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An Overview of External Imbalances in the Western Balkan Countries

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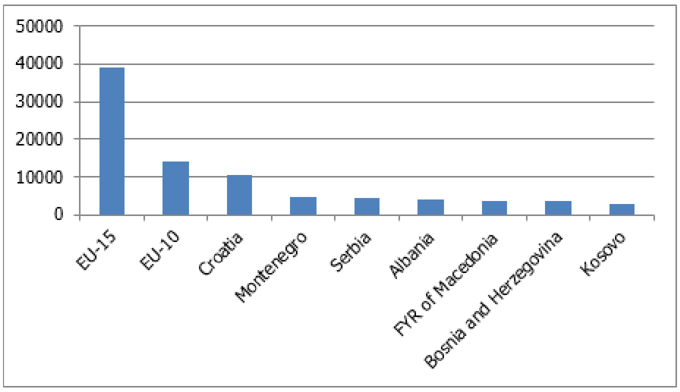
The Western Balkan countries have undergone dramatic economic transformations since the beginning of the 21st century. However, in spite of a complicated reform process launched after the political and economic instability of 1990s, the countries still lag way behind EU member states. What makes it so difficult for them to catch up with more developed economies of the continent? ***Cigdem Borke Tunali*** *provides an analysis from an economic standpoint.*

'Even though the Western Balkan countries have made a significant progress in terms of economic stability in recent years, their economies are still vulnerable. Current account deficits are unavoidable', argues Dr Tunali (Image by Peter Denton, Dubrovnik 1991, CC BY-SA 2.0)

As shown by a recent special report by the International Monetary Fund (IMF), after the political and economic disorders of 1990s the region – Albania, Bosnia and Herzegovina, Croatia, FYR of Macedonia, Montenegro and Serbia – embarked on a reform process by liberalizing their trade and capital accounts, removing the obstacles which prevent the development of private sectors and founding the institutions necessary for the functioning of the market mechanism. According to the figures, however, the Western Balkans still have very low GDP per capita levels in comparison to the members of the European Union (Figure 1). While the GDP per capita of Croatia – the most junior member of the Union – is very close to the new member states' (EU-10) average, it considerably falls behind the average GDP per capita of the EU's core members (EU-15). GDP per capita levels of the other countries in the region are not even half of the average GDP per capita levels of either EU-15 or EU-10. Hence, stated by Dimitar Bechev in a recent paper, the Western Balkan countries constitute "*the periphery of the periphery"* of Europe.

Figure 1: GDP per capita Levels of the Western Balkans and EU in 2013 (constant 2005 Dollar)

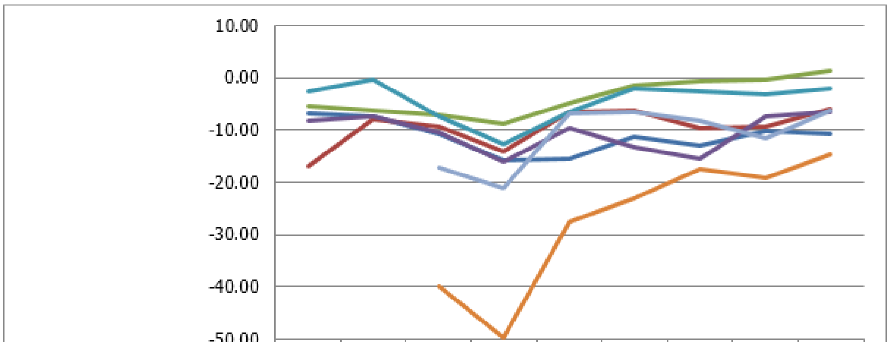


Source: *World Bank, World Development Indicators, 2015 and author's calculations*

The Western Balkan countries have experienced severe economic troubles, specifically as a result of the 2008 Global Economic Crisis, with Croatia not being able to recover since. I argue that, among the key challenges faced by these countries, the problem of external imbalances or current account deficits (negative net sales abroad, or putting it in simple words: a country imports more than it exports) is a particularly significant one that would be deserving of more attention.

Figure 1 shows the current account balances of the Western Balkan countries over the period 2005-2013. As clearly shown by the figure, the Western Balkan countries had huge current account deficits during this period and they skyrocketed at the outbreak of the 2008 Global Economic Crisis. Except for Croatia, Macedonia and Montenegro, the average current account deficit of the Western Balkan countries over the period under investigation was around 10 percent of GDP. While Croatia and Macedonia are the first and second best countries with an average current account deficit of 3.76 and 4.37 percent of GDP between 2005 and 2013 respectively, Montenegro has the highest current account deficit (the average current account deficit is 27.39 percent of GDP) and it is in the worst position among the Western Balkan countries.

Figure 2: Current Account Balance of the Western Balkan Countries (2005-2013, as a percent of GDP)*

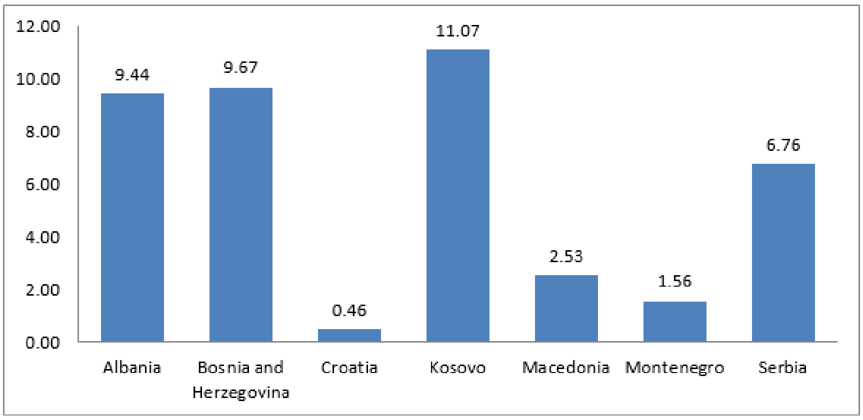


	2005	2006	2007	2008	2009	2010	2011	2012	2013
Albania	-6.82	-7.35	-10.75	-15.67	-15.37	-11.34	-12.95	-10.19	-10.67
Bosnia and Herzegovina	-16.92	-7.95	-9.39	-14.12	-6.58	-6.12	-9.65	-9.22	-5.95
Croatia	-5.42	-6.37	-7.21	-8.63	-4.88	-1.51	-0.65	-0.44	1.24
Kosovo	-8.22	-7.24	-10.32	-16.19	-9.67	-13.17	-15.36	-7.45	-6.38
Macedonia	-2.66	-0.44	-7.42	-12.57	-6.54	-2.12	-2.52	-3.14	-1.91
Montenegro			-39.86	-49.74	-27.66	-23.14	-17.57	-19.01	-14.70
Serbia			-17.10	-21.10	-6.73	-6.48	-8.25	-11.52	-6.13

Source: *World Bank, World Development Indicators, 2015.*
**Montenegro and Serbia have data only for the period 2007-2013.*

One of the striking features of the external imbalances in the Western Balkan countries is the significant difference between the current account and the trade deficits. According to the World Bank statistics, with the exception of Croatia and Macedonia, the difference between the average current account and trade deficits over the 2005-2013 period is between 7.15 (Serbia) and 25.17 (Kosovo) percent of GDP. This big difference mainly stems from the workers' remittances. Figure 3 shows the average of the workers' remittances in these countries as a percent of GDP between 2005 and 2013. As it is obvious from the figures, workers' remittances are rather high particularly in Albania, Bosnia and Herzegovina and Croatia. Although workers' remittances can be seen as a panacea for the foreign exchange shortage in developing countries, the inflow of foreign exchange by this channel may also lead to a number of negative effects on the receiving economy. One of these negative effects is the so-called "Dutch Disease" which is described as a phenomenon that occurs due to the large inflow of foreign currency and results in the appreciation of domestic currency and thereby the decrease of the export sectors' competitiveness. Thus, workers' remittances should be used to increase the export capacity of the recipient countries in order to avoid these negative side effects. This is especially significant in the Western Balkan countries given that they need to have strong export sectors.

Figure 3: The Average of Workers' Remittances in the Western Balkan Countries (2005-2013, as a percent of GDP)

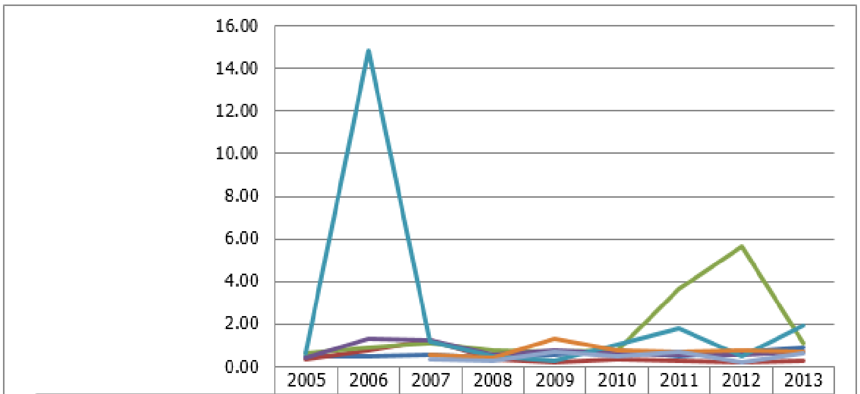


Source: *IMF, Balance of Payments Statistics, 2015; World Bank, World Development Indicators, 2015 and author's calculations.*
**Montenegro and Serbia have data only for the period 2007-2013.*

Without doubt, when we take into account the level of economic development of the Western Balkans, it becomes obvious that current account deficits are unavoidable for these countries in order to carry out the investments which are required to catch up with the developed countries, since domestic saving rates of these countries are quite low and current account deficits enable these countries to invest more than their domestic savings. However, large and persistent current account deficits may cause a crisis by increasing the vulnerability of the economies, unless it is financed by long-term, stable capital inflows such as foreign direct investment (either private or institutional, such as EBRD or EIB).

From this point of view, it is significant to investigate the amount of current account deficit that is financed by foreign direct investment inflows in the Western Balkan countries. Figure 4 presents foreign direct investment to current account balance ratio for these countries over the period 2005-2013. According to this figure, although foreign direct investment inflows were in excess of current account deficits in most of the Western Balkan countries (except Albania, Montenegro and Serbia), just before the onset of the 2008 Global Economic Crisis these inflows fell short of the deficits after the crisis. More importantly, the large amount of foreign direct investment has flown to non-tradable sectors in the Western Balkans (Kinoshita, 2011). Hence, these inflows do not contribute to the export capacity and consequently do not help to solve the external imbalances of the Western Balkans in the long-term.

Figure 4: Foreign Direct Investment to Current Account Balance Ratio in the Western Balkan Countries (2005-2013)*



	2005	2006	2007	2008	2009	2010	2011	2012	2013
Albania	0.45	0.47	0.56	0.43	0.51	0.77	0.51	0.66	0.89
Bosnia and Herzegovina	0.33	0.77	1.23	0.37	0.20	0.35	0.27	0.21	0.28
Croatia	0.63	0.92	1.06	0.74	0.66	0.75	3.66	5.62	1.07
Kosovo	0.43	1.28	1.22	0.54	0.72	0.59	0.52	0.56	0.71
Macedonia	0.59	14.85	1.16	0.49	0.30	1.04	1.81	0.49	1.92
Montenegro			0.53	0.38	1.31	0.77	0.68	0.77	0.66
Serbia			0.36	0.26	0.66	0.45	0.66	0.18	0.59

Source: *IMF, Balance of Payments Statistics, 2015*
**Montenegro and Serbia have data only for the period 2007-2013.*

In a nutshell, even though the Western Balkan countries have made a significant progress in terms of economic stability in recent years, their economies are still vulnerable because of the severe economic problems. Considering the low level of development of these countries, it is obvious that current account deficits are unavoidable in order to carry out the investments necessary for the convergence to the developed countries. Hence, the Western Balkan countries should firmly implement structural reforms which provide economic stability and lead to higher foreign direct investments in export sectors. As pointed out in a recent study by the European Commission, rigidities in the labour markets, inefficient legal systems which are not capable of ensuring rule of law, large shares of public sectors and the existence of underdeveloped financial markets are the key areas in which the structural reforms are strongly needed.

Note: This article gives the views of the authors, and not the position of LSEE Research on SEE, nor of the London School of Economics.

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