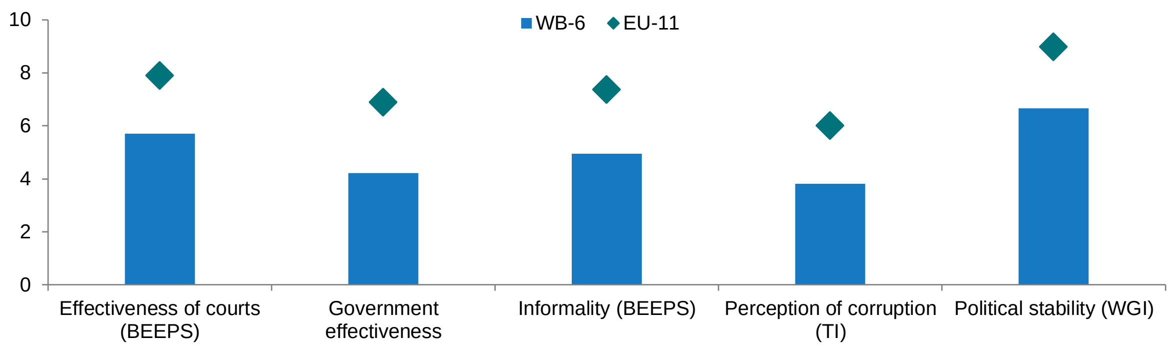
Source: EBRD (2023) and authors' calculations.

Note: Each quality is measured by the EBRD on a scale of 1 (worst) to 10 (best), according to a methodology described in EBRD (2023), with the latest scores available at https://2023.tr-ebrd.com/ (last accessed on 1 February 2024).

Governance is a major weakness at national and corporate levels. Western Balkans countries typically score badly relative to EU countries when it comes to rule of law, effectiveness of governments and the courts, and corruption (Chart 11). Deficiencies in property rights, including in regard to intellectual property, also stand out as an important deterrent to investors. Any progress in this area has been very limited; overall, the regional score on this quality worsened between 2016 and 2023 (although Montenegro and Serbia recorded some minor improvements), in contrast with the other transition qualities, for which scores have generally risen over the same period. Standards of corporate governance in the Western Balkans also lag behind best practice, with major weaknesses in stakeholder rights, transparency and disclosure.

Chart 11: Selected indicators of the "well governed" quality

1 (worst) to 10 (best)



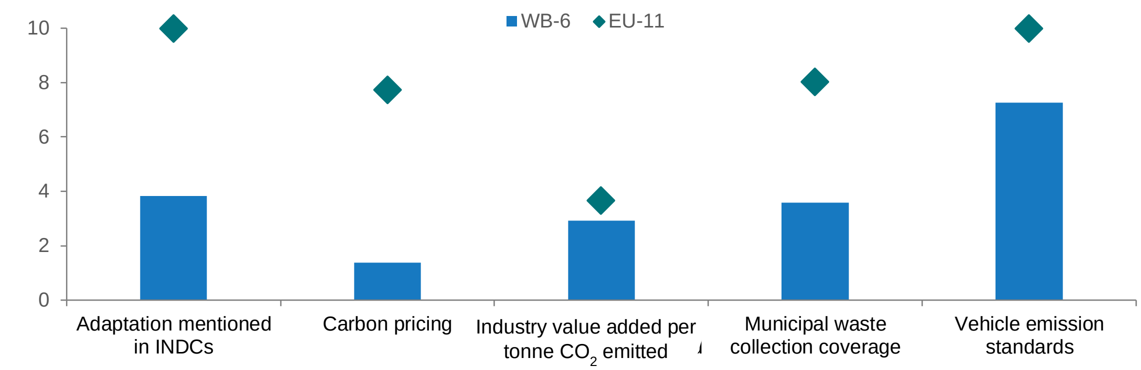
Source: EBRD (2023) and authors' calculations.

Note: Each quality is measured by the EBRD on a scale of 1 (worst) to 10 (best), according to a methodology described in EBRD (2023), with the latest scores available at https://2023.tr-ebrd.com/ (last accessed on 1 February 2024).

The region faces huge green challenges. Measures to mitigate the damage from climate change are urgently needed, given the currently high level of carbon dioxide (CO_2) emissions. As the dependence on fossil fuels grows more unreliable and insufficient, greening the energy sector is becoming crucial for the region's resilience and continued competitiveness on export markets. It is questionable, however, whether the Western Balkans countries have the institutional and regulatory capacity to implement complex measures such as carbon pricing and a "just transition" (retraining and compensating affected population groups and regions in the transition from fossil fuels to renewables). The region also performs badly on coverage of municipal waste collection and protection of important terrestrial areas (Chart 12).

Chart 12: Selected indicators of the "green" quality

1 (worst) to 10 (best)



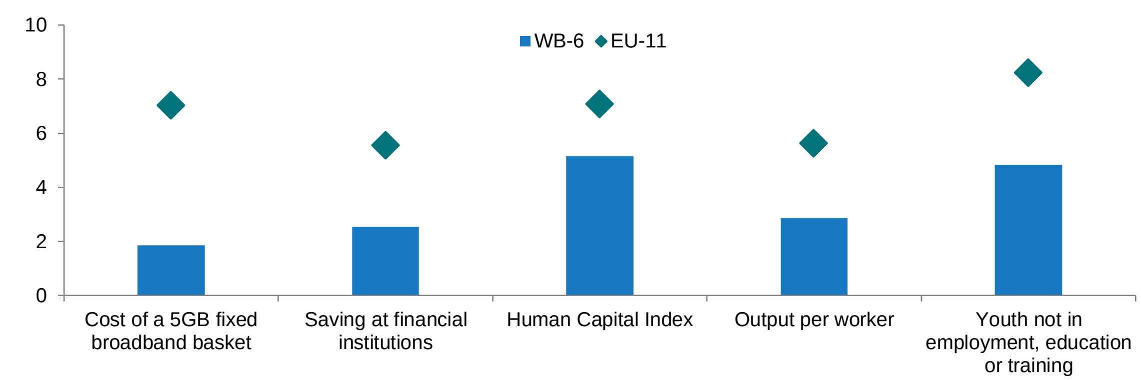
Source: EBRD (2023) and authors' calculations.

Note: Each quality is measured by the EBRD on a scale of 1 (worst) to 10 (best), according to a methodology described in EBRD (2023), with the latest scores available at https://2023.tr-ebrd.com/ (last accessed on 1 February 2024).

Skills and access to services need greater attention. The region has lower labour participation rates than the EU-11 average and a relatively high percentage of young people not in education, employment or training (NEETs). The relatively low score on the World Bank's Human Capital Index highlights how current health and education outcomes are hindering the productivity of the next generation of workers.[11] Lower levels of skills, in particular digital, are a result of inefficiencies in the education and training sectors and vulnerabilities in the labour market. Access to services is also problematic, with sanitation, savings in financial institutions and the cost of broadband all areas where particular deficiencies have been identified (Chart 13).

Chart 13: Selected indicators of the "inclusive" quality

1 (worst) to 10 (best)



Source: EBRD (2023) and authors' calculations.

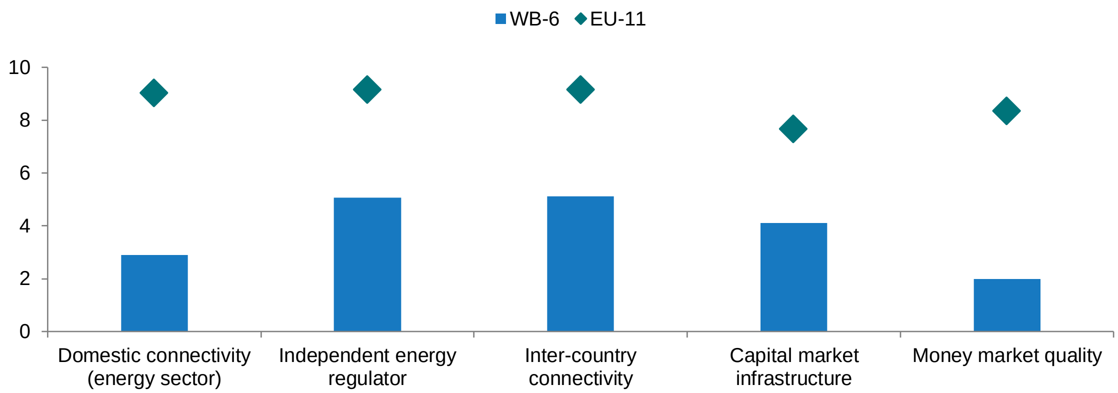
Note: Each quality is measured by the EBRD on a scale of 1 (worst) to 10 (best), according to a methodology described in EBRD (2023), with the latest scores available at https://2023.tr-ebrd.com/ (last accessed on 1 February 2024).

[11] World Bank (2020).

Strengthening resilience will require improvements in energy regulation and a deepening of financial markets. The ATQ for resilience covers two themes: energy and the financial sector. All measures of energy-resilience factors in the WB-6 point to major weaknesses relative to the EU-11, because of limited progress in the regulatory framework, a lack of private-sector participation in the sector, and limited inter-country connectivity. Financial-sector resilience could be enhanced by boosting the money and capital markets, widening the investor base in financial instruments and strengthening risk management, corporate governance and supervision standards in financial institutions (Chart 14 and Box 1).

Chart 14: Selected indicators of the "resilient" quality

1 (worst) to 10 (best)



Source: EBRD (2023) and authors' calculations.

Note: Each quality is measured by the EBRD on a scale of 1 (worst) to 10 (best), according to a methodology described in the EBRD (2023), with the latest scores available at https://2023.tr-ebrd.com/ (last accessed on 1 February 2024).

Box 1: The financial sector: relatively healthy but not deep enough to accelerate convergence

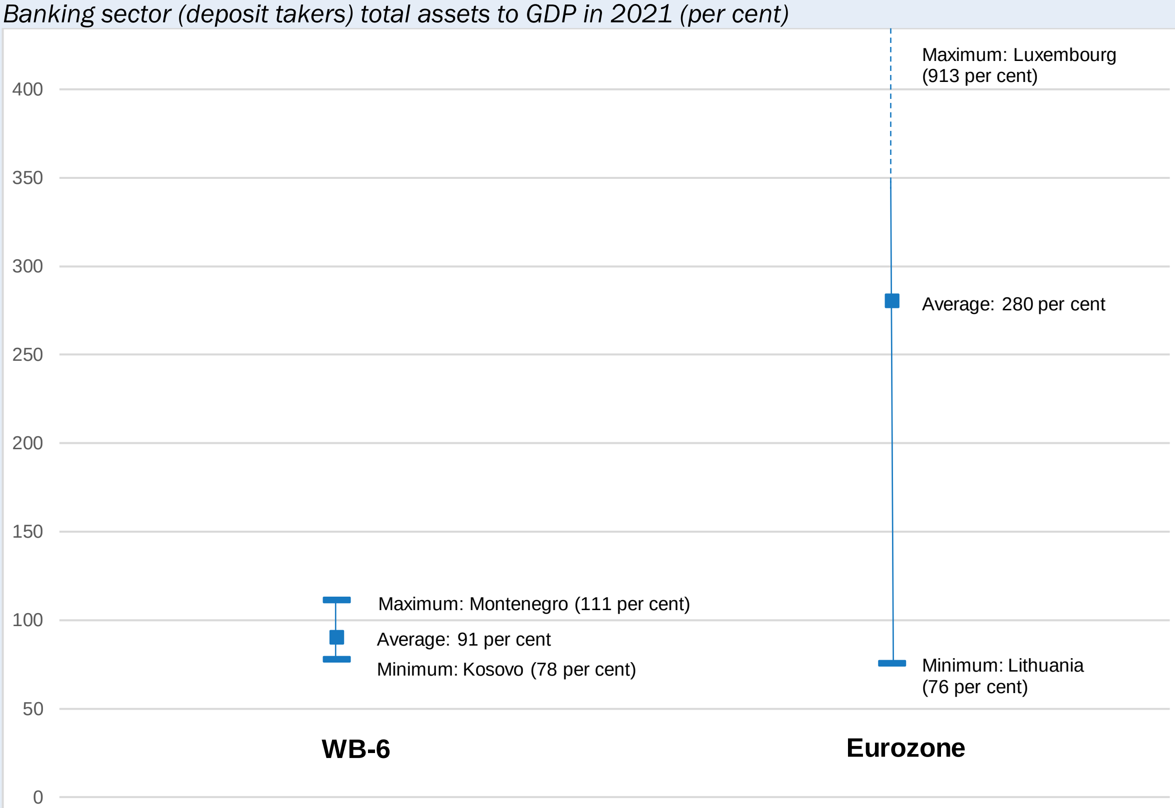
Financial sectors in the Western Balkans are dominated by banks... The banking sector is dominant in the Western Balkans, making up 80 to 90 per cent of the financial sectors' total assets, except in Kosovo (68 per cent in 2020), where there is a sizeable and growing private pension-fund sector.[12] Other financial intermediaries (including insurance companies, pension and investment funds or stock exchanges) generally play a minor role in providing financing for the economy.

...and most banks are foreign owned. Banks in the Western Balkans region are mostly owned by foreign (primarily EU) parent banks. This ownership structure helped in terms of introducing modern business models and information and communication technology (ICT) systems, but also contributed to overleveraging in the run-up to the global financial crisis, demonstrated by high loan-to-deposit ratios. The Vienna Initiative, established in 2009 by the EBRD, EIB, European Commission, IMF and World Bank, helped prevent disorderly deleveraging by parent banks in central, eastern and south-eastern Europe, thus preserving financial stability after the global financial crisis. Commercial banks in the Western Balkans have now reached healthy ratios of capitalisation and liquidity , relying largely on their deposit bases.

Banking sector penetration is still relatively low. Financial sector depth (measured as total assets or private-sector credit of the financial or banking sector) is usually positively correlated with economic development, and causality runs in both directions.[13] Financial depth, however, can reach excessive levels: some of the countries with the highest ratios of private-sector credit to GDP in 2010 (Cyprus, Ireland, Spain, the Netherlands, Portugal, the United Kingdom, Luxembourg, and Switzerland) have had major crisis episodes since 2008. The Western Balkans average of banking sector assets, at below 100 per cent of GDP, is far from these levels and much lower than the eurozone average of 280 per cent of GDP (Chart 15).

Chart 15: Banking sector penetration remains low in the region

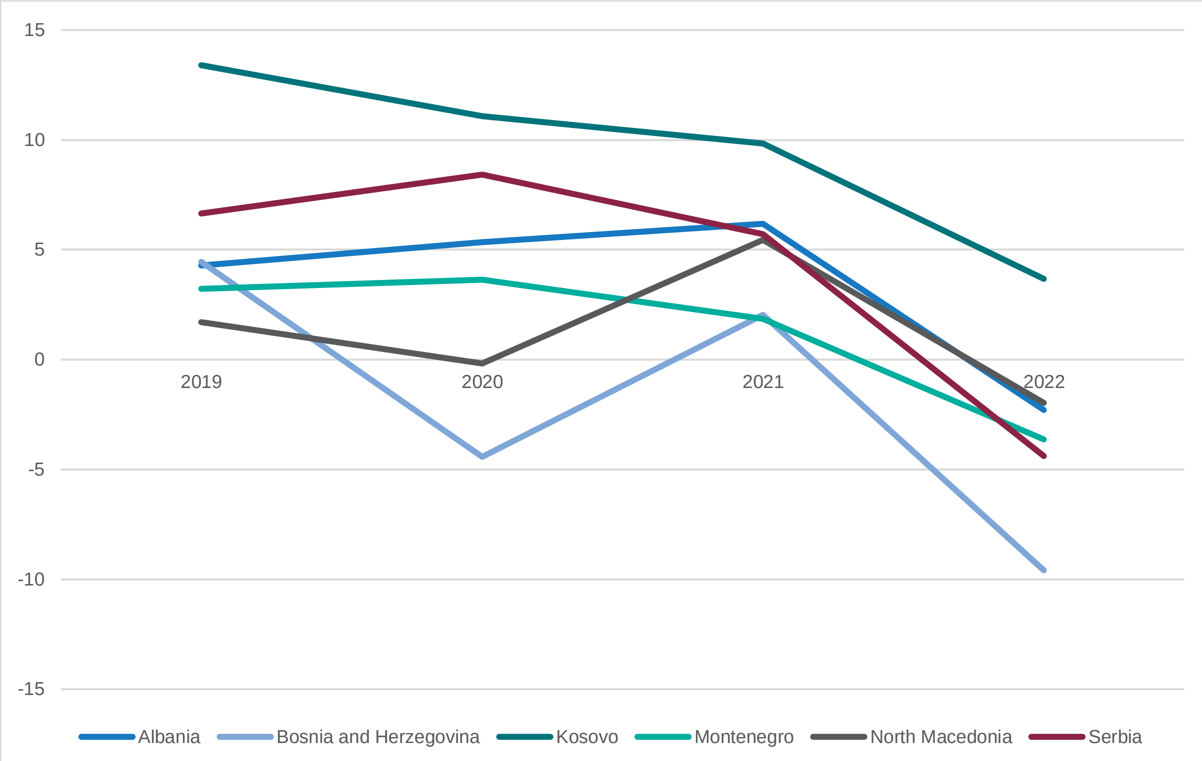
Banking sector (deposit takers) total assets to GDP in 2021 (per cent)



Source: IMF Financial Soundness Indicators (FSIs).

12 See OECD (2022b).
13 See Sahay et al. (2015).

Chart 16: Corporate credit has slowed as the effects of government support programmes fade
Real corporate credit growth in per cent, average annual consumer price index (CPI) used as deflator



Sources: IMF FSIs, Eurostat, national central banks and statistical offices.

The banking sector is well capitalised and liquid, and non-performing loans have fallen to low levels… The ratio of regulatory capital to risk-weighted assets ranged from 15 per cent (Kosovo) to 20 per cent (Serbia) in 2022, similar to levels in EU countries. Banks in the region are liquid and financed mainly by deposits, as indicated by a ratio of liquid to total assets ranging from 21 per cent (North Macedonia) to 38 per cent (Serbia) in 2022, generally higher than in the EU. This indicates ample liquidity buffers and the potential to further expand financing activities. Non-performing loans have reached low levels, from 1.9 per cent in Kosovo to 6.3 per cent in Montenegro, comparable to those in central, eastern and western Europe.[14]

…but corporate credit growth has been slowing. Banking sector indicators suggest a good basis for increasing financing activities, but the economic outlook (including the slowdown in the main export markets) is currently not supportive. A recent EIB banking survey indicates that banks are set to maintain tight credit conditions in the near future.[15] Corporate credit was supported by government programmes during Covid-19, but slowed and reached negative real growth rates in 2022, except in Kosovo (Chart 16).

Underdeveloped capital markets lack the scale required to finance the region's investment needs. Non-bank financial intermediaries (for example, insurance, leasing or factoring companies) and institutional investors (for example, investment or pension funds) have minimal roles in providing financing to the corporate sector, and organised financial markets (corporate and government bond markets, or stock exchanges) are illiquid. This limits available financing alternatives for larger corporates, while the lack of availability of early capital financing (seed or venture, for example) constrains the growth opportunities for promising SMEs.

[14] See IMF FSIs: https://data.imf.org/?sk=51B096FA-2CD2-40C2-8D09-0699CC1764DA&sId=1390030341854 (last accessed on 1 February 2024).
[15] See EIB (2023).

SMEs still face difficulties in accessing finance. Large-scale liquidity measures, subsidised credit lines and scaled-up state-backed credit guarantee schemes helped support SME lending during and after Covid-19. Sustainable economic growth requires access to affordable finance, enabling investments and improving competitiveness. According to the most recent EBRD-World Bank Business Environment and Enterprise Performance Survey (BEEPS VI), SMEs still have more difficulty accessing finance than corporates do, as evidenced by a loan rejection rate of 45 per cent for SMEs versus 31 per cent for corporates.[16] An analysis by EBRD economists proposes targeted intervention to support SME liquidity needs, using case-by-case assessments of individual firms' debt capacity information from credit bureaus and registries. Government initiatives to roll over existing debt (for example, debt moratoriums and loan-maturity extensions) instead of providing fresh debt might better serve SMEs with excess indebtedness.[17]

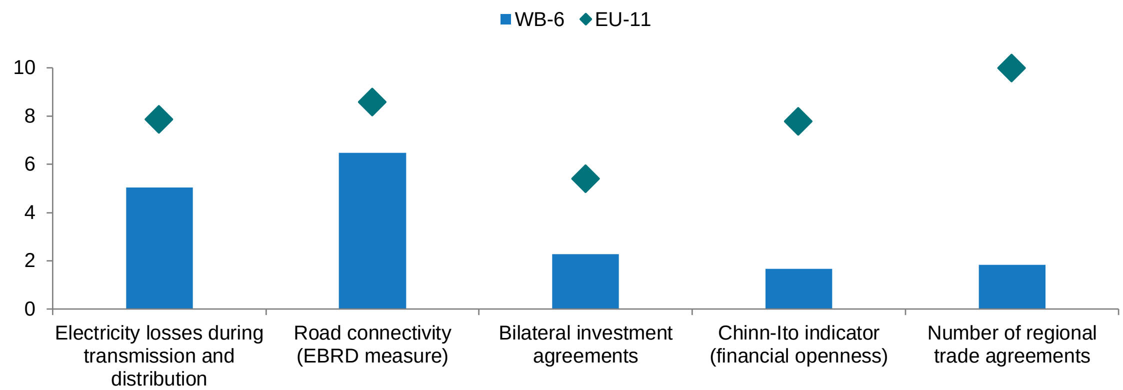
Developing green finance markets would help the regional green agenda. Dedicated green finance instruments and markets could help finance the sizeable investment needs in the region. Better alignment of fiscal, economic and environmental policies, gradually eliminating public subsidies on economic activities with a high carbon footprint, and introducing effective carbon taxation would be important first steps. To enable financial institutions to introduce new green instruments, regulators need to develop sustainability strategies, green taxonomies and climate and environment risk-assessment methodologies. Mobilising private capital towards climate mitigation and adaptation is key to establishing green financing instruments and markets. Financial authorities, in cooperation with corporates and financial market participants, could develop green finance guidelines for securities issuances and establish minimum entry requirements for independent assessors, ratings or verification services. Given the nascent state of corporate bond markets, fiscal incentives for market participants may also be necessary.[18]

Integration into global markets should be speeded up. The legacy of decades of under-investment and slow reforms has left the region with transport and energy infrastructure that is often dilapidated and not fit for purpose. Unreliable electricity supply is sometimes a concern for businesses and households alike. Road connectivity across borders is also problematic, exacerbated by barriers at the borders. But the region is also in danger of lagging behind on new technology such as internet coverage and affordable broadband. Total trade volumes in most cases are still significantly below potential, and the main exported goods remain of low value added, despite some increases in complexity. Foreign direct investment (FDI) inflows in recent years exceed those of the EU-11 relative to GDP, but the stock of FDI remains significantly smaller. Further attracting foreign capital and better integrating foreign companies into domestic supply chains would help to boost exports, in particular those of local SMEs as they face particular difficulties in accessing more developed export markets (Chart 17).

[16] See https://www.beeps-ebrd.com/ (last accessed on 5 February 2024).
[17] See Stepanov et al. (2020).
[18] See World Bank (2021).

Chart 17: Selected indicators of the "integrated" quality

1 (worst) to 10 (best)



Source: EBRD (2023) and authors' calculations.

Note: Each quality is measured by the EBRD on a scale of 1 (worst) to 10 (best), according to a methodology described in EBRD (2023), with the latest scores available at https://2023.tr-ebrd.com/ (last accessed on 1 February 2024).

IV. Boosting convergence: a three-pronged approach to reforms

A comprehensive and regional approach to reforms and growth is needed for long-term sustainable growth. Individually, the Western Balkans countries are small and, by not being part (yet) of a regional powerhouse like the EU, they suffer from inadequate market size, substantial border frictions and limited attractiveness to foreign investors. But together, the region has a substantial presence, with a population of more than 17 million and a GDP of around €120 billion. A collective and coordinated approach to the fundamental issues facing the region's economies, as presented in the previous section, showing a common willingness to tackle long-standing problems, would be a catalyst for a rapid increase in investment and growth.

Common problems affect all countries in the region. Many of the most fundamental obstacles to investment and doing business are present in most or all countries. These include an excessive state presence in the economy with oversized state institutions, severe weaknesses in public administration and institutional quality, a lack of skills (in part due to the ongoing brain drain), poor-quality transport infrastructure, high levels of pollution and an over-reliance (in most countries) on fossil fuels. For that reason, policies that work in one country have a good chance of being successful elsewhere in the region as well.

A targeted and selective approach is needed. The past decades have often seen efforts towards a comprehensive reform programme founder on the back of a lack of focus, insufficient capacity to implement, and changes in political direction and personnel. The approach we suggest below is more targeted. Recognising the interrelations among the six qualities discussed earlier, we propose a three-pronged approach to reforms.

First, improve standards of governance. The lack of proper governance in public institutions is probably the most difficult problem to address because it is long standing, pervasive and affects virtually all aspects of life. The result is a malfunctioning economy that encourages young people to seek better opportunities abroad and leaves behind whole communities often isolated in less populated parts of the country. But the experience of other countries shows that lasting improvements can be made, with the right determination and commitment and leveraging the new opportunities opened up by the digital revolution.

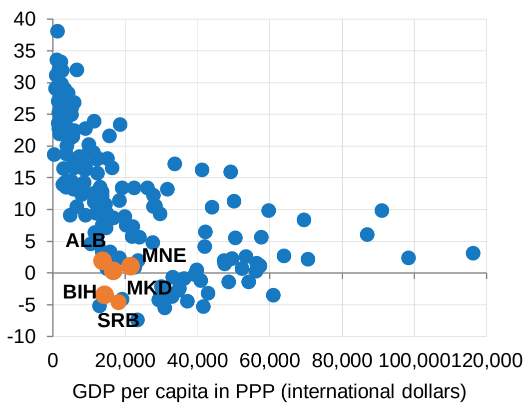
Second, open economies further to trade and investment. Countries in this region should strive as hard as possible to increase their attractiveness to investors willing to either set up businesses in the region or to involve existing companies in global value chains. This could be achieved by strengthening the quality and impartiality of public institutions and services, and further improving the business environment. Part of this agenda must also involve attracting private know-how and investment into formerly, or currently, state-run companies. Other necessary actions include stepping up investment in transport infrastructure and removing barriers to trade on the borders.

And third, go green. The advantages of doing so – and the costs arising from delay in terms of climate damage – are well known by now. What is perhaps less well appreciated is the potential the region has, particularly in wind, solar and hydro projects. A decisive move towards renewables and carbon neutrality, along with the appropriate regulation, would strengthen the region's resilience to future energy shocks. For exporters, it would also mitigate or eventually eliminate the negative consequences of carbon border taxes soon to be introduced in the EU.

V. Better governance can help overcome adverse demographic trends

The population of the Western Balkans is declining. The reason is twofold: a higher number of deaths than natural births each year in some countries, and constant net emigration. The rate of natural population change is significantly lower in this region than in most upper-middle- and high-income countries (Chart 18). Prior to the pandemic, in 2019, Bosnia and Herzegovina and Serbia had negative rates of natural population change, meaning that more people died each year than were born. This is a particular issue for Serbia which now has an old age dependency ratio equivalent to the EU average (Chart 19).[19,20] Albania and North Macedonia also had more deaths than births in 2021. This trend is likely to continue and may even worsen, according to United Nations (UN) forecasts. Together with net outward migration, this contributes to the shrinking of the working-age population.

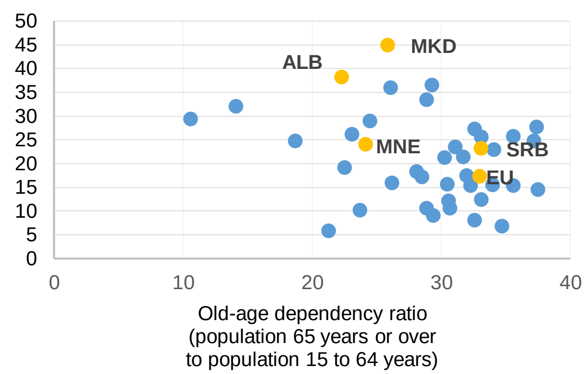
Chart 18: The annual rate of natural population change is more negative than in most other countries with similar GDP per capita
Natural population change in 2019 (per cent)



Source: IMF WEO, UN World Population Prospects.

Note: Kosovo is excluded due to a lack of comparable data.

Chart 19: The old-age dependency ratio is bound to increase as the population rapidly ages
Increase in the share of population aged 65 and older in the last decade, per cent (2022 or the latest available data)



Source: Eurostat and authors' calculations.

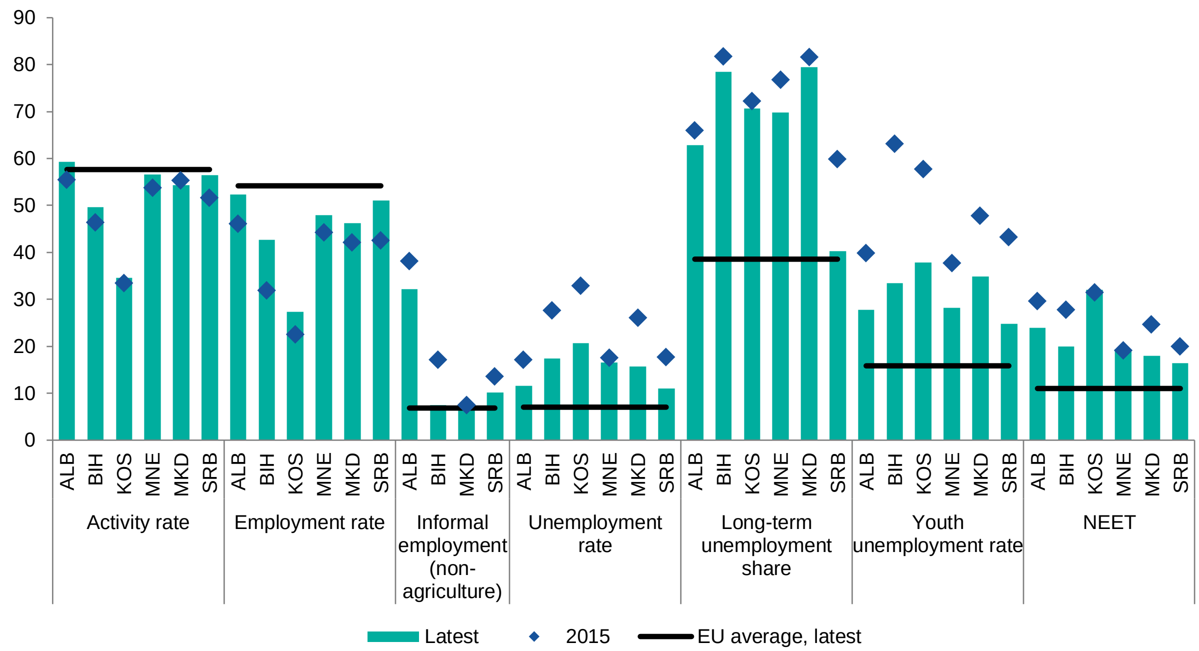
An ageing population poses an increasing burden. Low birth rates and higher life expectancies are transforming the age pyramid towards an older population structure. As the population ages, fewer workers enter the labour force while more workers enter retirement. This will eventually put pressure on both the state and the working-age population due to a rise in accumulated pension obligations, reducing the economy's competitiveness. The increased burden posed by an ageing population can be tackled only by raising living standards and hence pensioners' savings ahead of retirement. Policies are needed, therefore, to boost labour productivity, increase labour force participation and immigration, promote lifelong learning and lengthen working lives.[21]

Human capital potential is further held back by high levels of inactivity and other labour-market problems. Since 2012, most countries in the region have recorded significant increases in employment and falling unemployment.[22] Despite this good progress, labour-force participation in the Western Balkans is lower than in EU comparators, unemployment is higher (especially for long-term and youth unemployment), and the share of NEETs is nearly double the EU average (Chart 20). Key underlying issues include the low participation rates of

[19] The old age dependency ratio is the ratio (expressed as a percentage) between the number of people aged 65 and over (the generally economically inactive population) and the number of working-age people (aged between 15 and 64).
[20] See Eurostat: http://bit.ly/49dYZeL (last accessed on 1 February 2024).
[21] See EBRD (2018).
[22] See WIIW and World Bank (2020).

women (Chart 21) and youth, weak government capacity to enforce rules (and hence widespread informality in the labour market) and, in some countries, high labour taxation and social security contributions. Women continue to undertake a hugely disproportionate amount of unpaid work in the household without the right support for balancing work and family-related responsibilities. Improving accessibility, affordability and quality of care facilities, therefore, could help increase women's labour force participation.

Chart 20: Labour-market outcomes have improved but remain worse than in the EU
In per cent



Source: World Bank World Development Indicators (WDIs), Vienna Institute for International Economic Studies (WIIW) SEE Jobs Gateway, Eurostat, ILO and authors' calculations.

Note: Latest year is 2022 or 2021 depending on data availability. Kosovo is excluded from the informal employment figure due to a lack of comparable data.

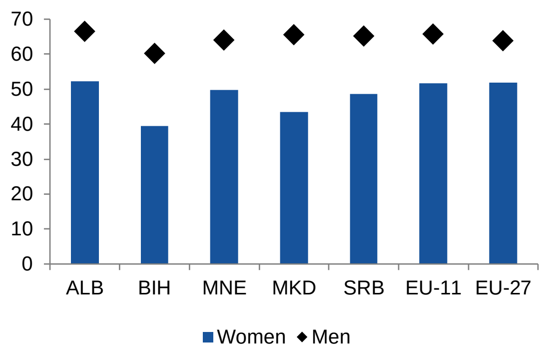
High levels of youth unemployment are driven by low-quality education, skill mismatches and a difficult transition from school to work. Formal educational attainment in the region is relatively high; the proportion of the population within the age group 25 to 64 years with completed upper-secondary education was higher in Serbia and Montenegro (82.3 and 87.6 per cent respectively in 2020) than in the EU-27 (79 per cent on average).[23] However, "learning-adjusted" years of schooling are below those of the EU, and the region generally underperforms on international student assessments such as the Trends in International Mathematics and Science Study (TIMSS) and the Programme for International Student Assessment (PISA) (Chart 22).

Furthermore, employment rates of those recently graduated from school are relatively low, suggesting that education does not equip young people with the skills required by the labour market.[24] Evidence further suggests that outdated educational curricula contribute to skill mismatches, while opportunities to gain practical skills are limited and the integration of university into research and innovation is insufficient.[25] On the private-sector side, the limited availability of on-the-job training may be an additional constraint – hence the high rates of youth unemployment and NEETs. Enhancing the quality of the labour force by reforming and

[23] See Eurostat https://ec.europa.eu/eurostat/databrowser/view/tps00065/default/table?lang=en&category=t_educ.t_educ_outc (last accessed on 8 February 2024).
[24] In Serbia, the employment rate of young people who graduated one to three years ago was 60 per cent in 2021, compared to 74 per cent in the EU. See Eurostat: https://ec.europa.eu/eurostat/databrowser/view/EDAT_LFSE_24__custom_3712146/default/table?lang=en (last accessed on 1 February 2024).
[25] See European Training Foundation (2019).

modernising the education systems, encouraging higher take-up of science, technology, engineering and mathematics (STEM) courses and better linking vocational education with the private sector would enhance the attractiveness of the region to foreign investors.[26]

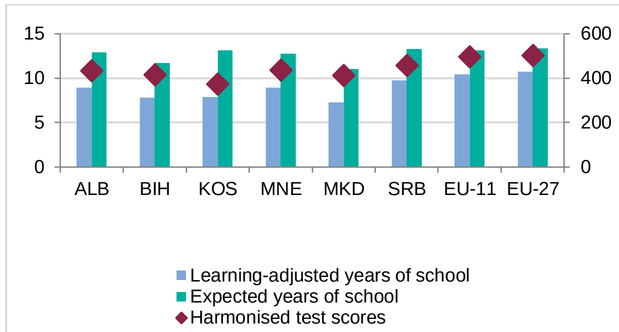
Chart 21: Sizeable gap in the labour force participation between women and men
Labour force participation rate (per cent)



Source: ILO.

Note: Kosovo is excluded due to a lack of comparable data.

Chart 22: Education gaps contribute to poor performance of youth on the labour market
Years of schooling and harmonised TIMSS-equivalent test scores, 0-650



Source: World Bank.

Emigration has shrunk the labour force. Approximately one-fifth of the population born in the Western Balkans currently lives abroad, mostly concentrated in wealthy western European countries and the United States of America.[27] The estimated share of emigrant stocks to total population ranges from 14 per cent in Serbia to 51 per cent in Bosnia and Herzegovina.[28] Western Balkans intraregional migration stands at around 15 per cent of the total regional migrant stock, with Serbia having the highest level of inward migration from other WB-6 countries.[29] In the short term, emigration pressures are likely to remain strong. Family migration is an important pull factor for those thinking of emigrating, in particular in economies with large and strong diaspora networks such as Albania, Bosnia and Herzegovina and Kosovo. According to a recent Gallup poll, Albania was among the 10 countries in the world where at least half of the population would like to move abroad, followed by Kosovo where nearly half of people expressed the same inclination, in both 2018 and 2021.[30]

Emigration has positive and negative economic impacts on the home country. Those who leave typically end up in blue-collar jobs abroad; over-qualification, defined as having formal education that is higher than what is required for the occupation held, is widespread. But while the outward flow of often well-educated people is typically seen as a brain drain, there is some recent evidence of brain gain in Montenegro, North Macedonia and Serbia, in particular as students studying abroad return after graduating.[31] For those who stay abroad, the remittances they send back, at 10 per cent of GDP on average, are a substantial source of income and poverty alleviation for households at home. At the same time, remittances may also reduce the incentive to work, contributing to the low labour force participation rates discussed earlier, especially among women.[32] Investments from the diaspora remain sporadic and do not have a systemic impact on the economic development of the home country. Potential investors among the diaspora often cite lack of trust in public institutions as one of the key reasons why they choose not to invest in their home country.[33]

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[26] See Jovanovic et al. (2021).
[27] See OECD (2022a).
[28] See UN DESA: https://www.un.org/development/desa/pd/content/international-migrant-stock (last accessed on 1 February 2024).
[29] See UN DESA: https://www.un.org/development/desa/pd/content/international-migrant-stock (last accessed on 1 February 2024).
[30] See https://bit.ly/3ublP88 and https://bit.ly/3OvGU3Q (both last accessed on 5 February 2024).
[31] See Leitner (2021). For more details on the profile of emigrants per country, also see Regional Cooperation Council (2021).
[32] See WIIW (2018).
[33] See OECD (2022a).

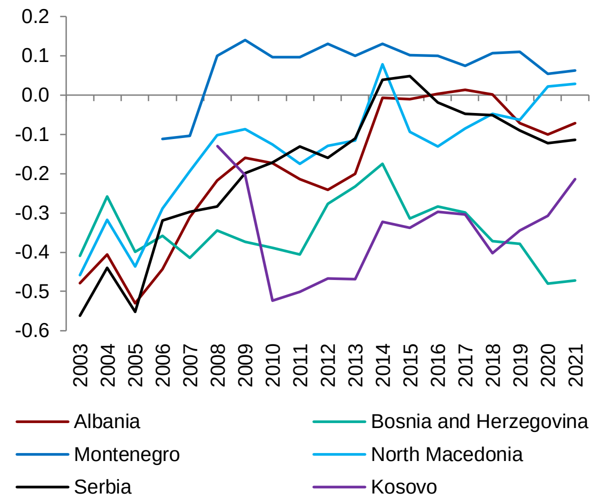
Chart 23: Governance standards continue to lag behind those in the EU...

On a scale of -2.5 (the worst) to 2.5 (the best), 2021

Source: World Bank WGIs and authors' calculations.

Chart 24: ...with limited improvement, or even deterioration, in recent years

Average score across the WGIs' six dimensions, on a scale of -2.5 (the worst) to 2.5 (the best)



Source: World Bank WGIs and authors' calculations.

Poor governance is a key driver of emigration.[34] According to an OECD survey of current and past migration experience in the Western Balkans, corruption or political instability in the home country is the most important reason for emigrating.[35] Out of 13 reasons offered, 66.7 per cent of respondents ranked corruption or political instability in their home country as very important, while 19.2 per cent deemed it important. The share of respondents choosing those two options is higher among those who emigrated in the last five years than those who emigrated earlier. Better employment opportunities ranked as the second most important reason for emigration, followed by higher salaries. Similar results emerge from a recent study by the Fiscal Council of Serbia. Their research shows that improving institutions, including by decreasing corruption and strengthening the rule of law, and advancing the quality of public services such as education and healthcare, could decrease the level of emigration to western European countries by 10-15 per cent over a five-year period – much more than the impact of an increase in the average salary level.[36,37]

Governance standards in the Western Balkans have stagnated or worsened. According to the World Bank's Worldwide Governance Indicators (WGIs), which measure the quality of public institutions across six different dimensions,[38] the Western Balkans region has a long way to go before reaching the level of governance standards in the EU (Chart 23). By this measure, standards improved in the first decade of the 21st century, but have stagnated or gone backwards since then in most WB-6 countries (Chart 24).

Government effectiveness is weak. This problem is particularly severe in Bosnia and Herzegovina, but also present in other WB-6 countries, as it was in Bulgaria and Romania immediately prior to their EU accession (Chart 25). Public administration in the region has long been regarded as inefficient and lacking capacity. As regularly emphasised in EU progress reports, this reflects the lack of merit-based recruitment, competence, accountability and independence of civil servants. Further evidence of the prevalence of cronyism comes from the latest round of the EBRD-World Bank Life in Transition Survey, carried out in 2022. In response to a question about the most important factor for success in life, 38 per cent of respondents in the Western

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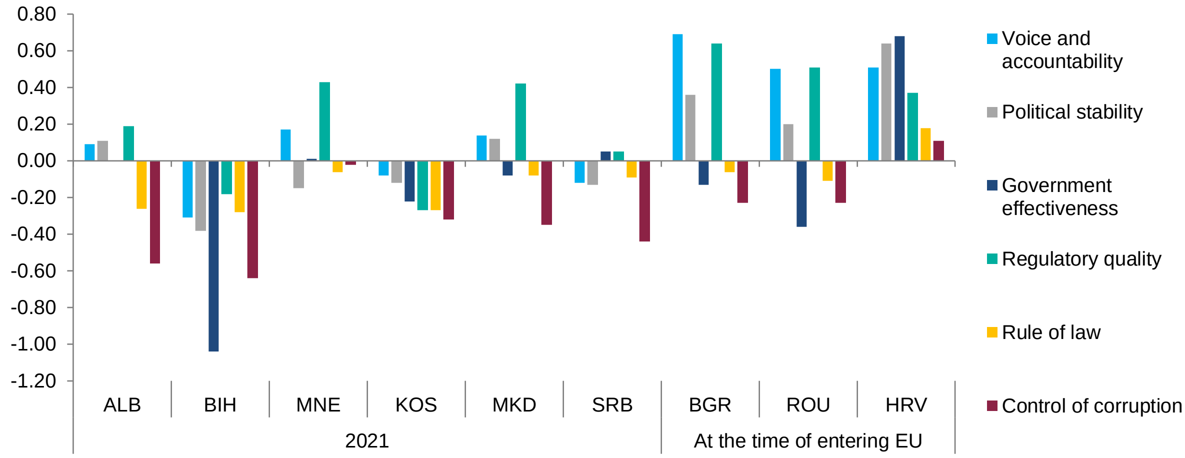
[34] See European Training Foundation (2022).
[35] See OECD (2022a).
[36] The study covers the following EU-11 and Western Balkans countries: Albania, North Macedonia, Serbia, Bulgaria, Croatia, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovak Republic and Slovenia.
[37] See Petrovic et al. (2020).
[38] The six dimensions are voice and accountability, political stability, government effectiveness, regulatory quality, rule of law and control of corruption.

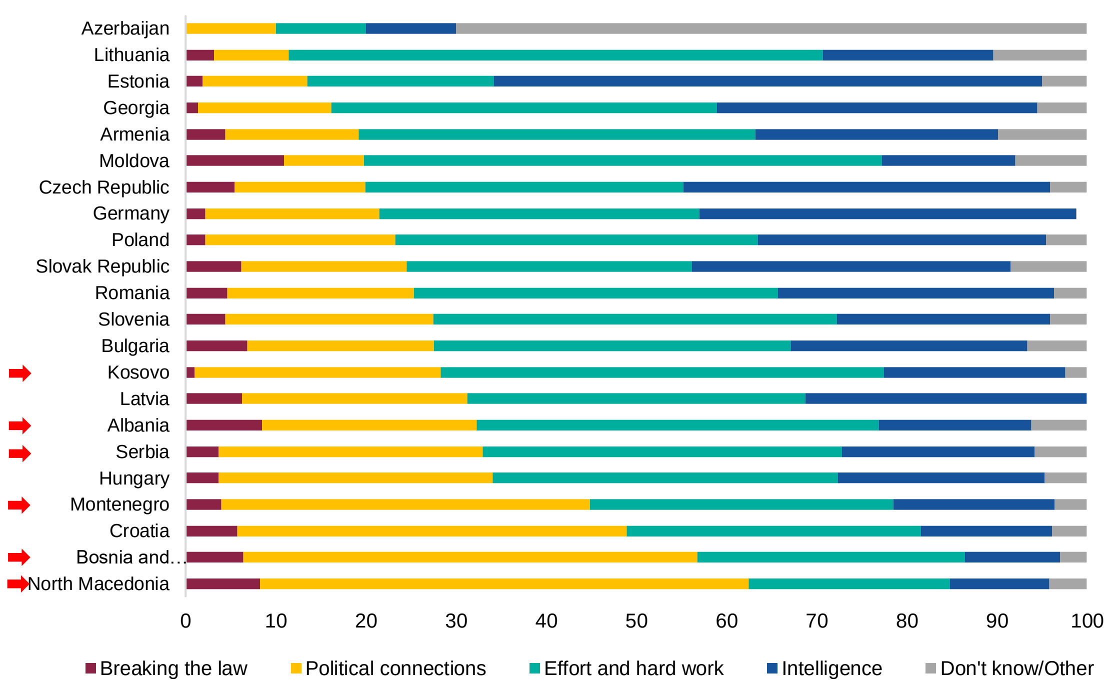
Chart 25: Governance standards are behind those of recent EU members at the time of accession
On a scale of -2.5 (the worst) to 2.5 (the best)



Source: World Bank WGIs.

Balkans chose political connections rather than options such as effort and hard work, or intelligence and skills – a percentage far above the average in EU countries included in the survey (Chart 26).

Chart 26: Political connections are viewed as a major, and in some countries the most important, factor for succeeding in life
Percentage of respondents, in 2023



Source: EBRD-World Bank Life in Transition Survey, 2023.

Note: These are preliminary results as of 21 June 2023. Data for Kosovo, Bosnia and Herzegovina and the Czech Republic are incomplete.

Control of corruption and rule of law remain areas most in need of improvement. Perceptions of corruption remain widespread, with only limited improvements over time according to various indices, including

Transparency International's Corruption Perception Index. Determined steps to fight corruption and implement strong safeguards have not yet been taken in this region. Results from the World Justice Project's Rule of Law Index 2022 highlight weaknesses in the extent to which the government and its officials and agents are limited and held accountable under the law (Table 1).

Table 1: Many rule-of-law weaknesses

On a scale of 0 (the worst, red) to 1 (the best, green), in 2022

	Overall	Constraints on government powers	Absence of corruption	Open government	Fundamental rights	Order and security	Regulatory enforcement	Civil justice	Criminal justice
Kosovo *Rank: 57/140*	**0.56**	**0.56**	**0.48**	**0.58**	**0.6**	**0.83**	**0.48**	**0.48**	**0.46**
North Macedonia *Rank: 63/140*	**0.53**	**0.47**	**0.45**	**0.5**	**0.6**	**0.8**	**0.48**	**0.52**	**0.45**
Bosnia and Herzegovina *Rank: 70/140*	**0.52**	**0.46**	**0.42**	**0.47**	**0.6**	**0.77**	**0.49**	**0.47**	**0.48**
Serbia *Rank: 83/140*	**0.49**	**0.37**	**0.42**	**0.46**	**0.55**	**0.77**	**0.46**	**0.49**	**0.39**
Albania *Rank: 87/140*	**0.49**	**0.43**	**0.36**	**0.46**	**0.59**	**0.78**	**0.42**	**0.46**	**0.40**

Source: World Justice Project's Rule of Law Index.

Better governance can improve economic and labour-market outcomes and attract foreign investment. Governance matters for wider economic development of a country, which in turn shapes the quantity and quality of jobs offered. Poor-quality institutions and an absence of robust property rights hinder investment, thereby undermining long-term growth and the speed of convergence. Improving governance can be directly linked to improvements in firm-level performance; a previous EBRD study shows that a meaningful reduction in a firm's exposure to corruption is associated with an increase in its sales growth.[39] Research has also shown that the effect of corruption on firms' growth is three times greater than the negative impact of extra taxes because of greater uncertainty and transaction costs associated with corruption.[40] Improving the quality of governance is also seen as key to attracting further FDI in the Western Balkans region, alongside improving the quality and availability of the labour force and infrastructure.[41] In this context, investment councils, with the support of the EBRD, can play a vital role in identifying problems that hold back investors and proposing solutions (see Box 2).

Box 2: The role of EBRD-supported investment councils

Investment councils are helping improve the business climate through public-private dialogue. In several Western Balkans countries, the EBRD has supported the establishment of investment councils. Each council benefits from the participation of high-level government officials, business associations and multilateral agencies with the principal aim of leveraging the private sector's experience to enhance the content and prioritisation of policy reforms.

The investment council in Albania was established as a platform for public-private dialogue in 2015, chaired by the Minister of Finance and Economy and supported by a full-time Secretariat managed by the EBRD. As at December 2022, the investment council had endorsed a total of 295 recommendations prepared and presented by the Secretariat, of which 44 per cent have been implemented and 16 per cent are in the process of implementation. Through implemented recommendations, the Albanian investment council has already improved the investment climate, including through the simplification of tax and custom

[39] See EBRD (2019).
[40] See Fisman and Svensson (2007).
[41] See Jovanovic et al. (2021).

procedures, enhanced transparency of investment incentives, reduction of the regulative burden on businesses, standardisation of inspection procedures, improvements in the process of obtaining construction permits, and completion of the legal framework in key sectors such as electronic communications and renewable energy.

In Montenegro, the Secretariat to the Competitiveness Council has been active since 2019, providing full-time support to the Competitiveness Council. Since its establishment, the Secretariat has facilitated 16 Competitiveness Council sessions and has been actively engaged in 22 governmental working groups for economic reform, coordinating the work of five of them and helping to advance 30 regulatory acts. The Secretariat's key contributions to improving the business environment include establishing the Registry of Levies, an up-to-date online database containing all fiscal and para-fiscal charges; coordinating business registration reform aimed at simplifying and digitalising the process of company registration; identifying a list of key barriers to doing business and engaging with the authorities to overcome those barriers; and introducing gender mainstreaming in public-private dialogue.

Governance improvements take time, but important first steps should be implemented now. Changing the status quo takes strong political will to recognise the problem and dedication to follow through on delivery.[42] This involves the implementation of public-administration reform to make sure the civil service is professionally run, with transparent, merit-based recruitment and remuneration procedures in place. Unnecessarily complex regulations should be simplified to remove the potential for those holding public office to abuse their positions. Policies to protect the media and civil society freedom also play a vital role in fighting corruption.

Leveraging digital technology can increase transparency, limit the space for corrupt activities, support increased accountability and improve efficiency across various public services. E-government services can simplify the interactions between governments and citizens or businesses, saving time and costs. Estonia, a world leader in government digitalisation efforts, is estimated to have saved the equivalent of 2 per cent of its GDP by introducing digital signatures.[43] Most countries in the Western Balkans made major advances between 2015 and 2020 in improving the overall level of government services offered in a digital form.[44] This often went hand in hand with an overall simplification of the regulatory framework. Further efforts towards digitalisation in the Western Balkans region are hampered, however, by the lack of digital skills among the population.[45] Broadening the availability of broadband services and making ICT training opportunities more available may help in this respect.[46] The regulatory framework has a crucial role in shaping the digital economy, but within the region, Bosnia and Herzegovina still does not have digital identification in place, a key building block in the provision of digital services. Lastly, recent security breaches and cyber-attacks in Albania point to the need to work on strengthening cybersecurity in parallel.

Digital solutions in public procurement can offer massive public savings, efficiency gains and innovation. While governments in the Western Balkans use e-procurement systems to varying degrees, such systems are largely seen as a means to disseminate information and documents, rather than to support interactions and transactions between authorities and businesses, in particular at the post-tendering stage.[47,48] Lessons can be learned from Ukraine, which has an award-winning e-procurement system, ProZorro, in place, saving billions of dollars since it became fully operational in the middle of 2016. ProZorro was initiated by a group of civic

[42] See EBRD (2019) for a discussion of policies to improve governance.
[43] See Vassil (2016).
[44] See EBRD (2021).
[45] See EBRD (2021).
[46] Kosovo exceeds almost all EU economies with 95.1 per cent of households having fixed broadband connections in 2020. See Eurostat:https://ec.europa.eu/eurostat/databrowser/view/ISOC_BDE15B_H__custom_8557481/default/table?lang=en https://ec.europa.eu/eurostat/databrowser/view/isoc_ci_it_h__custom_9742076/default/table?lang=en (last accessed on 1 February 2024).
[47] See OECD (2020).
[48] In addition to the drawbacks of the digital solution, there are significant regulatory issues which further weaken the public procurement processes in the Western Balkans – public procurement laws are often not applicable to infrastructure projects (see OECD (2020)) and there is a high number of exemptions from public procurement rules. According to the European Commission (see European Commission (2022a)), 67 per cent (€3.2 billion) of the cumulative value of public procurement contracts in 2021 were exempt from the application of the public procurement law. North Macedonia, however, has a central e-procurement system the use of which is mandatory for publishing contract notices and tender documents for all contracts covered by the public procurement law. The system also offers electronic submission.

activists and data experts, built initially with the help of international organisations, including the EBRD, and implemented under the guidance of a few strongly supportive high-level public officials. It grew into an extensive network of collaboration between government, private enterprises, civil society and other stakeholders. It offers full transparency over the entire procurement process; obliges all government entities, including SOEs, to use the platform; connects a number of private marketplaces responsible for attracting and serving clients, thereby significantly increasing competition; and involves both businesses and civil society to ensure mutual control. The benefits of the system are numerous – increasing competition, reducing the time and money spent on contracting processes, helping buyers make better decisions and making procurement fairer for suppliers – and can be replicated in the Western Balkans.[49]

[49] In 2021, ProZorro was used by 40,000 customers and more than 260,000 suppliers with the total number of purchases equal to 18 per cent of Ukraine's GDP. It is estimated to have saved up to around 10 per cent of overall public spending. Full transparency of public contracts allows for easier oversight, but also led to data-driven innovations such as ProZorro.Sale, the world's first e-Bay for state assets.

VI. Strengthen cross-border linkages to boost competitiveness

Competitiveness and integration go hand in hand… All countries in the Western Balkans are small open economies, but with a degree of openness that falls well short of the most successful small economies in the EU. This relative lack of integration with external markets holds back competitiveness and deters investment. Numerous studies show significant benefits from increasing trade integration, including higher economic growth and improved living standards.[50] These effects work through several channels, including increasing market size and economies of scale, enhancing productivity and innovation, and allowing access to affordable products for low-income households.

…and competitiveness and private-sector development are also intimately linked. More than three decades of transition throughout central and eastern Europe has demonstrated that the most successful economies are those where private businesses can thrive, property rights are respected, and entrepreneurship and innovation can flourish. State institutions of course must play a crucial role in providing the right enabling environment, but SOEs are typically far less able than their privately owned counterparts to respond nimbly to market signals.

The state still plays a disproportionately large role in the region's economies. SOEs are a prominent feature of all economies in the Western Balkans, but particularly in Bosnia and Herzegovina, Montenegro and Serbia. In certain sectors, especially in electricity, SOEs are dominant in all countries in the region. These companies are also a significant source of employment – and patronage – in the local economies. In Serbia, for example, SOEs and the public sector together account for around a quarter of employment within the working-age population.[51] The distortionary effect can be seen in the labour market, with wages in the public sector in Serbia being on average 7 per cent higher than in the private sector as at July 2022, even though public companies' productivity is on average around 20 per cent lower than in private companies.[52] Such findings, combined with non-transparent hiring practices in many SOEs, help to explain why (as discussed above) many people in Serbia and elsewhere in the region believe political connections, rather than effort and hard work or intelligence and skills, are the most important factor for success in life.

The outsize presence of SOEs holds back competition and innovation. Extensive research has been carried out into the effects of SOEs on growth and economic development. A recent study by the IMF of SOEs across central and south-eastern Europe shows that SOEs tend to be less productive and less profitable than privately owned firms.[53] An in-depth EBRD study of the experience of privatisation across post-communist economies also points to the potential benefits of restructuring and privatising SOEs, provided there is strong political ownership, sales are done transparently, and privatisation is carried out as part of a broader programme of reform.[54] SOEs are also associated with stifling competition, inefficient work practices and corruption. Poor governance lies at the heart of the problems associated with state ownership, according to the IMF. Lastly, SOEs are only around half as likely to innovate (bring in a new or significantly improved process or allocate funds to acquiring external knowledge, for example) as privately owned firms are.[55]

Privatising would bring wider indirect benefits, too. Previous studies show the impact of restructuring and selling off SOEs,[56] in terms of fresh investment and improved productivity post-privatisation. A commitment to selling off unproductive or underperforming state assets is a strong signal of reform commitment and openness to investment, and a sign that the government is willing to take on vested interests who are usually opposed to such reforms.

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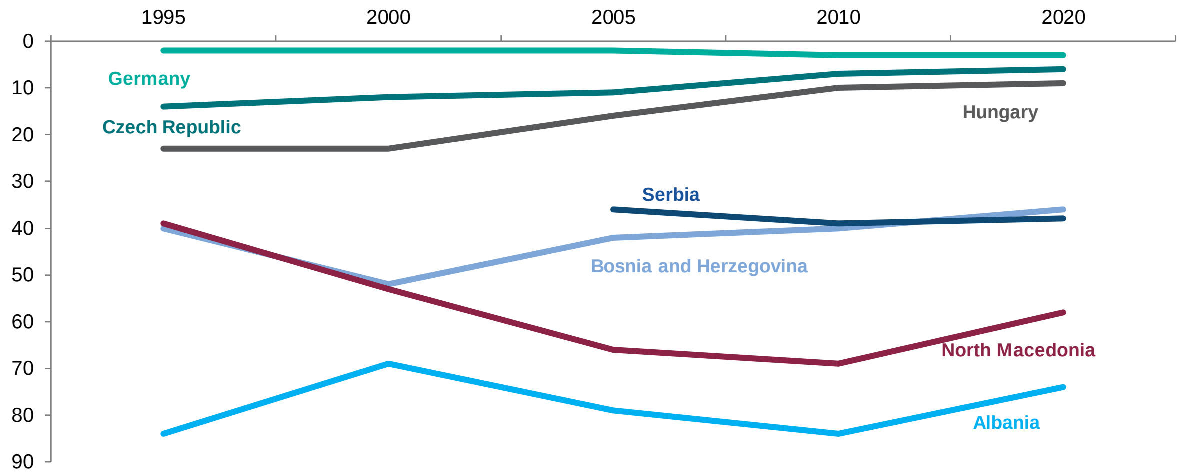
[50] See, for example, IMF, World Bank and WTO (2017).
[51] See Statistical Office of the Republic of Serbia (2022).
[52] See https://publikacije.stat.gov.rs/G2022/HtmlE/G20221267.html (last accessed on 2 February 2024) and Richmond et al. (2019).
[53] See Richmond et al. (2019).
[54] See EBRD (2016).
[55] See EBRD (2021), Chapter 2, Figure 2.15.
[56] For an overview of studies see, for example, Megginson and Sutter (2006).

Greater innovation can lead to a more complex structure for manufacturing goods. Increasing FDI inflows have helped the region integrate more in global value chains and to a greater degree of complexity (Chart 27), thus also creating new opportunities for exports.

Chart 27: The complexity of Western Balkans economies has increased somewhat over time but remains well below that of central and eastern Europe or western Europe

Harvard Growth Lab Economic Complexity Index ranking from best (1) to worst



Source: Harvard Growth Lab.

Note: Harvard Growth Lab's Economic Complexity Index increases as the number and complexity of the products a country exports increases. A country is ranked better if the index is higher. Kosovo and Montenegro are excluded due to a lack of comparable data. The chart shows the ranking of countries based on the index. The lower the ranking score, the more complex the country's product offer.

International trade is a key determinant of firms' competitiveness and innovation. Participation in international trade depends on several factors, including the export capacity of domestic firms in an industry, FDI, trade costs and barriers, the quality of infrastructure and the availability (or migration) of skilled workers. Trade integration also helps raise the level of international trade by creating a larger market size, increasing competition within the integrated market, and inducing specialisation and international knowledge spillovers.[57]

Trade openness in the WB-6 is below that of the smaller former Central European Free Trade Agreement members from central and eastern Europe (CEFTA CEE) (excluding Poland).[58,59] Western Balkans economies have seen rising trade levels over the past two decades but are still less open than central and eastern European economies when measured according to the ratio of exports and imports of goods and services to GDP (Chart 28).

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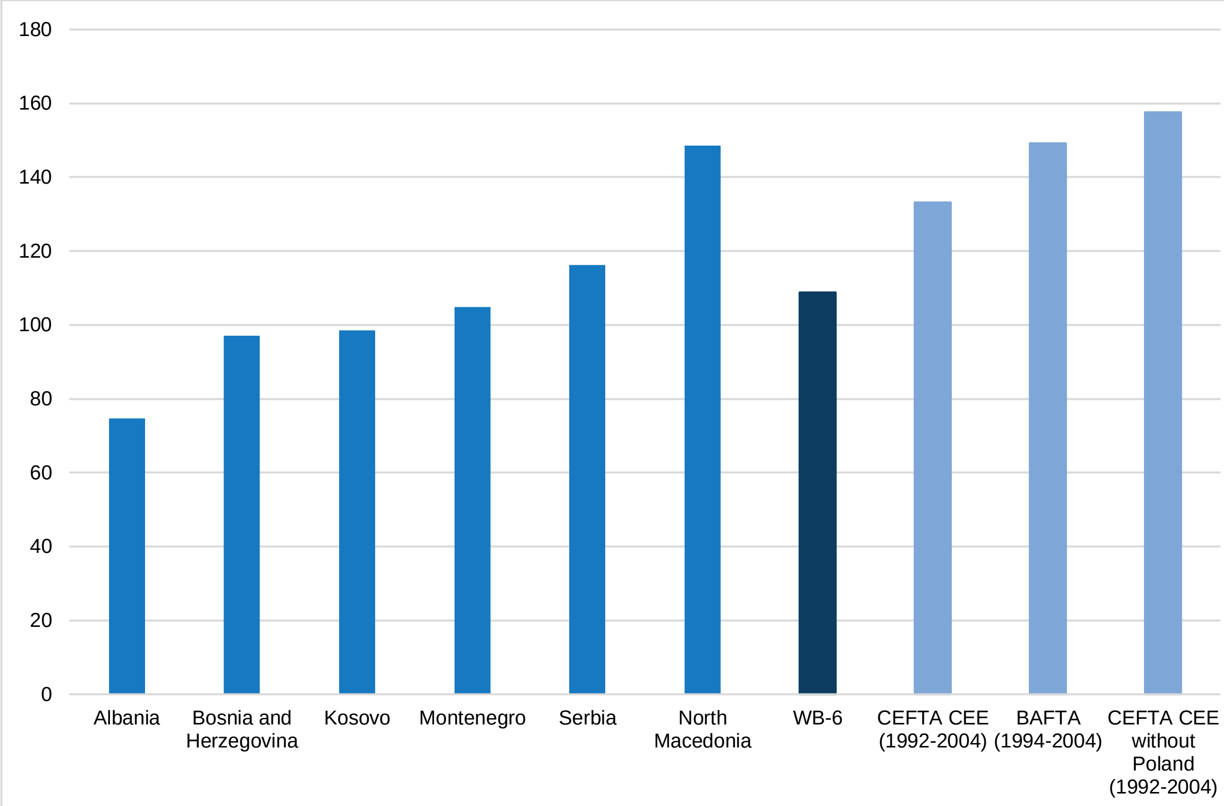
[57] See Ficarra et al. (2022).

[58] CEFTA CEE members in this case are those that joined CEFTA in 1992 (Czech Republic, Hungary, Poland and Slovak Republic).

[59] It is important to mention that North Macedonia, with trade openness (goods and services) at close to 148.5 per cent of GDP in 2021, is above the level of the Czech Republic (142.5 per cent), while still below that of Hungary (162.8 per cent) or the Slovak Republic (187.8 per cent).

Chart 28: Trade openness remains below that of the CEFTA CEE members

Total goods and services exports and imports, percentage of GDP, in 2021



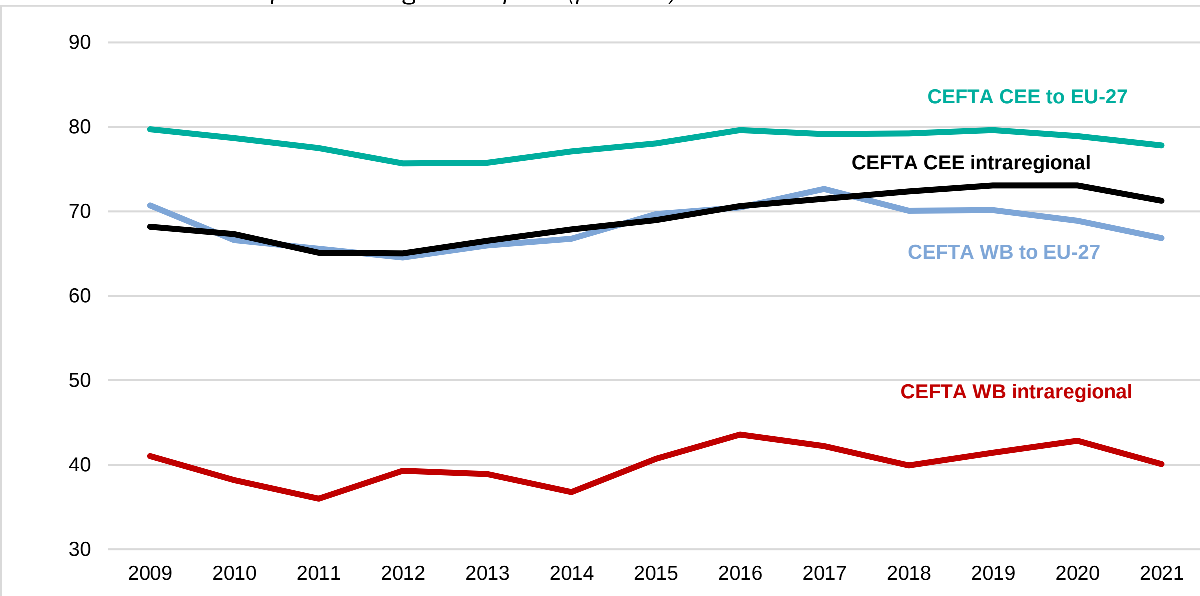
Source: World Bank, Kosovo Agency of Statistics.

The product structure of intraregional trade in the Western Balkans is less sophisticated than it is among earlier CEFTA members. Manufactured products still made up less than 45 per cent of total exports 15 years after becoming members of CEFTA, compared with more than 70 per cent in Western Balkans CEFTA (CEFTA WB) exports to the EU-27 or among the four central and eastern European countries (Chart 29).[60] Food and simpler, more-commoditised products, which dominate intraregional trade in the Western Balkans, might be enough to maintain the present trade levels, but provide fewer opportunities for expanding intraregional trade than manufactured products do, as the latter are more varied and can be better tailored to local tastes.

[60] CEFTA WB denotes the Western Balkans members of CEFTA: Albania, Bosnia and Herzegovina, Kosovo, Montenegro, North Macedonia and Serbia.

Chart 29: Product structure of intraregional trade is less sophisticated compared with earlier CEFTA members

Share of manufactured products in goods exports (per cent)



Source: World Integrated Trade Solution (WITS).

Note: CEFTA WB exports exclude Kosovo due to the lack of comparable data.

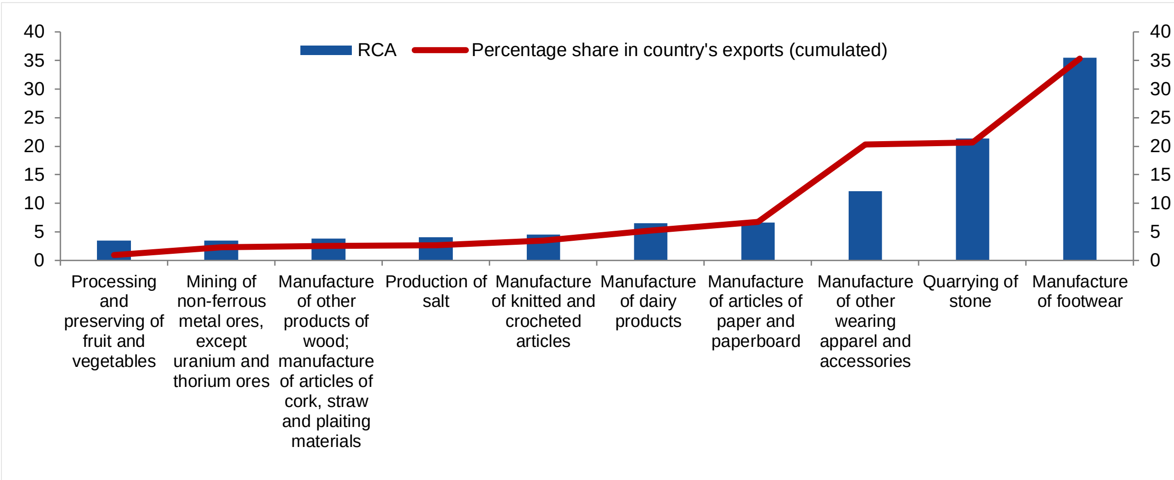
The region can exploit its competitive advantages in the "old" economy. There are revealed comparative advantages in several sectors, largely in areas such as food, wood or furniture, metal processing, apparel and the manufacturing of certain machines and equipment (Chart 30). A detailed OECD report identified three main areas where the region is competitive and has further growth potential: apparel manufacturing, automotive components, and business process and ICT outsourcing.[61]

[61] See OECD (2009).

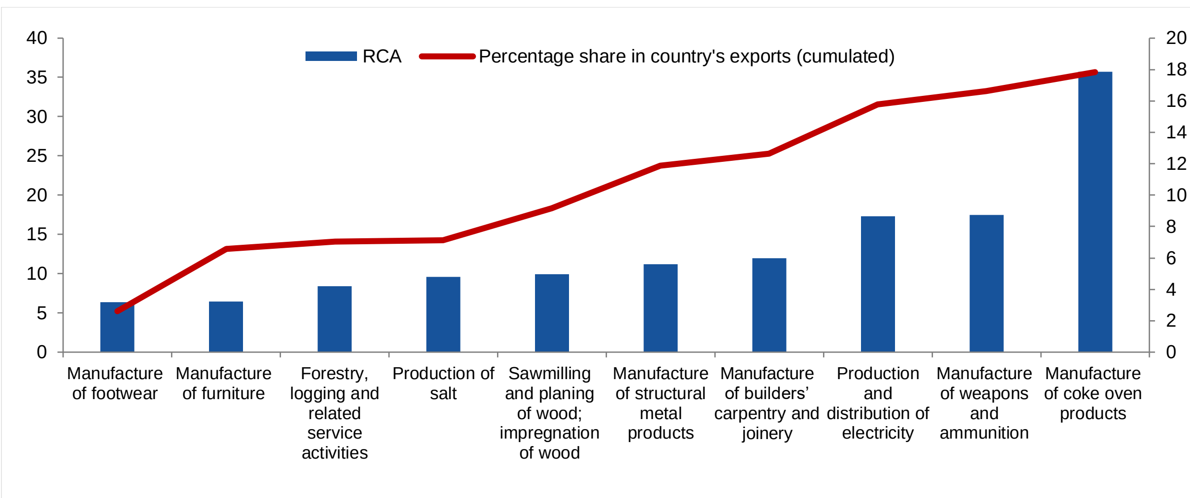
Chart 30: The region has comparative advantages mainly in the "old" economy

Revealed comparative advantages in exports and cumulative share of those products in exports in 2021 (per cent)

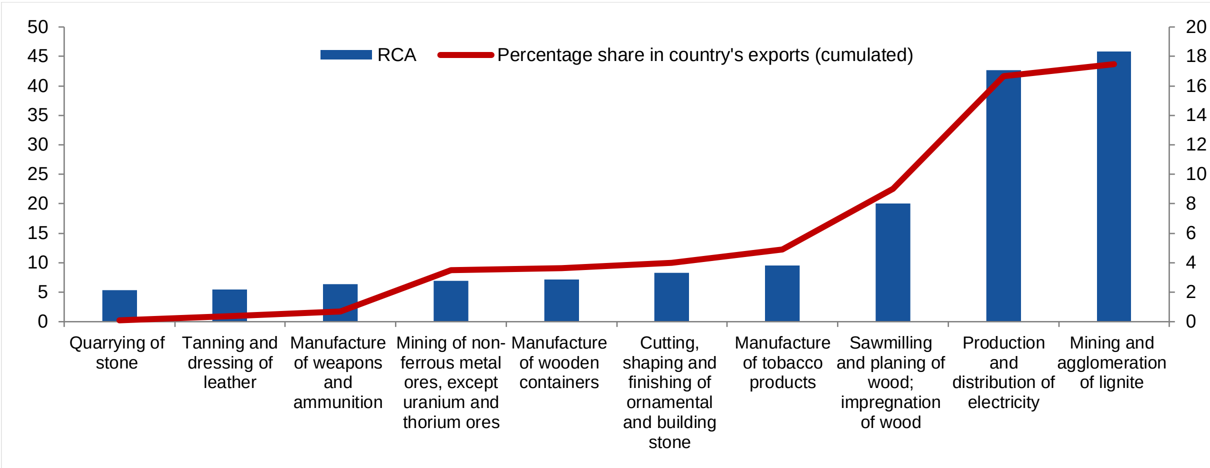
Albania



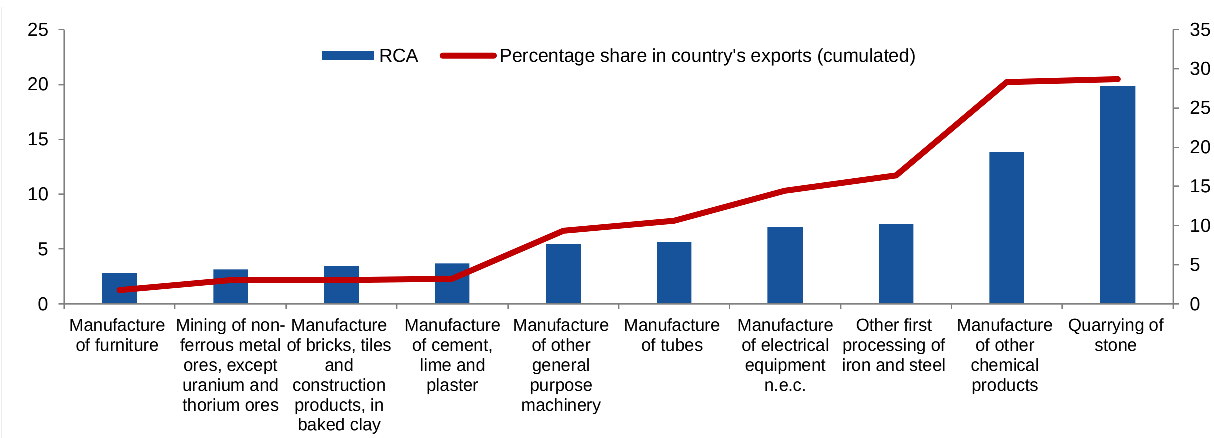
Bosnia and Herzegovina



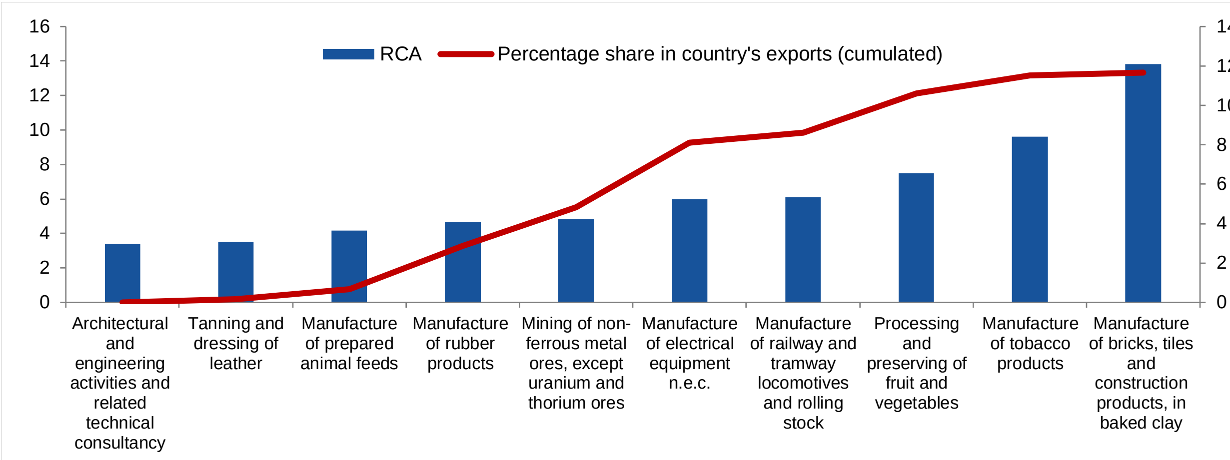
Montenegro



North Macedonia



Serbia



Source: WITS.

Note: Revealed comparative advantage is measured as the ratio of the share of a country's export of a certain product to the total world export of that product and the country's share in world exports, based on a three-digit NACE classification. Kosovo is excluded due to a lack of comparable data.

Global or regional leaders have emerged in some sectors, showing a positive example that others can emulate. An EBRD-commissioned study identified 35 "hidden champions" or potential hidden champions in the Western Balkans:[62]

- Albania: food, carnival masks, fabricated metal products, online payments, ICT, wood recycling
- Bosnia and Herzegovina: coffee, telecom software, retro bicycles, fire-protection glass products, packaging, ICT, beekeeping
- Kosovo: fruit drinks, carbon-fibre auto parts, ICT
- Montenegro: domain registration, port solutions for super yachts and mega yachts
- North Macedonia: chemicals, freight transport, wine, ajvar production
- Serbia: point-of-sale equipment, lighting, copper products, ICT, packaging, protective clothing.

The services sector (mainly tourism and ICT) is growing fast in some countries… Montenegro and Albania have strong and expanding tourism sectors (contributing 25.5 per cent and 17.4 per cent to GDP in 2021, respectively)[63] that partly compensate for the large trade deficit in goods (above 45 per cent of GDP in the case of Montenegro). ICT exports are growing rapidly in the region, having reached 2.4 per cent of GDP, just below the EU-27 average (Chart 31). Serbia increased its ICT services exports more than elevenfold between 2010 and 2022, and now exceeds the ICT exports of Estonia, one of the forerunners of digital services in Europe. This was helped by increasing global demand for digital services, relatively low labour costs and increasing interest in ICT education in the Western Balkans.[64]

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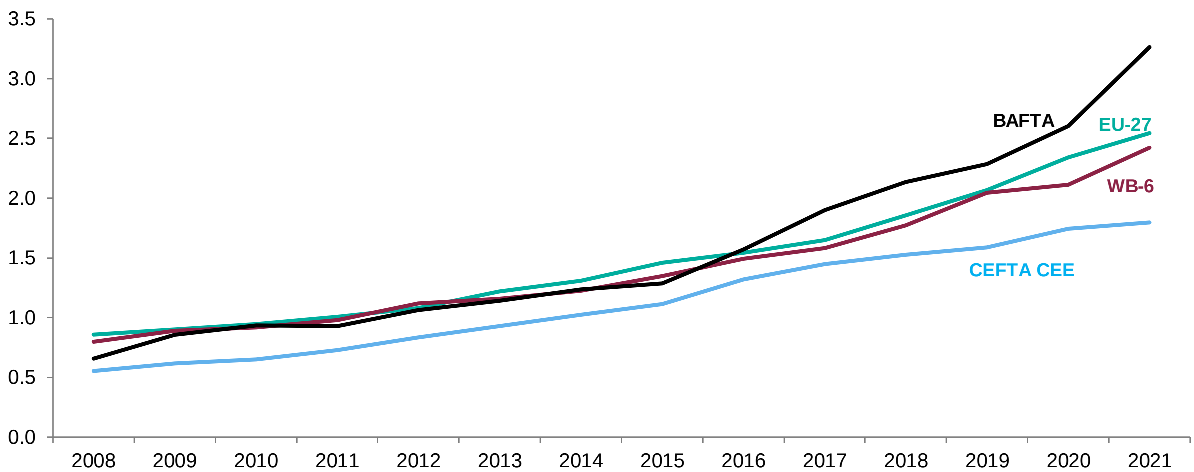
[62] Hidden champions are SMEs that are global or regional leaders in their niche markets and usually serve other businesses; thus they are "hidden" from the public. See IEDC Bled School of Management – CEEMAN (2019).
[63] See World Travel and Tourism Council (2022).
[64] Total annual labour cost in computer programming, consultancy and related activities was €29,000 in Serbia, €10,200 in Albania versus €67,000 on average in the EU-27. See Eurostat: https://bit.ly/3u7oSOE (last accessed on 1 February 2024).

Chart 31: ICT exports in the region are relatively large and growing fast
ICT exports as a percentage of GDP



Source: World Bank.

Note: Baltic Free Trade Area (BAFTA) countries are Estonia, Latvia and Lithuania; CEFTA CEE countries are Poland, Hungary, Czech Republic, Slovak Republic, Slovenia, Romania, Bulgaria, Croatia and Moldova.

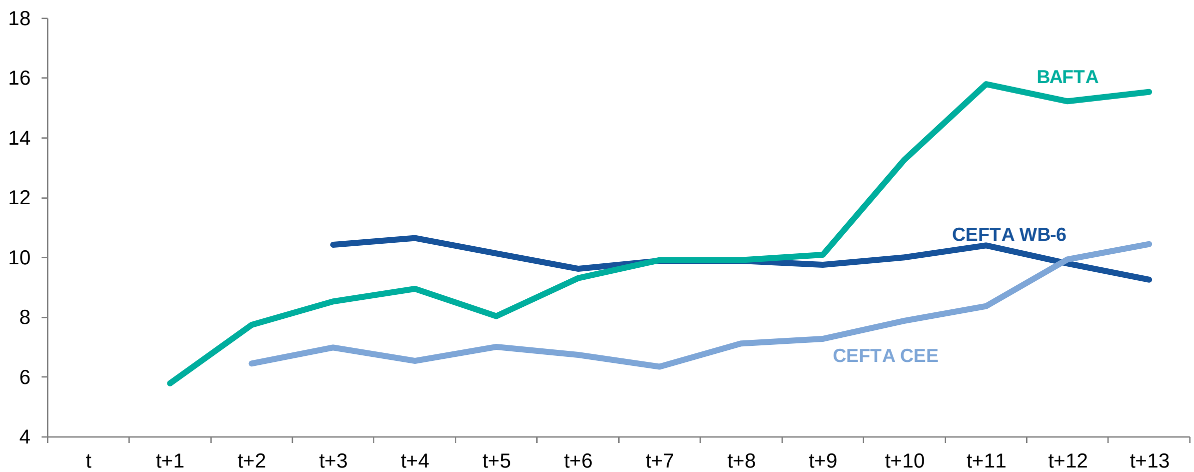
...but constraints are becoming more binding. Labour shortages in the tourism sector are becoming increasingly acute, and need to be addressed by inclusive employment practices raising the participation levels and skills of under-represented groups (for example, youth, women and minorities), as well as by increasing the formalisation of employment. Wages are increasing fast in the ICT sector (between 5 and 10 per cent annually between 2012 and 2020 versus less than 1 per cent in the EU-27), reducing the wage competitiveness of the Western Balkans. The future pool of experts may be constrained by the continuing decline in population due to the adverse demographic trends discussed earlier, as well as by emigration, especially as a higher share of those with more advanced digital skills are more likely to emigrate.[65] There is already evidence from across the EBRD regions, including the Western Balkans, to suggest that workers with highly sought-after skills, such as ICT, are migrating to advanced economies at a higher rate, exacerbating the problem.[66]

[65] See EBRD (2021).
[66] See EBRD (2021).

There is significant scope to expand trade with the EU, the region's main trading partner… While trade and investment links are already strong, Western Balkans economies can gain significantly from further increasing their trade integration with the EU.[67] A recent study shows that stabilisation and association agreements (SAAs) and (even more so) full EU membership would boost trade flows between the new trading partners by an estimated 25 and 92 per cent, respectively. Trade integration through these agreements strengthens forward linkages in global value chains,[68] allowing more products to be sold directly and indirectly on global markets. Based on these findings, Western Balkans economies could benefit most from further increasing economic integration with the EU, even before full accession. Possible methods include joining the EU's customs union and expanding the existing SAAs. Near-shoring certain activities of EU companies (particularly those of Austrian and German firms) in the Western Balkans is also possible, but may require know-how to be transferred further and the sophistication of products or services to be enhanced. These activities could come about through higher FDI inflows and improving the business performance of SMEs, as well as by enhancing the transport infrastructure in certain countries and addressing the skills deficits highlighted earlier in this paper.[69]

…while strengthening regional cooperation can also bring tangible results… CEFTA, originally founded to promote intraregional trade among central and eastern European countries, now promotes intraregional trade among the Western Balkans economies and Moldova. So far, the experience of the two groups – CEFTA CEE and CEFTA WB – has differed somewhat: CEFTA CEE members increased intraregional trade after joining CEFTA and even more so after EU accession. In contrast, trade among CEFTA WB countries has not increased significantly (Chart 32). Other initiatives focusing on regional cooperation include the Regional Cooperation Council, which works to establish a common regional market that allows the free flow of goods, services and people, while the Open Balkans Initiative has similar goals, but so far includes only three Western Balkans countries (Albania, North Macedonia and Serbia).

Chart 32: Intraregional trade in the Western Balkans has not deepened over time
Intraregional goods exports as a percentage of GDP



Source: WITS, Kosovo Agency of Statistics.

Note: t denotes the year of joining CEFTA; that is 1992 for the CEFTA CEE countries, 1994 for the BAFTA countries, and 2007 for the CEFTA WB countries.

…mainly through facilitating international trade. As CEFTA removed tariffs for intraregional trade, the main obstacles to intraregional trade are non-tariff barriers and ineffective border procedures, increasing the time and cost of exporting and importing. These obstacles include unnecessary physical inspections and

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[67] See Bertelsmann Stiftung and WIIW (2020).
[68] Forward linkages in global value chains show the quantity of countries' exports that are used in other countries' exports as inputs.
[69] See Reiter and Stehrer (2021).

inconsistent rules of origin.[70] According to the World Bank, waiting times at Western Balkans border crossings are five times longer than in many EU countries, resulting in an overall total waiting time of close to 3,000 years for trucks annually.[71] This is discouraging in the context of increased regional trade integration. A recent study showed that a new reform, aimed at increasing the speed of border crossings for trucks via an electronic preannouncement of truck arrivals, led to a three-hour decline in waiting times, equivalent (in terms of boosting trade) to removing a 2 per cent ad valorem tariff.[72]

Moving goods across borders faster also requires better infrastructure. The fact that the region still lags behind in terms of integration into the global economy is due in large part to the lack of interconnected physical infrastructure and the prevalence of missing cross-border links (see Box 3). Such problems require a regional approach, with full commitment by the respective governments to make cross-border projects work. Innovative technologies, such as the one described in the previous paragraph, can play an important role in a region where geographical constraints can be difficult to overcome.

Box 3: The link between roads and trade

According to an EBRD assessment, there remains ample scope to improve road transport connectivity in the Western Balkans. Road travel times between major cities in south-eastern Europe are 40 per cent longer; speeds are 27 per cent slower; and overall travel times are 72 per cent longer than their potential (that is, compared with a perfectly straight road).[73] While Serbia performs well in terms of road connectivity, with road travel times only around 27 per cent longer than their potential (and in line with the results of advanced comparator countries), Montenegro, Bosnia and Herzegovina, Kosovo, North Macedonia and Albania are among the 14 worst-performing EBRD economies in terms of road transport connectivity, partly due to the challenging mountainous terrain.[74]

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[70] See World Bank (2019).
[71] See https://bit.ly/3HLjFPo (last accessed on 5 February 2024).
[72] See Del Mar et al. (2023).
[73] Based on an EBRD network analysis conducted in 2020 on Google Maps data. South-eastern Europe includes Albania, Bosnia and Herzegovina, Bulgaria, Kosovo, Montenegro, North Macedonia, Romania and Serbia.
[74] Comparator countries are Australia, Austria, Canada, France, Germany, Italy, the Netherlands, Spain, the United Kingdom and the United States.

Table 2: Road travel distances, speed and times in the EBRD regions[75]

Distance and time measured in per cent compared to potential, speed in km per hour

Region	Distance	Speed	Time
	Corridor weighted average	Corridor weighted average	Corridor weighted average
	(actual route/potential, per cent)	(actual route km/hour)	(actual time/potential, per cent)
Comparators average	128	91	141
EBRD regional average	133	76	166
Central Asia	147	66	227
Southern and eastern Mediterranean	127	78	154
Central Europe and the Baltic states	126	88	132
Eastern Europe and the Caucasus	125	70	160
South-eastern Europe	140	73	172
Other (Russia and Türkiye)	126	85	151

Source: EBRD.

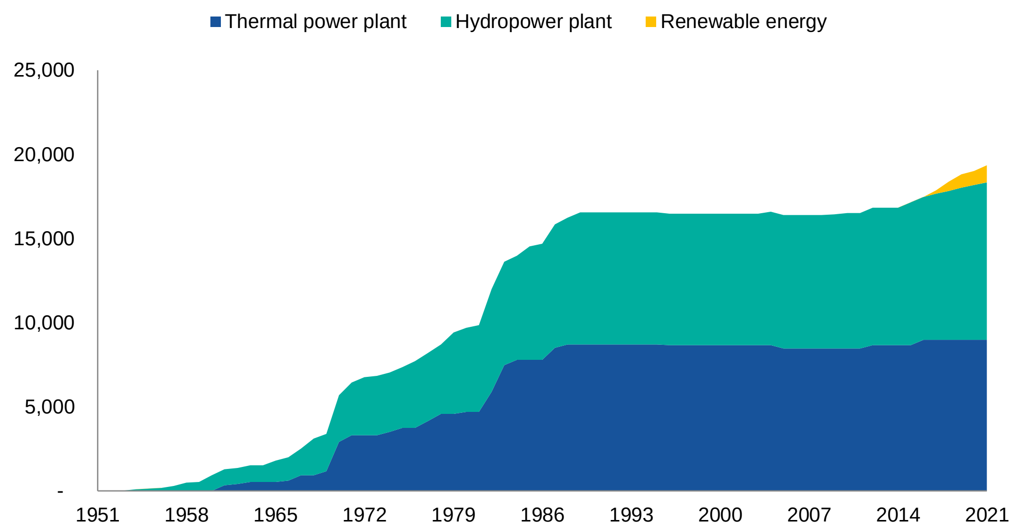
Given the high intensity of goods trade within the region and with the EU, faster road connections could play a key role in facilitating trade. Large-scale transport infrastructure investments, regular road network maintenance, the deployment of e-tolling and shorter queuing times at borders reduce transport costs within and between countries. Evidence from developing countries shows that reduced transport costs have a significant impact on trade flows, and may further open markets and encourage new industries to form.[76] The Western Balkans' agenda for regional integration, and integration into the wider European transport network, is defined within the Transport Community Treaty signed in 2017 and its associated definition of Trans-European Transport Network (TEN-T) corridors,[77] and within separate action plans, including a Road Action Plan. Alongside continued investment in road infrastructure, further progress is needed to implement road maintenance measures, ensure intelligent transport system and e-tolling interoperability, and incorporate green and smart elements into road investments to develop a trade-facilitating TEN-T road network in the Western Balkans.[78]

[75] In April 2022, in response to the invasion of Ukraine, the EBRD Board of Governors decided to suspend the access of Belarus and Russia to Bank resources. The EBRD has closed its offices in Minsk and Moscow.
[76] See, for example, Lall et al. (2022), Anderson and van Wincoop (2003), and Freund and Rocha (2011).
[77] The TEN-T is a planned set of road, rail, air and water transport networks in the EU, including multimodal transport.
[78] See Transport Community (2022).

VII. Going green will boost growth and strengthen resilience to energy shocks

Energy generation in the Western Balkans is mostly dated, inefficient and polluting. Most energy production capacity dates from the 1970s and 1980s, and nearly half of production capacity comes from coal-powered thermal power plants (Chart 33). These factors, exacerbated by years of under-investment and the declining quality of coal (plants are largely fuelled by high-sulphur-content lignite), result in inefficient energy production and higher greenhouse gas emissions of thermal power plants than those of similar plants in the EU. Encouragingly, new renewable energy capacity has been commissioned at an enhanced rate since 2016, largely in wind and small hydropower plants. However, much more renewable energy generation capacity is urgently needed to replace ageing production plants, meet growing demand and achieve decarbonisation targets.

Chart 33: Cumulative generation capacity in the Western Balkans
In MWh



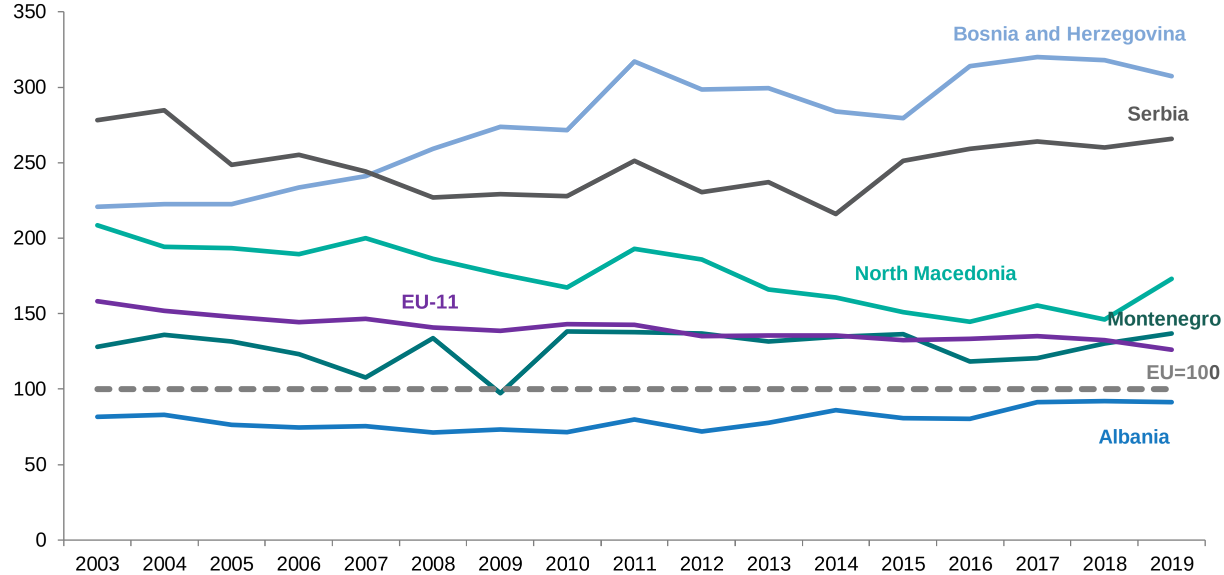
Source: EBRD calculations.

Carbon intensity is high. In the Western Balkans, carbon intensity is driven by electricity and heat producers which, as of 2020, make up around two-thirds of CO_2 emissions in Bosnia and Herzegovina, Serbia, Kosovo and Montenegro, and more than half of CO_2 emissions in North Macedonia.[79] (Albania is an exception as electricity production is dominated by hydropower.) Although broadly declining in line with global trends, carbon emissions are double the levels in the EU (as a ratio to GDP in PPP terms) (Chart 34).

[79] See IEA country profiles: https://www.iea.org/countries/serbia (last accessed on 2 February 2024).

Chart 34: Carbon intensity of the Western Balkans economies is very high

CO_2 emissions in kg per PPP $ of GDP, where EU=100



Source: World Bank WDIs.

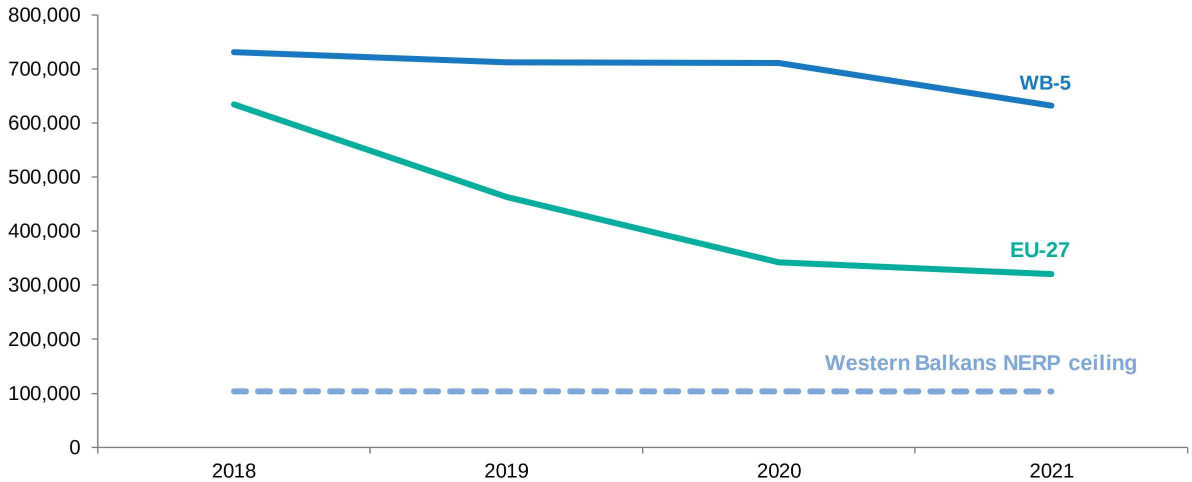
Note: Kosovo is excluded due to a lack of comparable data.

Inefficient energy production has harmful health effects… In 2021, the Western Balkans coal thermal power plants reporting their emissions under the Large Combustion Plant Directive (43 facilities belonging to 18 thermal power plants) emitted nearly twice as much sulphur dioxide (SO_2), a pollutant highly toxic to humans, as all (some 50,000) large-scale industrial installations in the EU (Chart 35).[80] In addition to coal-powered thermal-power-plant emissions, a transport sector dominated by out-of-date vehicles, waste dump sites and poorly regulated industrial activity contribute to high levels of ambient air pollution. The inevitable result is poorer health outcomes in the Western Balkans countries than in the neighbouring EU countries. The annual mortality rate, measured as premature deaths per 100,000 inhabitants, attributable to PM2.5, the particulate matter causing the brunt of the harm, is almost double the EU-27 average in Bosnia and Herzegovina, Serbia, North Macedonia and Kosovo and only slightly lower in Montenegro and Albania.[81]

[80] Authors' calculations based on EEA data on self-reported emissions under the Large Combustion Plant Directive (for Western Balkans countries) and the Industrial Emissions Directive (for EU countries).
[81] See Ortiz et al. (2021) and European Commission (2022b).

Chart 35: SO_2 emissions from the Western Balkans remain higher than the EU's and are repeatedly breaching emission ceilings

SO_2 emissions in tonnes



Source: European Environmental Agency.

Note: WB-5 refers to all Western Balkans countries except Albania, which has no operational large combustion plants.

...and puts countries in breach of legal obligations. Emission levels in the Western Balkans regularly breach limits agreed with the Energy Community Secretariat. The National Emission Reduction Plan (NERP) represents a transition from the Large Combustion Plants Directive to the new Industrial Emissions Directive,[82,83] under which the emission limit values of three key pollutants – SO_2, nitrogen oxides (NO_x) and dust – are determined at the national level, rather than at the level of each power plant. This gives some flexibility to the energy sector to align with the standards and plan necessary investments accordingly. However, despite the authorities' commitments to comply with limits set out in the NERP from 2018 to 2027, the four countries (Bosnia and Herzegovina, Kosovo, North Macedonia and Serbia) repeatedly breached limits between 2018 and 2021, with SO_2 emissions proving the most difficult for the countries to reduce.[84] In 2021, only NO_x emissions were still below the sum of the countries' ceiling for the year (although Bosnia and Herzegovina and Kosovo breached national ceilings), while total SO_2 emissions of plants in Bosnia and Herzegovina, Kosovo, North Macedonia and Serbia were five times, and dust emissions nearly two times, the level allowed.[85]

High carbon levels are harming the region's competitiveness. The maintenance costs of ageing plants and pollution control equipment are becoming ever more expensive and difficult to finance. More recently, the elevated prices of coal and gas imports have further undermined the competitiveness of fossil fuels on a global level. As a result, the Western Balkans' inefficient production system, characterised by high technical losses and unacceptable levels of ambient pollution, is becoming increasingly unviable. Meanwhile, the cost of renewable energy production continues to fall, affirming the role of sustainable energy as a key tool in the global effort to reduce and ultimately phase out fossil fuels.[86] Increasing pressure to decarbonise is also coming from the imminent introduction of the EU's CBAM, which is part of the Union's ambitious policy on global climate action relating to international partners that have not achieved the same level of climate

[82] The Large Combustion Plants Directive was introduced by the European Commission in 2001 and specifies emission limit values for large combustion plants. Each plant can individually comply with a ceiling, or an overall emission reduction can be achieved through a NERP. In the case of non-compliance, the Energy Community Secretariat takes legal action. See https://bit.ly/3vYdC7M (last accessed on 2 February 2024).
[83] Adopted in 2010, the Industrial Emissions Directive sets out, among other measures, stricter EU wide emission limits for select pollutants and introduces inspections. See https://bit.ly/3Up4MtS (last accessed on 2 February 2024).
[84] Albania and Montenegro are excluded, as Albania has no operational large combustion plants and Montenegro only has one and therefore cannot add up the total of several plants to make a national ceiling.
[85] See CEE Bankwatch Network (2023).
[86] See IRENA (2022).

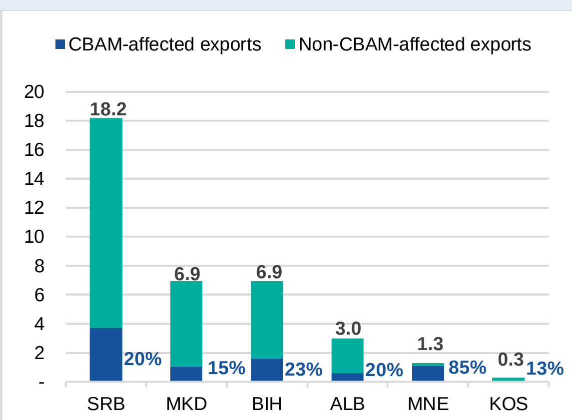
ambition. The legislation is set to affect some €8 billion worth of exports from the Western Balkans region from 2026 (see Box 4).[87]

Box 4: The EU's CBAM is set to challenge the competitiveness of Western Balkans' exports on the external markets

Emissions allowance trading is the cornerstone of the EU's climate policy. The EU Emissions Trading Scheme (ETS) covers CO_2 emissions from high-polluting sectors (energy and industry), putting a price on carbon to facilitate the replacement of fossil fuels with clean energy sources. A key challenge for the EU ETS has been to help carbon-intensive sectors reduce their emissions while avoiding the risk of shifting production to locations with less stringent carbon policies (known as "carbon leakage").

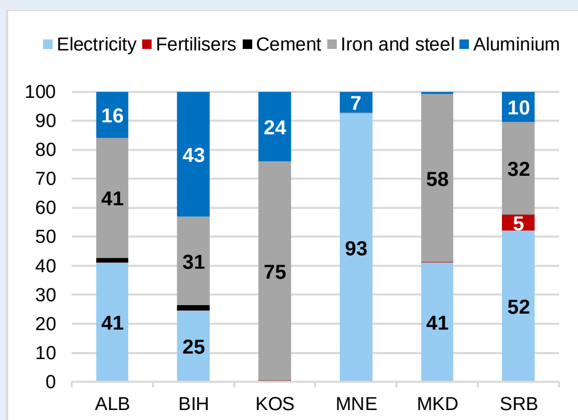
The EU is introducing the CBAM in response to this challenge. The mechanism addresses carbon leakage at the border by putting a carbon price on imports equivalent to the price for similar goods produced within the EU and subject to the ETS. According to the regulation adopted by the European Parliament in April 2023, the CBAM is to focus, during a transitional period from 1 October 2023 to 31 December 2025, on direct emissions from a limited number of industrial sectors with a high risk of carbon leakage – iron and steel, cement and clinker, fertiliser, aluminium, electricity and indirect emissions from fertiliser, cement and electricity. Importers' obligations during the transitional period will be limited to reporting. Potential additions to the product scope will be considered before the end of the transitional period.[88] From 2026, the free allocation of CO_2 emissions will be phased out and the CBAM will be gradually phased in by 2034. In parallel, the EU is working on extending the scope of the CBAM regulation to include all sectors subject to the ETS by 2030, meaning that the Western Balkans economies should anticipate a significant broadening of the product scope.

Chart 36: CBAM-affected exports as share of all exports to the EU
In 2022, in nominal € billion terms and per cent



Source: Eurostat and authors' calculations.

Chart 37: Structure of CBAM-affected exports
In 2022 (per cent)



Source: Eurostat and authors' calculations.

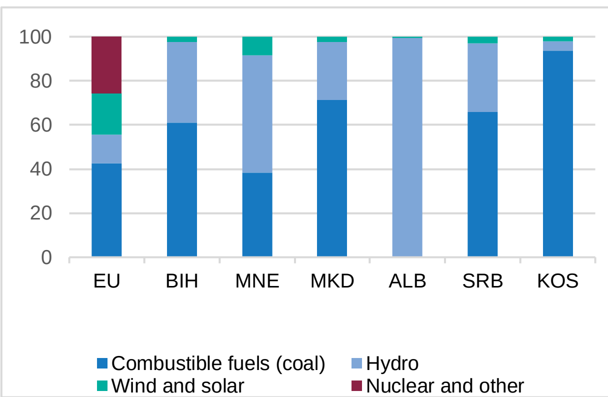
The tight trading relationship with the EU and the carbon intensity of the Western Balkans economies make the region vulnerable to the CBAM. The EU has, historically, been the largest single trading partner for all the Western Balkans countries. In 2022, exports of CBAM products to the EU accounted for 22 per cent of all Western Balkans exports to the EU.[89] The most significant impact will be felt by export-oriented iron and steel and aluminum industries, where EU exports account for a large share of overall production. While

[87] This is the total value of all CBAM-affected products exported from the Western Balkans to the EU in 2022.
[88] The European Council reserves the right to extend the product scope and extend the coverage of indirect emissions before full implementation (on 1 January 2026), but it needs to submit the proposal to European Parliament no later than 31 December 2024.
[89] Authors' calculation based on Eurostat data. CBAM products refer to the initial scope as defined in the regulation from April 2023: iron and steel, cement and clinker, fertiliser, aluminium, and electricity.

the effects of the CBAM will be highly dependent on the governments' approaches (policy options include the implementation of countries' own carbon pricing mechanisms or a request for exemption of electricity until 2030 under certain conditions), the legislation is bound to have a profound impact on entire industries as profit margins shift and countries gain and lose export competitiveness based on their energy mix.

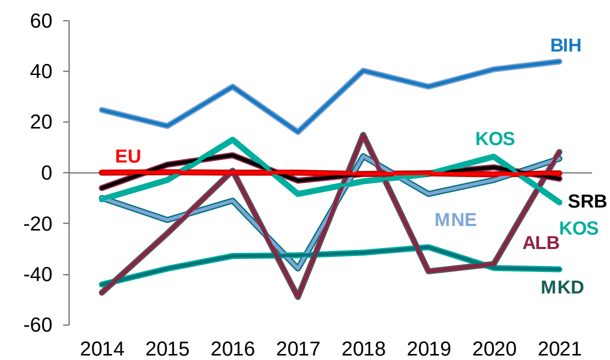
Unpredictable domestic electricity production has made the region vulnerable to external shocks. While the Western Balkans region as a whole produces enough electricity to satisfy its own consumption, and even generates significant exports destined for the EU (some 13 per cent of power generation in the Western Balkans was exported to the EU in 2011-20), the more detailed picture is mixed, with exports varying significantly by country and by year (charts 38 and 39).[90] Between 2014 and 2021, only Bosnia and Herzegovina was consistently a net electricity exporter, with net exports at around a fifth of domestic production, while North Macedonia was a net electricity importer each year. All countries exhibited significant variations in annual production, Albania's pattern being particularly volatile given the overwhelming dependence on hydropower. The patterns are explained largely by hydrological conditions, but the ageing coal fleet is increasingly contributing to the variation due to breakages, overhauls and an overall declining trend in production.

Chart 38: The Western Balkans coal and hydro sectors dominated power production...
Percentage of net electricity generation based on GWh



Source: Eurostat.

Chart 39: ...resulting in large variations in domestic power generation
Net exports as share of electricity available for final consumption, based on TJ



Source: Eurostat and authors' calculations.

The energy crisis in 2022 had significant implications for security of supply... As supplies of gas from Russia to Europe were curtailed in the winter of 2021-22, gas prices in Europe soared, putting upward pressure on electricity prices at a time of high consumption during an unusually cold winter for the continent.[91] Against the background of surging prices of gas and electricity imports, technical problems in ageing coal-powered thermal power plants and a lack of water for hydropower made for a significant dip in domestic energy production. Albania, Kosovo and North Macedonia declared a state of emergency in the energy sector during the winter of 2021-22. All countries except Bosnia and Herzegovina and Montenegro have since provided subsidies to energy SOEs.[92] Albania's electricity sector is highly vulnerable to rainfall patterns and had to import almost half of its electricity consumption, at a very high cost, during the winter.[93] A domestic energy crisis affected Serbia, where a breakdown of the country's biggest thermal power plant in December 2021 meant that losses of state-owned energy companies amounted to some 2 per cent of Serbia's GDP during the following six-month period.[94] Similar breakdowns happened in Kosovo and North Macedonia, which also rely heavily on lignite. For

[90] See CEE Bankwatch Network (2022).
[91] See EBRD (2022): "Gas accounts for the bulk of derived heat production in the EBRD regions. In some economies, gas is also an important source of electricity production. Even where electricity is not directly derived from gas, electricity and gas prices tend to co-move."
[92] See World Bank (2023).
[93] See IMF (2022).
[94] See Fiscal Council Republic of Serbia (2022).

Kosovo, the crisis meant a temporary reliance on rolling blackouts. In North Macedonia, public-sector arrears increased to 3.1 per cent of GDP on the back of support provided to SOEs, while the 2023 budget contains large allocations for energy subsidies to the domestic electricity producer to protect households from an increase in electricity prices, equal to 1.7 per cent of projected GDP.[95]

…and revealed the underlying structural challenges hindering energy resilience. The energy crisis made it clear that long-standing problems associated with prolonged under-investment in energy infrastructure could no longer be ignored or postponed. The authorities in each country had to speed up the development of renewable generation and district heating capacity and improve the governance and financial viability of energy SOEs. Success in these areas would be key to reducing dependence on imports and building resilience to shocks. At the same time, several large gas projects are proposed or under way in the region, including pipelines, gas-fired power plants and liquefied natural gas terminals.[96] At present, gas consumption is low in the region and supplies in the Western Balkans are almost entirely sourced from Russia, under bilateral contracts in the case of Serbia and Bosnia and Herzegovina and under market prices in North Macedonia. While new interconnections would help diversify gas supply, building up new gas capacities would introduce new economic and energy security implications for the green transition.

Measures are being taken to ensure energy security. The Western Balkans countries have taken important steps to enhance energy security and advance the green transition in terms of strategic planning, enhancement of the regulatory framework for renewables and market integration. Albania and North Macedonia have already adopted their national energy and climate plans (NECPs), while the remaining countries are legally obliged to submit drafts of their plans to the Energy Community Secretariat by June 2023 and to adopt them by June 2024. The NECPs are an important tool for steering the energy transition as they define a country's overarching energy and climate goals and policies, and measures to achieve them, in harmony with other national strategic documents. All WB-6 countries have at least partly implemented regulations on renewables self-consumption ("prosumers") and most countries have switched from feed-in tariffs for renewables to market-based incentives for utility-scale projects. Serbia was the only economy with an operational day-ahead electricity market until 2023, when it was joined by Montenegro, North Macedonia and Albania (with the exchange also entrusted to operate the Kosovo market). Work is under way to develop intraday markets. These short-term markets are important for the uptake of renewables and are a condition for the exemption of electricity under the CBAM.

Accelerating the deployment of renewables requires institutional and regulatory capacity and complementary energy-sector reforms. A major reform agenda lies ahead, as the authorities seek to overcome the disadvantages associated with small, fragmented markets and high costs of entry for new investors in renewable energy sources. It is vital to have the right regulatory framework and market organisation, so that market participants can invest in new technologies such as energy storage and smart grids. Independent regulation can also help reduce or remove political interference, which in the past has caused a lack of transparency and reputational risks for investors. A credible strategy is also needed to address high levels of energy poverty in the region, which has been exacerbated by the recent wave of price increases and makes it difficult to ensure cost recovery for necessary investments of key sector players. Complex measures complementary to green transition efforts, such as carbon pricing and a just transition, are likely to prove challenging and account for an initial loss in jobs, but can no longer be ignored.

Renewable energy auctions can help scale up generation capacity quickly and cost-effectively. Electricity generation from renewables differs markedly from generation from traditional sources such as coal and gas, as most renewables tend to have a near zero marginal cost of generation. The design of electricity markets and the framework for attracting investment into renewable energy therefore needs to take into account the large initial investment required and, in the case of the Western Balkans, the absence of a sufficiently liquid energy market, and provide some sort of minimum support to investors for the energy delivered under a long-run arrangement. A broad consensus has emerged that competition is a transparent means to identify the level of support to be provided to utility-scale renewable energy projects and to select projects to which support is provided.[97]

[95] See World Bank (2023).
[96] See Global Energy Monitor and CEE Bankwatch Network (2023).
[97] See EBRD, Energy Community Secretariat and IRENA (2018).

Renewable energy auctions have been highly successful so far and should be further developed. Auctions, or competitive bidding processes, encourage bidders to reveal costs, promote cost-efficient development and effectively drive costs down for consumers while policymakers benefit from greater control over sector development. Auctions also provide a clear and predictable regulatory framework and allocation of project risks, important factors from an investors' perspective. Granting support for renewable energy on market-based principles through auctions has been widely used in EU and non-EU countries alike, and they are being used increasingly in the Western Balkans, with EBRD support (see Box 5). Evidence from the EU shows that in many member states the introduction of tenders for renewables reduced the support cost considerably compared with administrative schemes, enhanced the deployment of renewable energy capacities and provided a solid framework for technological improvement.[98] Auctions are also a regulatory requirement for the Western Balkans as the countries are obliged to transpose the EU acquis related to renewable energy support schemes as signatories of the Energy Community Treaty.

[98] See European Commission (2022c).

Box 5: EBRD support for renewable energy auctions in the Western Balkans

The EBRD has a successful track record of supporting policymakers in establishing the regulatory framework for renewable energy and implementing renewable energy auctions. In a breakthrough case for the Western Balkans region, the EBRD supported the Albanian authorities in conducting the country's first renewable energy auctions, alongside comprehensive support in developing the regulatory framework. Albania relies heavily on hydropower sources and, during periods of peak demand or droughts, has to import electricity, which is typically generated from fossil fuels in neighbouring countries. Since the launch of the first auctions in 2019, a total capacity of some 690 MWh has been awarded through four auctions with record prices at only a fraction of Albania's summer import prices. The auctions have attracted an increasing number of national and international developers, mobilised local bank financing and served as a catalyst for the decision to apply competitive procurement for all future renewable energy projects.

VIII. Concluding remarks

The main message behind our paper is a positive one: after more than three decades of transition, the Western Balkans remains a region full of potential for sustainable growth and continued progress towards EU living standards. The region has made enormous strides since the 1990s in terms of peace, political stability and normalisation, and higher GDP. At the same time, there is also a palpable sense of frustration and disappointment throughout the region at the slow pace of reform and the slowdown in convergence towards the EU since the global financial crisis of 2008-09. The fundamental question therefore facing policymakers in the region, and partner international institutions, is how to reinvigorate the catch-up process.

The key to success lies in implementing targeted reforms that make the economy function better and boost productivity. Throughout this paper we have advocated for a three-pronged approach to the reforms needed to achieve this convergence: govern better, improve cross-border linkages and go green. Improving governance would not only allow the economy to function more efficiently and effectively but would also make people's lives better and thus give incentives for young people to stay in the region rather than emigrating, therefore reducing the severe demographic problems facing all countries. Opening up the economies further by improving cross-border infrastructure and reducing barriers on the border would make the region more competitive and innovative, and more attractive to foreign investment. And going green, by phasing out fossil fuels and exploiting the region's great potential for renewable sources of energy, would bring major health benefits (by reducing pollution) and strengthen resilience to future global energy shocks. By acting collectively, with common goals, the region can enhance its attractiveness to outside investors, who are vital for making convergence a reality.

As of late-2023, the region stands at a crossroads, with an uncertain future. The EU's new Growth Plan for the Western Balkans, announced by the European Commission on 8 November 2023, and especially its financial part, the Reform and Growth Facility, is a welcome step forward in creating a relatively flexible financial instrument that can support the economic convergence of the Western Balkans. The Plan, which has yet to be approved by the European Council, brings extra funding to the region, mainly in the form of loans but also with a 20 per cent boost to grant funds already committed under the existing Instrument of Pre-Accession Assistance programme. Importantly, the use of funds, including for budget financing, will be tied to progress in socioeconomic reforms. For that reason, the design of reform agendas by individual governments takes on a new importance. Our hope is that, in shaping these agendas, priority will be given to those areas identified in this paper, as that is where the needs are greatest and the reward for reform implementation will be highest.

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Glossary

ATQ	assessment of transition qualities
BAFTA	Baltic Free Trade Area
BEEPS	Bank Business Environment and Enterprise Performance Survey
CBAM	Carbon Border Adjustment Mechanism
CO_2	carbon dioxide
CPI	consumer price index
CEE	central and eastern European
CEFTA	Central European Free Trade Agreement
EU	European Union
EBRD	European Bank for Reconstruction and Development
ETS	Emissions Trading Scheme
EIB	European Investment Bank
FSI	Financial Soundness Indicator
FDI	foreign direct investment
GDP	gross domestic product
IMF	International Monetary Fund
ILO	International Labour Organization
ICT	information and communication technology
NEEPs	young people not in education, employment or training
NERP	National Emission Reduction Plan
NO_x	nitrogen oxides
NECP	National Energy and Climate Plan
OECD	Organisation for Economic Co-operation and Development
PPP	purchasing power parity
PISA	Programme for International Student Assessment
SOE	state-owned enterprise
SME	small and medium-sized enterprise
STEM	science, technology, engineering and mathematics
SAA	Stabilisation and Association Agreement
SO_2	sulphur dioxide
TIMSS	Trends in International Mathematics and Science Study
TEN-T	Trans-European Transport Network
UN	United Nations
WB-6	the six economies of the Western Balkans
WEO	World Economic Outlook
WDI	World Development Indicator
WIIW	Vienna Institute for International Economic Studies
WGI	Worldwide Governance Indicator
WITS	World Integrated Trade Solution