How the Western Balkans can catch up
Peter Sanfey, Jakov Milatović and Ana Krešić

Abstract
Countries in the Western Balkans – Albania, Bosnia and Herzegovina, FYR Macedonia, Kosovo, Montenegro and Serbia – all aspire to membership of the European Union, but they face a major convergence challenge in terms of living standards. The main reason behind this prosperity gap lies in the failure over the years of Western Balkans countries to be competitive, meaning that they lack the appropriate factors and institutions needed for high levels of long-term productivity. The key issue is whether the Western Balkans countries can narrow the gap in the coming decade and, if so, what do they need to do to achieve this.

The vital requirement for catching up with the rest of the European Union is a boost to investment in the region. The Western Balkans have a number of attractive features for investors. The long-term EU perspective is a major plus and a unique quality of the region compared with other emerging markets, as it helps to anchor market-oriented reforms and European standards. Strong macroeconomic stability, strategic geographic location, diverse economies, favourable tax regimes and low unit labour costs, combined with a relatively well-educated population, are common attributes throughout the region.

Looking ahead, sources of growth include trade integration, within the region and with the rest of the world, exploitation of the region’s energy resources, improvement of the transport infrastructure and technological innovation. However, long-term challenges remain, such as the possibility of a slowdown in reforms, risks posed by financial instability, adverse demographic trends and climate change. But provided governments in the region remain committed to reforms and regional cooperation, these challenges can be mitigated, if not overcome.

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Introduction

As of early 2016, the six countries of the Western Balkans – Albania, Bosnia and Herzegovina, FYR Macedonia, Kosovo, Montenegro and Serbia – face a formidable array of challenges. For the past seven years growth rates have been in low single digits at best, and negative at times in some countries. Levels of unemployment and poverty are persistently high. Supplies of foreign credit and capital from private sources – plentiful in the pre-crisis years – have largely dried up. Meanwhile, banks in the region remain preoccupied with the legacy of the crisis, especially the high levels of non-performing loans (NPLs), rather than lending to the real economy. At the same time, governments face severe limits in what they can do to tackle these problems. The fiscal space for Keynesian-style public spending projects is limited, while monetary policy is naturally constrained in these small open economies which all have a high degree of euroisation. So how can the Western Balkans countries catch up with their richer EU neighbours?

The size of this challenge – and the potential – facing the Western Balkans is illustrated in Chart 1, which shows the extent of the gap in living standards vis-à-vis western, southern and eastern European EU countries. Looking at the regional averages, GDP per capita in the Western Balkans, adjusted for purchasing power parity, is roughly half that of eastern European EU countries, one-third that of southern EU members and a mere quarter of the richest EU members in western Europe. Such gaps reflect many years of under-performance and turbulence in the Western Balkans.

**Chart 1: Convergence potential**

Source: World Economic Outlook, IMF, October 2015.

Note: Countries are ordered from highest to lowest. Luxembourg is an outlier in terms of GDP PPP per capita and is not included.

The central argument of this paper is that the Western Balkans can narrow these gaps in the coming decade. Under the right circumstances, these economies can achieve growth rates that, even if not quite matching the pre-crisis years (when growth was artificially boosted by a huge credit boom), can make a serious dent in unemployment and poverty and bring living standards closer to those in the European Union. Attracting foreign investment will be vital for achieving this growth. The region has significant advantages as an investment destination, but these are often overshadowed by a lingering image problem from the turbulence of the
1990s. These countries have significant unexploited potential in areas such as trade integration, transport infrastructure, energy development and innovation.

The paper proceeds as follows. In Section 1 we summarise where the region stands on a range of cross-country indicators, starting with the widely used World Economic Forum’s Global Competitiveness Index, but drawing also on other sources such as the World Bank’s Doing Business report and Governance Indicators and the EBRD’s Assessment of Transition Challenges (ATCs). The picture is complex but certain patterns emerge from the analysis. Encouragingly, countries in the Western Balkans have improved on average in their performance over the past decade. However, the failure to make efficient use of talent, the lack of business sophistication and quality transport infrastructure are the main reasons holding back the competitiveness of the region.

Section 2 summarises some of the advantages of the region from an investor perspective. Principal among these are progress towards eventual EU membership combined with the growing degree of regional cooperation in recent years and the high degree of macroeconomic stability. But there are other advantages too, including diverse economies that can accommodate a wide range of investments in different sectors, low tax rates (and often favourable tax breaks for large investors), competitive unit labour costs, and relatively high levels of education and language skills, especially among young people. The Western Balkans region is also well-placed geographically – its strategic location is of growing interest to global economic powers, notably China and its “One Belt, One Road” initiative.

In Section 3 we outline some of the potential sources of growth in the coming decade. Foreign direct investment (FDI) will be essential for growth, and levels of FDI are expected to rise in the coming years, boosted by enhanced inflows from less traditional sources such as the Gulf countries and China. Trade integration, both internal and external, can be an important growth driver in years to come, especially as the quality of cross-border infrastructure improves and non-tariff barriers to trade decline. A number of major transport and energy projects are in the pipeline, which will also help boost growth rates across the region. Lastly, the region’s capacity for innovation has been under-exploited so far, suggesting that this can be an important growth driver as well.

In the last section we conclude with a brief discussion of some of the longer-term challenges facing the region. One risk is that further structural reforms are postponed or even reversed, leaving the region “stuck” in transition, or worse. Another risk comes from financial sector fragility. Strong international support has helped prevent systemic bank failures, but continued vigilance is needed to ensure a healthy financial sector. There are also risks that might affect the long-term sustainability of the region. As elsewhere in central and eastern Europe, populations in the Western Balkans are aging, and in some cases declining in absolute terms, as a result of low birth-rates and emigration of mostly young people. Global warming is another concern. But, provided political leaders in the region take a long-term perspective and a cooperative regional approach, these risks can be mitigated, if not overcome.
1. How competitive is the Western Balkans region relative to others?

In the introduction we suggested that the Western Balkans lag behind the rest of Europe because economies in the region have been less competitive than others. The notion of “competitiveness” can mean different things to different authors. In this paper we deem a country to be highly competitive if it has the right combination of institutions and policies, such as effective governance and an enabling business environment, and factors of production to achieve high levels of productivity. To understand why the region finds itself in its current state, and to assess the potential for catch-up, it is important to see where these countries stand across a range of indicators vis-à-vis its comparators in the European Union.

How competitive are the Western Balkans countries? The natural starting point to answer this question is the World Economic Forum’s Global Competitiveness Report (GCR), a publication that bills itself as the “world’s most comprehensive assessment of national competitiveness”\(^1\). But the GCR by no means captures all aspects of this concept. Other surveys and studies can complement the report by providing greater insights into specific aspects of the business environment and governance that hold back private sector development and deter investment.

Table 1: Rankings in Global Competitiveness Index 2015-16

<table>
<thead>
<tr>
<th></th>
<th>ALB</th>
<th>BIH</th>
<th>MKD</th>
<th>MNE</th>
<th>SRB</th>
<th>WB</th>
<th>EU-11</th>
<th>EU</th>
<th>EU-15</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Basic requirements</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>1st pillar: Institutions</td>
<td>84</td>
<td>127</td>
<td>52</td>
<td>70</td>
<td>120</td>
<td>91</td>
<td>72</td>
<td>47</td>
<td>30</td>
</tr>
<tr>
<td>2nd pillar: Infrastructure</td>
<td>88</td>
<td>103</td>
<td>78</td>
<td>73</td>
<td>75</td>
<td>83</td>
<td>52</td>
<td>33</td>
<td>18</td>
</tr>
<tr>
<td>3rd pillar: Macroeconomic environment</td>
<td>118</td>
<td>98</td>
<td>47</td>
<td>79</td>
<td>125</td>
<td>93</td>
<td>47</td>
<td>59</td>
<td>66</td>
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<tr>
<td>4th pillar: Health and primary education</td>
<td>52</td>
<td>48</td>
<td>76</td>
<td>33</td>
<td>62</td>
<td>54</td>
<td>45</td>
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<tr>
<td><strong>Efficiency enhancers</strong></td>
<td></td>
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<td>5th pillar: Higher education and training</td>
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<td>46</td>
<td>54</td>
<td>71</td>
<td>63</td>
<td>40</td>
<td>30</td>
<td>20</td>
</tr>
<tr>
<td>6th pillar: Goods market efficiency</td>
<td>63</td>
<td>129</td>
<td>33</td>
<td>70</td>
<td>127</td>
<td>84</td>
<td>53</td>
<td>39</td>
<td>29</td>
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<tr>
<td>7th pillar: Labour market efficiency</td>
<td>97</td>
<td>131</td>
<td>84</td>
<td>74</td>
<td>118</td>
<td>101</td>
<td>68</td>
<td>54</td>
<td>45</td>
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<tr>
<td>8th pillar: Financial market development</td>
<td>118</td>
<td>113</td>
<td>52</td>
<td>44</td>
<td>120</td>
<td>89</td>
<td>56</td>
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<td>48</td>
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<tr>
<td>9th pillar: Technological readiness</td>
<td>89</td>
<td>79</td>
<td>63</td>
<td>55</td>
<td>51</td>
<td>67</td>
<td>37</td>
<td>26</td>
<td>16</td>
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<td>10th pillar: Market size</td>
<td>104</td>
<td>97</td>
<td>108</td>
<td>131</td>
<td>75</td>
<td>103</td>
<td>66</td>
<td>54</td>
<td>37</td>
</tr>
<tr>
<td><strong>Innovation and sophistication factors</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>11th pillar: Business sophistication</td>
<td>95</td>
<td>125</td>
<td>72</td>
<td>102</td>
<td>132</td>
<td>105</td>
<td>63</td>
<td>39</td>
<td>19</td>
</tr>
<tr>
<td>12th pillar: Innovation</td>
<td>118</td>
<td>115</td>
<td>58</td>
<td>69</td>
<td>113</td>
<td>95</td>
<td>58</td>
<td>37</td>
<td>20</td>
</tr>
<tr>
<td><strong>Global Competitiveness Index</strong></td>
<td>93</td>
<td>111</td>
<td>60</td>
<td>70</td>
<td>94</td>
<td>86</td>
<td>50</td>
<td>36</td>
<td>23</td>
</tr>
</tbody>
</table>

Source: World Economic Forum’s Global Competitiveness Index Historical Database.

Note: In this paper, WB refers to the Western Balkans, ALB to Albania, BIH to Bosnia and Herzegovina, KOS to Kosovo, MKD to FYR Macedonia, MNE to Montenegro and SRB to Serbia.

Table 1 shows the 2015-16 GCR global rankings for each country (excluding Kosovo, for which data are not available), along with three benchmark comparators: the European Union, the EU-15 (the 15 member states prior to the 2004 expansion) and the EU-11 (the 11 countries in central Europe, the Baltic states and south-eastern Europe that joined in 2004 or

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The table shows the clear competitiveness gap between the Western Balkans region and the European Union. On average, the region is ranked 86th (ranging from FYR Macedonia in 60th to Bosnia and Herzegovina in 111th place), compared with an average 50th place for the EU-11 and 36th for the European Union as a whole. The gap is particularly large with respect to the EU-15, where the average ranking is 23rd.

The GCI is made up of three broad categories, which are divided into 12 pillars, and the rankings of the five Western Balkans countries by categories and pillars are also contained in Table 1. The rankings differ widely, both within and across countries. The region scores reasonably well on indicators associated with health and primary education, as well as higher education and training (except for on-the-job training), electricity and telephone infrastructure and information and communications technology (ICT) use. However, the most problematic areas are: efficient use of talent, that is, capacity to attract talent from abroad and retain talent, as confirmed by the brain drain problem; and reliance on informal (family and friend) relationships rather than on professional management. The second area dragging down the overall ranking is business sophistication. Despite the high heterogeneity, on average countries lack well-developed business clusters and are characterised by shallow value chains. Transport infrastructure ranks badly mostly due to the limited passenger-carrying capacity in airline traffic, but also because of the poor quality of overall infrastructure, including roads, railways and ports.

On a more positive note, Table 2, which shows the 2007-08 GCR scores compared with the latest available (2015-16), suggests that there has been a gradual improvement in competitiveness since the pre-crisis years. In contrast, scores of the EU countries have remained on average almost the same as before. The biggest jump in competitiveness is in FYR Macedonia, where the score has improved by 0.6 points (on the GCR’s 1 to 7 scale) and now lies just behind the EU-11 average. Notable advances have also occurred in Albania and Montenegro, but less so in Bosnia and Herzegovina and Serbia. In an important sense, therefore, the Western Balkans economies are converging with EU comparators in terms of competitiveness.

### Table 2: Global Competitiveness Index, evolution of the scores

<table>
<thead>
<tr>
<th></th>
<th>2007-08</th>
<th>Rank</th>
<th>2015-16</th>
<th>Rank</th>
<th>Difference in scores</th>
</tr>
</thead>
<tbody>
<tr>
<td>Albania</td>
<td>3.5</td>
<td>109</td>
<td>3.9</td>
<td>93</td>
<td>0.44</td>
</tr>
<tr>
<td>Bosnia and Herzegovina</td>
<td>3.6</td>
<td>106</td>
<td>3.7</td>
<td>111</td>
<td>0.15</td>
</tr>
<tr>
<td>FYR Macedonia</td>
<td>3.7</td>
<td>94</td>
<td>4.3</td>
<td>60</td>
<td>0.55</td>
</tr>
<tr>
<td>Montenegro</td>
<td>3.9</td>
<td>82</td>
<td>4.2</td>
<td>70</td>
<td>0.30</td>
</tr>
<tr>
<td>Serbia</td>
<td>3.8</td>
<td>91</td>
<td>3.9</td>
<td>94</td>
<td>0.10</td>
</tr>
<tr>
<td>WB</td>
<td>3.7</td>
<td>96</td>
<td>4.0</td>
<td>86</td>
<td>0.31</td>
</tr>
<tr>
<td>EU-11</td>
<td>4.4</td>
<td>48</td>
<td>4.4</td>
<td>50</td>
<td>0.05</td>
</tr>
<tr>
<td>EU</td>
<td>4.7</td>
<td>34</td>
<td>4.8</td>
<td>36</td>
<td>0.03</td>
</tr>
<tr>
<td>EU-15</td>
<td>5.1</td>
<td>21</td>
<td>5.1</td>
<td>23</td>
<td>0.01</td>
</tr>
</tbody>
</table>

Source: Authors’ calculations based on the World Economic Forum’s Global Competitiveness Index.

The GCR scores are a useful starting point for investors who wish to get a sense of how competitive a country is. However, other cross-country surveys and reports can provide

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2 The EU-15: Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, Portugal, Spain, Sweden and the United Kingdom. The EU-11: Bulgaria, Croatia, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, the Slovak Republic and Slovenia.
complementary perspectives and insights, especially when it comes to economic governance and the overall quality of the business environment. To shed further light on these two areas, we draw on three other surveys and reports: two from the World Bank (Governance Indicators and Doing Business scores) and the joint EBRD-World Bank Business Environment and Enterprise Performance Survey (BEEPS).

The World Bank’s Governance Indicator scores are shown in Chart 2. As with the GCR scores, there is some distance to go for Western Balkans countries to match EU standards. But again, a look at the scores over time suggests that the gap is, on average, narrowing steadily. The biggest increase over the past 15 years has been in political stability, which is an indication of the region’s growing political maturity. However, due to a low starting point, on present trends it would take several decades before Western Balkans countries catch up with EU members in terms of governance. Still, this convergence is expected to speed up in the process of EU approximation.

Chart 2: The Worldwide Governance Indicators, 2014

![Chart 2: The Worldwide Governance Indicators, 2014]

Source: The World Bank’s Worldwide Governance Indicators database.

Note: Scores range from -2.5 for weak governance performance to 2.5 for strong governance.

The World Bank’s annual Doing Business scores provide further insight into the obstacles faced by enterprises in the region. The latest rankings on overall ease of doing business vary widely, from 12th (FYR Macedonia) to 97th (Albania) out of 189 countries. The width of this range exaggerates the differences among countries of the region. The rankings therefore need to be interpreted cautiously: few would argue that it is really easier to do business in FYR Macedonia than in Canada or Germany, for example, despite their relative positions in the overall scores. However, as with other indicators considered here, the sub-components and their trends over time can be more revealing. Common problems across the region include: dealing with construction permits (Albania ranks in last place globally on this measure); getting electricity; and paying taxes, despite recent improvements in some cases. On the other hand, all countries made notable progress in ease of starting a business, registering property and trading across borders.

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3 The full scores are available at: [www.doingbusiness.org](http://www.doingbusiness.org).

4 Albania’s overall ease of doing business ranking was downgraded by 35 places to 97th. This was almost entirely because the country’s position in the category relating to construction permits dropped, caused by the government’s decision to suspend the issuing of construction permits during the territorial reform process until urban plans are in place.
Chart 3: Business environment obstacles

Note: Estimated for a hypothetical “average” firm. Higher values correspond to a more severe obstacle to doing business.

To gain further insight into the obstacles, as perceived by businesses, we turn lastly to the EBRD-World Bank *Business Environment and Enterprise Performance Survey* (BEEPS). The BEEPS, carried out every three to four years since the first round in 1999, is a face-to-face survey of top managers that looks at various aspects of the business environment through both quantitative and qualitative questions. One of the parts of the survey is an opinion-based question that asks respondents to grade areas according to their perception of how severe an obstacle is. The responses range from “not an obstacle”, which can be scored at 0, to “a very severe obstacle”, scored 4.

Chart 3 highlights the main obstacles, ranked by severity, for a hypothetical “average” firm in each country. In virtually all countries, competition from the informal sector stands out as a key constraint. This is a long-standing problem in the region and efforts to address it have been sporadic at best. The Albanian government’s recent initiative to tackle the problem is welcome and may yield concrete results (see Box 1, p38). Having reliable access to electricity is also identified by many businesses in Albania and Kosovo as a major obstacle, consistent with the analysis of the World Bank’s *Doing Business* report.

Access to finance is another major obstacle to doing business, according to many respondents to the BEEPS. A quarter of all surveyed firms across the EBRD region described themselves as credit-constrained, meaning that they need a loan but are either rejected when they apply for a bank loan or feel discouraged from applying (see Chart 4). In the Western Balkans, this share is highest in Montenegro, where more than one-third of all surveyed firms feel credit-constrained, and lowest in Bosnia and Herzegovina (13 per cent). In addition, overall demand for bank credit has decreased significantly in the post-crisis period. The percentage of interviewed firms that needed additional bank credit (including both the “credit-unconstrained” and “credit-constrained”) declined from 61 per cent in 2008-09 to 47 per cent in 2013-14 across the EBRD region. The decline was even higher in the Western Balkans; from 15 percentage points in Serbia to 20-25 percentage points in the rest of the region. This is not surprising because, in the presence of slow economic growth, fewer firms needed loans to expand their production capacity and this has been only partially offset by increased demand for working capital on the part of firms negatively affected by the financial crisis.
But what is driving these constraints? Chart 5 provides further insights. Overwhelmingly in the Western Balkans region the main driver is the discouraging level of interest rates. Despite the high number of banks in the region, competition among lenders appears to be limited and small and medium-sized enterprises (SMEs) in particular struggle to get the funds they need to grow their businesses. Other reasons that discourage firms from applying for bank credit include: complex procedures, collateral requirements and size of the loan.

To conclude this section, it is fair to say that the Western Balkans region lies behind western European comparators in terms of competitiveness, governance and ease of doing business. But there are plenty of reasons to be optimistic about future trends. In particular, institutions and governance standards are being slowly but steadily improved, especially in the EU candidate countries. The next section outlines some of the potential advantages of the region not fully captured by the cross-country data sets mentioned above.
2. What can the Western Balkans offer investors?

In this section we focus on why the Western Balkans can be attractive to investors. There are seven features of the region that, in our view, are worth emphasising. They are: prospective EU membership; macroeconomic stability; strategic location; favourable taxes; diverse economies; and low labour costs combined with a relatively educated population. Each of these will be discussed in turn.

**Prospective EU membership**

The new European Commission Enlargement Strategy,\(^5\) released in November 2015, has reaffirmed the European prospective of all Western Balkan countries, without exception. Although full membership is not on the cards for any of these countries during the mandate of the present Commission (2014-19), the past year has seen further progress in most countries in the enlargement process. The most advanced in this regard is Montenegro which, having started membership negotiations in June 2012, had by December 2015 opened more than half of the negotiation chapters of the EU *aquis communautaire*, including the most challenging Chapters 23 and 24 relating to judiciary and fundamental rights; and justice, freedom and security, respectively. Serbia opened its first chapters in December 2015, including the one on normalisation of its relations with Kosovo, almost two years after the symbolic opening of the accession negotiations in January 2014. Albania, a candidate country since June 2014, is deemed in the latest European Commission report to be “making steady progress” while Bosnia and Herzegovina – not yet a candidate – is judged to be “back on track” (see Box 2, p39) and submitted its application for membership on 15 February 2016. Kosovo and the European Union signed a Stabilisation and Association Agreement (SAA) in October 2015 (see Box 3, p40). Only FYR Macedonia, a candidate since 2005, has failed to make demonstrable progress since then as its name dispute with Greece remains unresolved.

The latest EC Enlargement Strategy has introduced a new methodology to assess the progress of aspirant countries. The report includes a five-point scale in a few pilot areas, including rule of law (functioning of the judiciary, fight against corruption and fight against organised crime), public administration reform, and key economic criteria (the existence of a functioning market economy and the capacity to cope with competitive pressure and market forces within the European Union). These are: (1) Early stage; (2) Some level of preparation; (3) Moderately prepared; (4) Good level of preparation; and (5) Well advanced (see Table 3).

### Table 3: State of progress on EU approximation

<table>
<thead>
<tr>
<th>Public administration reform</th>
<th>ALB</th>
<th>BIH</th>
<th>MKD</th>
<th>KOS</th>
<th>MNE</th>
<th>SRB</th>
</tr>
</thead>
<tbody>
<tr>
<td>Functioning of the judiciary</td>
<td>3</td>
<td>1</td>
<td>3</td>
<td>2</td>
<td>3</td>
<td>3</td>
</tr>
<tr>
<td>Fight against corruption</td>
<td>2</td>
<td>2</td>
<td>2</td>
<td>1</td>
<td>2</td>
<td>2</td>
</tr>
<tr>
<td>Fight against organised crime</td>
<td>2</td>
<td>2</td>
<td>2</td>
<td>1</td>
<td>2</td>
<td>2</td>
</tr>
<tr>
<td>Economic criteria</td>
<td></td>
<td></td>
<td></td>
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<td></td>
<td></td>
</tr>
<tr>
<td>The existence of a functioning market economy</td>
<td>3</td>
<td>1</td>
<td>4</td>
<td>1</td>
<td>3</td>
<td>3</td>
</tr>
<tr>
<td>The capacity to cope with competitive pressure within the European Union</td>
<td>2</td>
<td>1</td>
<td>3</td>
<td>1</td>
<td>3</td>
<td>3</td>
</tr>
</tbody>
</table>


Note: Scores are on a scale of 1 for early stage progress to 5 for well advanced (see text for details).

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Based on this, the country currently most advanced on its EU track – Montenegro – is at the top end regarding public administration, the judicial system, proximity to a functioning market economy, capacity to cope with pressure and market forces within the European Union, and in the ability to take on the obligations of membership, in all of which it is deemed to be “moderately prepared” (scoring 3 on the 1-5 scale). In contrast, Kosovo and Bosnia and Herzegovina are in general poorly prepared for EU membership, particularly regarding the economic criteria where both countries are “at an early stage” (scoring just 1 on the 1-5 scale) in the existence of a functioning market economy, and their ability to cope with competitive pressures and market forces within the European Union.

None of the Western Balkans countries will become full EU members in the next five years. But the long-term prospect of membership comes with substantial funding mainly in the form of the Instrument for Pre-Accession Assistance (IPA) for supporting reforms. Table 4 shows per country financial allocation from IPA funds for the period 2014-20, covering reforms in areas such as democracy and governance, rule of law, environment, transport and energy, competitiveness, social policies and agriculture and rural development. As many benefits of the European Union for the region accrue before full membership is obtained, it is important, therefore, that the current momentum in the process is maintained or even enhanced in the years to come.

Table 4: EU’s Instrument for Pre-Accession Assistance 2014-20, € million

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<td>Total, € million</td>
<td>649</td>
<td>166</td>
<td>664</td>
<td>646</td>
<td>271</td>
<td>1,508</td>
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Note: *2014-17. In addition, there is €2,959 million in funds for multi-beneficiary projects in the Western Balkans and Turkey.
Macroeconomic stability

For many years, countries in the Western Balkans region have enjoyed a high degree of macroeconomic stability. A stable economy anchors expectations and is a basic prerequisite for attracting the interest of foreign investors. Stable exchange rate regimes and low inflation rates are key pillars of the region’s macroeconomic stability. In four of the six countries the exchange rate is immovable vis-à-vis the euro, either because the euro is the only legal tender (Kosovo and Montenegro), or because the rate is fixed through a currency board (Bosnia and Herzegovina), or a long-standing peg (FYR Macedonia). Floating exchange rate regimes prevail in Albania and Serbia but excessive fluctuations are kept in check by central bank interventions; for instance, the Albanian lek has been at the rate of approximately 140 lek per euro for the last five years. As a result, all countries have had very low inflation for many years (see Table 5), aside from Serbia where the rate had reached high single digit levels (or even briefly double-digit territory) but is now comparable to other Western Balkan countries, as well as being below the central bank’s target range.

Table 5: Macroeconomic aggregates, five-year averages

<table>
<thead>
<tr>
<th></th>
<th>Inflation</th>
<th>Fiscal balance</th>
<th>Current account (BOP)</th>
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<tr>
<td></td>
<td>2003-08</td>
<td>2009-14</td>
<td>2003-08</td>
</tr>
<tr>
<td>Albania</td>
<td>2.7</td>
<td>2.5</td>
<td>-4.1</td>
</tr>
<tr>
<td>Bosnia and</td>
<td>3.2</td>
<td>1.1</td>
<td>-0.1</td>
</tr>
<tr>
<td>Herzegovina</td>
<td></td>
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<tr>
<td>Kosovo</td>
<td>2.0</td>
<td>2.2</td>
<td>0.6</td>
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<tr>
<td>FYR Macedonia</td>
<td>2.2</td>
<td>1.8</td>
<td>-0.1</td>
</tr>
<tr>
<td>Montenegro</td>
<td>4.8</td>
<td>2.1</td>
<td>-0.3</td>
</tr>
<tr>
<td>Serbia</td>
<td>9.8</td>
<td>7.1</td>
<td>-0.9</td>
</tr>
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</table>

Source: World Economic Outlook, IMF, April 2015.

Note: Fiscal balance and current account expressed as a per cent of GDP. Inflation rates are period averages.

The figures on current account and fiscal deficits are less impressive (also shown in Table 5); average current account deficits in the region (as a per cent of GDP) were 9.9 per cent in the period 2009-14 while fiscal deficits were 3.8 per cent over the same period. Montenegro has a particularly high current account deficit. However, the country is benefiting from a high level of FDI (relative to population and GDP), as investors are attracted by the country’s EU accession progress, strong tourism potential and its development as a regional energy hub. Kosovo traditionally has a major inflow of remittances, while other countries have comfortable levels of foreign currency reserves at the central bank, covering more than five months of imports and more than 100 per cent of short-term debt, which helps to put concerns about the current account in perspective.

In parallel, both public and private debt has increased significantly in most countries since 2007 (Chart 6). Serbia experienced the highest percentage-point-increase in public debt; for private debt it was FYR Macedonia. At the end of 2014 public debt levels were well above 60 per cent of GDP (one of the Maastricht criteria for eurozone members) in Albania and Serbia, and at that level in Montenegro. While this poses a risk to macroeconomic stability,
strong mitigating factors are also in play. Albania and Serbia are both in formal programmes with the IMF. The two countries have adhered closely to commitments made under their respective arrangements, which in both cases are explicitly designed to tackle fiscal imbalances and put public debt on a sustainable path.

**Chart 6: Changes in levels of public and private debt as % of GDP, 2007-14**

Source: EBRD Transition Report, 2015-16.
Note: Data comprise public debt, domestic private-sector debt and external debt of non-financial companies. The initial observation for Kosovo relates to 2009.

**Chart 7: Relative over-indebtedness in 2014**

Source: EBRD Transition Report, 2015-16.
Note: A negative sign reflects under-indebtedness relative to global comparators. See the EBRD Transition Report, 2015-16, Chapter 1, for further explanation.

In addition, private debt is on an increasing trend in all Western Balkans countries except in Bosnia and Herzegovina. The level of private debt is particularly high in Montenegro, at more than 110 per cent of GDP, while still low in Albania and Kosovo. Interestingly, however, debt levels across all countries where the EBRD invests are still, on average, lower than those of other emerging markets with similar characteristics. ⁷ This relative under-leverage is driven both by lower levels of household and corporate debt (see Chart 7). Therefore, this analysis suggests that in all Western Balkans countries there is room to increase household debt and also, in all countries except Montenegro, there is space for a corporate debt increase. Evidence suggests that domestic corporate credit has a greater positive impact on growth prospects compared with household debt or external corporate debt, and the countries that appear to have the greatest scope to increase domestic corporate debt are Bosnia and Herzegovina, FYR Macedonia and Serbia.

**Strategic geographic location**

An important advantage for the Western Balkans region is its easy and free access to EU markets. This has been enabled by its geographic proximity to major European markets and the free trade agreements that the countries of the region have signed with the European Union. The region is linked with the rest of Europe through the Pan-European corridors X (connecting the central Europe with Turkey through Austria, Slovenia, Croatia, Serbia, FYR

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⁷See the EBRD Transition Report, 2015-16: Rebalancing finance, Chapter 1, for an elaboration of this argument.
Macedonia and Greece), VII (connecting the Black Sea with the Ionian Sea and passing through Bulgaria, FYR Macedonia and Albania), and Vc (connecting central Europe with the Adriatic Sea via Hungary, Croatia, Bosnia and Herzegovina and Croatia again).

Owing to its geographic position between the East and West, the region is often referred to as a gateway to Europe. As sea shipping remains the cheapest way to transport goods from the Far East to Europe, China plans to establish a rapid transport connection from the Greek port of Piraeus, the first major European container port for ships entering the Mediterranean from the Suez Channel, through the Balkans further to the EU markets – the Balkan Silk Road. This will come as the part of the “One Belt, One Road” initiative unveiled by the Chinese President in 2013. The Balkan Silk Road will be based on the existing railroad network linking central Europe with the Aegean Sea via Serbia, FYR Macedonia and Greece. The first operational move to realise the plan was made when the Chinese shipping giant Cosco Pacific took over half of the Piraeus port in a 35-year concession with the aim of turning the port into one of Europe’s top five container ports. However, to take full advantage of the port, investments into transport links across the Western Balkans are needed, such as the €1.5 billion worth high-speed railway between Belgrade and Budapest as signed between China, Hungary and Serbia.

Location is also a major factor why the Western Balkans could play a role in improving the EU’s energy security through possible investments in new gas pipelines. This topic is discussed further in Section 3.

**Diverse economies**

Economies in the Western Balkans region tend to be quite diverse, rather than relying on one or a few sectors, and therefore offer a wide range of opportunities for investors. A diverse economy is also one that allows human capital development to expand in many different directions. Chart 8 shows how each Western Balkans economy is structured, that is, the contribution of different sectors in each country to gross value added (GVA), the measure of the value of goods and services produced in a country.

The category “domestic trade, transport and storage, accommodation and food services” is on average the largest sector of the Western Balkans economies, ranging from 18 per cent of GVA in Albania and Serbia to 27 per cent in Montenegro. While the wholesale and retail trade subsector accounts for about 15 per cent of the economies in the region, the importance of the accommodation and food services subsector in tourism-dependent Montenegro, with a share of 8 per cent, is what distinguishes this country from the rest of the region.

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8 GVA is linked to gross domestic product (GDP) through the following relationship: GVA + taxes on products - subsidies on products = GDP.
Industry accounts for one-fifth of GVA on average. However, this varies significantly across the countries. The role of industry is particularly important in Serbia (where it represents an equally important part of the economy as in EU-11) and, to a slightly lesser extent, in Bosnia and Herzegovina and Kosovo. Manufacturing is the predominant industrial subsector, especially in Serbia, FYR Macedonia and Kosovo. The utilities subsector of industry, including energy production, is important for Bosnia and Herzegovina and Montenegro. The mining subsector plays a minor role; from 1 per cent to 3 per cent of the economy in the case of Kosovo.

Meanwhile public administration, defence, education and social services account for 17 per cent of economic activity on average, from 13 per cent in Albania to over one-fifth of the economy in Bosnia and Herzegovina.

In general, the region is quite agriculture-intensive, and agriculture (together with forestry and fishing) accounts for 12 per cent of value added on average, ranging from only 7 per cent in Bosnia and Herzegovina to 23 per cent in Albania. Agriculture plays a vital role in the Western Balkans, both socially and in terms of employment. This contrasts significantly with the EU-11 where on average the sector accounts for only 4 per cent of economies. Serbia stands out as having a clear comparative advantage in farming, mainly due to fertile agricultural soil in its northern province of Vojvodina. Some large producers have been able to take advantage of both economies of scale and access to major export markets, primarily the European Union but also Russia, with which Serbia has a free trade agreement (the only country in the region to do so). The other five countries have less advanced agricultural sectors, mainly consisting of small-scale and inefficient subsistence farming. The potential for agribusiness to develop further in the region is significant provided countries can consolidate agricultural holdings, improve the quality of collection, storage and marketing, and develop agricultural support services such as insurance.

Real-estate-related activities account for one-tenth of economies, on average, and construction around 7 per cent, on average, but more than 10 per cent in Albania. The financial sector, professional/scientific/technical sector and ICT each account for just 4 per cent of value added, on average. This is again in contrast with the EU-11, where these sectors
account for a larger share, in particular the professional sector which is twice the size. These areas can be important attractors for future FDI.

Furthermore, several countries have strong potential for further growth in the tourism sector. In 2013, receipts from international tourists amounted to 21 per cent of GDP in Montenegro and 13 per cent of GDP in Albania. Both countries, as well as others in the region, expect tourism numbers to increase significantly in the coming years, especially as the quality of infrastructure and services improves towards the standards of the most advanced western markets.

**Favourable taxes**

A stable and favourable tax climate and incentives for foreign businesses are sometimes deciding factors when foreign investors make decisions about location of investment. Most countries in the Western Balkans have made significant progress in reforming their tax systems in line with best international practice. During the past decade, tax rates in the region have been relatively stable, there has been a fall in the administrative burden of submitting taxes and efforts have been made towards widening the tax base.

To substantiate these points, we draw on various sources. First, the World Bank’s *Doing Business* report, together with PwC for this area, covers three dimensions of paying taxes: total tax rate with contributions of different types of taxes; number of tax payments per year; and time needed to comply with the tax rules. Chart 9 shows the total tax burden as a percentage of firms’ profits and its composition: profit tax, labour tax and contributions, and other taxes.

**Chart 9: Total tax burden as a per cent of profit, 2015**

![Chart showing total tax burden as a per cent of profit](chart)


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9 See World Bank, World Development Indicators, International tourism, receipts (current US dollars).

10 As with other Doing Business sub-indices, the category “paying taxes” uses a case study scenario. This means that the same set of financial statements and assumptions about the company and transactions is used by a number of tax experts in each country to calculate what the company would have to do to satisfy tax procedures. Results are therefore comparable across the countries and give a richer picture than that obtained by simply looking at rates prescribed by laws.
Although there are differences among the countries in the Western Balkans region, the total tax burden is clearly lower than in any of the benchmarks (EU-11, EU, and EU-15). This is driven by both lower profit and a smaller labour tax burden. In fact, FYR Macedonia has one of the lowest total tax burdens in the world – largely because there are no labour taxes (that is, social insurance contributions borne by companies), but also because it levies taxes on corporate profits only once they are distributed as dividends and has low levels of other taxes. Bosnia and Herzegovina, Kosovo and Montenegro also have a relatively low tax burden. Albania and Serbia are the only two Western Balkans countries where the total tax share of profits is almost at the EU-11 level of 40 per cent.

Charts 10 and 11 show the number of tax payments per year and time needed to comply with the tax rules. All Western Balkans countries except FYR Macedonia have higher (that is, worse) scores compared with EU benchmarks in terms of the number of tax payments per year that need to be done. Consequently, the number of hours per year needed to comply with the three biggest taxes – corporate income tax, labour and social contributions, and VAT – are higher in the Western Balkans countries than in the European Union, except for Kosovo and FYR Macedonia. Hence, further work is needed in these two dimensions, including the timely reimbursement of VAT in some countries.

**Chart 10: Paying taxes: number of taxes, 2015**

**Chart 11: Paying taxes: hours needed, 2015**


Encouragingly, there have been positive changes over the years. A few countries have introduced online registration centres, with FYR Macedonia being the most advanced. Over the years FYR Macedonia has efficiently implemented a so-called “regulatory guillotine” project under which it drastically reduced regulatory burdens and red tape, and it is now the only country in the region with a successfully functioning one-stop shop for opening a business (see Box 4, p41). Registering a business in this one-stop shop can be done in four hours and includes the allocation of a Tax Identification Number. Additional tax reforms were carried out over the last eight years, bringing down the number of tax payments per year from 43 in 2006 to only 7 from 2014 onwards. The most progress in simplifying tax

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11 Other taxes considered are property tax, vehicle tax, capital gains tax, financial transactions tax, environmental tax, etc. VAT is excluded from the calculation as it is not borne by the company itself.

12 Number of payments per year takes into account total number of taxes and contributions, the method of payment, frequency of filling and payment, and number of agencies involved.

13 Providing no additional licenses, approval or other specific documents are needed. Also, besides the general tax registration at the one-stop shop, under some conditions visiting the Public Revenue Office might be necessary (e.g. for foreign legal entities).
payments was made by introducing electronic filing and payment systems in 2008, and further improving and encouraging their use for corporate income and value added taxes in 2014.

**Low labour costs combined with a relatively educated population**

A further advantage of the region is the relatively low cost of labour, as shown by unit labour costs (ULC), defined as gross labour cost divided by GDP. While ULC is not a perfect approximation of representative firm labour costs, it gives a good idea of a country’s labour cost competitiveness. Chart 12 shows that all Western Balkans countries have lower ULCs compared with the EU average. This is important for export-oriented companies in the region because, as discussed in Section 3 below, Western Balkans exporters typically specialise in labour-intensive industries.

**Chart 12: Unit labour costs, 2014**

![Chart 12: Unit labour costs, 2014](chart12.png)

Source: Statistical offices from the respective countries, Eurostat.

Note: Unit labour cost is calculated as [(average gross wage*number of employed)/GDP]*100. In the cases of Albania and Kosovo, average net wage is used due to lack of data on gross wage. One should keep in mind the high discrepancy between ULC in gross and net wage terms – 12 on average in other Western Balkans countries.

The advantage of low labour costs is complemented by the relatively educated population. The *Global Competitiveness Report* discussed earlier confirms this point as the health and primary education pillar is among the highest ranked out of all 12 dimensions measured in the GCI. Basic statistics on education such as literacy rates, as well as educational attainment and current enrolment, are favourable. All countries record high adult literacy rates, scoring on average 98 per cent in 2011, with the exception of Kosovo where the rate is 94 per cent.  

The educational attainment structure of those older than 25 shows that almost three-quarters of the population has at least secondary education (EU average is 81 per cent). Current enrolment rates in primary and secondary school are comparable to EU levels in most of the countries, and all countries except Albania (Kosovo not included) had a lower share of early

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15 UNESCO: Education database, 2015
school leavers than the EU average in 2013, with a decreasing trend over the last three years.\textsuperscript{16}

Although the share of population with secondary education is on average higher in the Western Balkans than in the European Union, the quality might lag behind, as shown by the PISA exams,\textsuperscript{17} which test skills and knowledge of 15-year-old students. Chart 13 shows the average scores in the three tested areas: science, maths and reading. In all three subjects, average scores in the Western Balkans are below those in the European Union or EU-11 countries, which might imply a lack of understanding of how to solve practical problems.

Chart 13: PISA results

![Chart 13: PISA results](image)

Source: OECD, 2015.

Note: Results shown are for 2012 except in the case of FYR Macedonia where, due to the lack of data, results for 2000 are shown.

The share of those with tertiary education is about half that of the EU average. However, the structure of those currently enrolled in tertiary education is similar to EU countries (see Chart 14). Nonetheless, the share of science, technology, engineering and maths (STEM) students in tertiary education, an important indicator capturing human capital crucial for adopting and creating technologies, is a bit lower on average than in EU countries. Still, this is not the case in Serbia, which has double the share of students in this category compared with the other Western Balkans countries, due partly to the importance of Belgrade as a regional university centre.

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\textsuperscript{16} Early school leavers are defined as a share of 18-24 year olds with at most lower secondary education and not in further education or training.

\textsuperscript{17} PISA stands for the OECD’s Programme for International Student Assessment.
Chart 14: Composition of tertiary education, 2014

Source: UNESCO's Education database.

Note: Data for 2012 are shown, except in the cases of Albania and Bosnia and Herzegovina where 2013 data are shown. Germany, Luxembourg and Romania are not included among the benchmarks.

Improving vocational education and training in line with private sector requirements is where more work can be done. This chimes with firm-level evidence from the BEEPS which points to difficulties in hiring people with adequate skillsets. However, on a more positive note, Western Balkans countries have made an effort to meet international standards by participating in the Torino process and the South East European Centre for Entrepreneurial Learning (SEECEL). As a result, countries in this region have adopted policy documents for medium- and long-term visions of their vocational education and training (VET) systems, with clear strategic objectives. They have also integrated entrepreneurship into VET curricula, thereby recognising the importance of small and medium-sized enterprises in the region and their connection to VET.
3. Where will growth come from in the coming decade?

In the previous sections we have shown that competitiveness is improving in the Western Balkans and that the region has a number of attractive features to offer investors. But these factors, while necessary, are not sufficient for future growth and convergence. In this section we explore some of the potential growth drivers in the coming decade. We first examine the structure of previous FDI to the region and we point to the growing importance of non-traditional source countries such as those in the Gulf and China. We then look at the importance of trade and the removal of cross-border barriers, followed by the impetus that can be expected from major transport and energy projects. Lastly, we highlight the role of innovation, another underdeveloped area that has major potential and will likely become increasingly prominent in the years to come.

Foreign direct investment

One of the most visible impacts of the global crisis in the Western Balkans has been the sharp drop in FDI to the region followed by a stagnating trend. While Serbia is the biggest recipient of FDI in aggregate terms, Montenegro received the biggest share of foreign capital in each of the last seven years in per capita terms. Still, the region lags significantly behind the European Union in terms of FDI stock per capita received; average FDI stock per capita in the Western Balkans is around €2,600 while in the European Union it is around €14,300, more than five times higher (see Chart 15).\(^{18}\) Even compared with the EU-11 average, the region’s average FDI stock per capita is less than half. The catch up potential is obvious.

**Chart 15: FDI stock per capita (€), 2014**

![Chart showing FDI stock per capita by country](chart.png)

Source: IMF World Economic Outlook.

Chart 16 shows the main sources, by country, of the stock of FDI to the region. Traditionally, the most important investors have been the eurozone countries, including Austria, followed by the Netherlands, Greece and Italy. However, an examination of FDI into individual countries of the region reveals important differences. Greece holds 26 per cent of FDI stock

\(^{18}\) Authors’ calculations based on UNCTAD’s International trade database, 2015.
in Albania, Austria is the top investor in Bosnia and Herzegovina and Serbia (21 and 17 per cent respectively), Turkey is the biggest investor in Kosovo\textsuperscript{19} (10 per cent), the Netherlands has 22 per cent in FYR Macedonia, while Russia holds 17 per cent of the stock in Montenegro.

Intra-regional FDI is limited, although Serbia is an important player in Bosnia and Herzegovina (second biggest investor) and in Montenegro (sixth biggest). Slovenian and Croatian investors are relatively active in the region; the former country is among top 15 FDI sources in all of the Western Balkan countries, while Croatia has invested notable capital in three countries of the region (Bosnia and Herzegovina, FYR Macedonia and Serbia).

Chart 16: Biggest FDI stock owners in Western Balkans (per cent), 2014

Western Balkans countries have a fairly diversified structure of FDI stock per activity (see Chart 17).\textsuperscript{20} The highest shares are in transport, storage and communication (Albania and Serbia), manufacturing as a part of industry (Bosnia and Herzegovina and FYR Macedonia), financial intermediation (Serbia, Bosnia and Herzegovina and FYR Macedonia) and real estate, renting and business activities (Kosovo). Some countries, notably Albania, have attracted FDI into natural resources. Much of the FDI in all countries has happened in the context of privatisations in sectors intended primarily for domestic consumption, such as financial services and telecommunications. As this source has largely dried up, countries in the region are focusing more on attracting FDI in tradeable sectors, which contribute to export capacity rather than domestic consumption.\textsuperscript{21}

\textsuperscript{19} The sources of FDI into Kosovo are somewhat unclear as more than 40 per cent of the stock is attributed to an “unspecified” source.

\textsuperscript{20} Activity is classified as follows: Agriculture, forestry and fishing; Industry (mining and quarrying; Manufacturing; Electricity, gas, steam and air conditioning, water supply and disposal); Construction; Trade, transport, communications, accommodation and food services (Wholesale and retail trade; Motor vehicles repair; Transport, storage and communications; Accommodation and food services); Financial and insurance activities; Real estate and business activities; Other and unclassified (including Public administration, social security, education and health).

\textsuperscript{21} Tradeable sectors are manufacturing, agriculture, mining and quarrying, retail and hotels, and non-tradeable construction, transport, communications, real estate and financial intermediation.
What can the region do to attract higher levels of FDI? One way is to offer fiscal incentives to investors. In the Western Balkans these are usually part of a broader package of investment incentives of each country, which are usually administered through national investment promotion agencies. Common fiscal incentives include tax holidays, with either tax exemptions or reductions under some conditions, concerning corporate income tax, VAT or import/export duties, and tax loss carry forward exemptions. All of these countries have set up economic zones, business parks, trade zones and other similar concepts, which offer tax exemptions as one of the benefits, though not all of them are fully functional yet.

While incentives may have a role, the administrative capacity to implement them credibly and consistently is often weak. For that reason, the focus should be on creating a simple, reliable investment framework. In this respect, it is important to note that all Western Balkans countries legally observe a level playing field between foreign and domestic companies. That is, no country limits foreign ownership or requires government approval, except in the sectors of special government attention like weaponry (and sometimes narcotics and media). However, restrictions to foreign investments are mostly not as direct as the rules considering ownership. The Heritage Foundation/Wall Street Journal Index of Economic Freedom summarises information on areas where countries formally limit foreign investments. On a scale of 0 to 100, where the maximum value represents a perfectly free country, Western Balkans countries score 67.5 on average, while the European Union scores 80.9. Additionally, problems often emerge not from the written laws but their implementation and enforcement, which is much more difficult to measure.

22The Index of Economic Freedom has been published by The Heritage Foundation and The Wall Street Journal since 1995. It is composed of four pillars, each covering different areas: rule of law (property rights, freedom from corruption), limited government (fiscal freedom, government spending), regulatory efficiency (business freedom, labour freedom, monetary freedom) and open markets (trade freedom, investment freedom and financial freedom). Investment freedom covers national treatment of foreign investment and pre-screening, foreign investment code (in terms of regulations, bureaucracy and transparency), restrictions on land ownership, sectoral investment restrictions, expropriation of investments without fair compensation, foreign exchange controls and capital controls.
The other way for the region to enhance FDI is to cast the net wider in terms of source countries. In this respect, the growing importance of the Gulf countries and China is encouraging. A glance at the FDI for 2014 only shows that the United Arab Emirates has become an important investor in several countries of the region, while China was among the top seven investor countries in Serbia. The UAE’s high-profile “Belgrade waterfront” real estate project in the Serbian capital is perhaps the most prominent example of this new-found interest. Meanwhile, China’s involvement in the Western Balkans region has grown rapidly in recent years and can be expected to lead to further investments as the new “Silk Road” project (mentioned above) takes hold in the coming years.

Trade

All countries in the Western Balkans realise that sustainable growth must be built on an improved export performance, rather than on cheap and plentiful supplies of foreign capital and credit, much of which has gone into non-export-oriented sectors. But how realistic is it to expect enhanced trade and export activity in the region in the coming years? In order to answer this question it is important to understand that these countries currently trade less than one would expect when one takes into account size, level of development and geographical location.

To illustrate this point, Chart 18 shows the level of trade openness, measured as the sum of exports and imports divided by GDP, for each country and the region as a whole against the EU-11 comparator. In broad terms, the degree of openness recovered somewhat after the dip in 2009 at the height of the crisis, and it appears to have stabilised at close to or below pre-crisis levels. But the region lags behind central European and Baltic comparators on openness, perhaps unsurprisingly given that the latter region has been part of the European Union’s large internal market for over a decade. The chart shows that the Western Balkans average trade openness is at 70 per cent of the EU-11 one. Furthermore, as noted earlier in Section 2, the impact of net trade flows on GDP growth rates has generally been negative, as these countries have run persistent trade deficits. Reversing this trend is a key goal of all countries in the region.

Chart 18: Trade openness in 2014

Source: the IMF’s World Economic Outlook.
Why is trade below potential? One reason is that it is a legacy of the break-up of Yugoslavia and conflicts in the region in the 1990s, and the many years of neglect and under-investment in infrastructure. But there are other related reasons associated with the product mix, inadequate inclusion in the European Union and global value chains and the obstacles faced by exporters.

First, the average share of manufactured goods in total exports is much lower in the Western Balkans than in the EU-11 (55 per cent versus 71 per cent). However, this varies widely across the countries (see Chart 19), from only 20 per cent in Montenegro to around 80 per cent in FYR Macedonia (the latter due to the strong pro-FDI policies of the country in the previous years, mostly in tradeable sectors such as car components). This reflects the fact that the region is not well integrated into the European supply chains, as confirmed by a recent study by the OECD. The results indicate that the Western Balkans is integrated mostly into the final stages of international supply chains in food, beverages and tobacco in addition to textiles and clothing, and mostly the intermediate stages of wood and cork, paper, printing and publishing, other non-metallic mineral products and fabricated metal products, as well as both first and intermediate stages of basic metals.

Chart 19: Manufactured goods by the technology level, % of total exports of goods, 2014

Not only is the role of manufactured goods on average smaller in the Western Balkans than in the EU-11, but the manufactured goods exported are also less sophisticated (as shown in Chart 19). Over 50 per cent of the region’s manufactured goods are classified as “labour and resource intensive” or “low-skill and tech intensive”, in comparison to about 30 per cent in the European Union. However, only 18 per cent fall into the category “high-skill and tech-intensive goods” in comparison to 27 per cent in the EU-11. Another way of seeing the Western Balkans region’s dependency on labour-intensive goods is to look at the breakdown of revealed comparative advantage (RCA) by industries. Chart 20 shows that this region has developed a relative export specialisation in industries that are labour- and resource-intensive and low skill- and technology-intensive. In contrast, EU countries have the highest

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24 Revealed Comparative Advantage for industry X in country Y is calculated as: (exports of industry X goods from country Y/total world exports of good X) divided by (Country Y’s total exports/total world exports). An index higher than one indicates a specialisation, or comparative advantage, in that specific good/industry.
revealed comparative advantage in medium skill- and technology-intensive industries, and are above the Western Balkans in terms of high skill- and technology-intensive industries. A more detailed analysis by specific industries shows that the strong comparative advantages in the region are in industries such as beverages and tobacco, food, clothes and raw materials.

**Chart 20: Revealed comparative advantage in industries grouped by technology levels, 2014**

Source: UNCTAD’s International trade database.

Second, exports in the Western Balkans typically face bigger obstacles to doing business than those in comparator countries. To see this, we can use once again the World Bank’s *Doing Business* report (see Charts 21 and 22). The main difference between this region and the EU-11 lies in the cost to export, with costs in the Western Balkans countries more than double that in the EU-11. Time to export is also longer although the differences are less pronounced. Any improvement over time on these measures has been slow.

**Chart 21: Cost to export, 2015**

**Chart 22: Time to export, 2015**


Note: Kosovo is presented separately from other Western Balkans countries as it is a clear outlier on these indicators.
This analysis points to two areas where further progress is needed in order for trade to be a major growth driver in the region. First, more needs to be done to tackle non-tariff barriers to trade. Efforts in this direction are ongoing within the CEFTA agreement, to which all countries in the region are signatories, but visible results on the problem areas would be a welcome signal to traders and investors. Second, the region should step up its integration into European (and regional) supply chains. Western Balkans countries now have an opportunity to find their place on the map of global suppliers and reap the benefits. For this to happen, though, these countries need to improve the quality of products and efficiency of processes (especially logistics and delivery methods), but also be ready for constant improvements to stay in the value chain. These enhancements are often fostered by higher levels of technology transfer and diffusion (in terms of adopting new technologies and enhancing skills in the workforce) among participating companies. As a result, firms participating in the global value chains tend to be more innovative that those restricted to more local activities.  

**Transport infrastructure**

Good quality infrastructure is an important pre-condition for a region’s competitiveness and economic development. Unfortunately, as anyone who travels around the Western Balkans knows, the quality of transport infrastructure often leaves a lot to be desired. Years of neglect and under-investment have left even major road and railway networks in a poor state. The point is illustrated by Chart 23 which shows each country’s scores (except for Kosovo) from the WEF rankings on quality of infrastructure. The comparison with EU countries highlights the extent of the challenge facing the region. An analysis of the sub-indices suggests that low rankings are driven by the poor quality of roads in Montenegro and Serbia, the weaknesses of railroads in FYR Macedonia and Albania, inadequate (river) ports infrastructure in Serbia and limited air transport in all countries but Serbia.

![Chart 23: Quality of transport infrastructure, 2015](image)

Source: World Economic Forum’s Global Competitiveness Index Historical Database.

Traditionally, the government has been the main source of spending on transport infrastructure. Spending in this area has a very visible impact on the ground (literally) as it

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25 For further elaboration, see the EBRD’s *Transition Report*, 2014: Innovation in Transition.
facilitates mobility of people and goods. Also, indirect multiplier effects from spending on infrastructure tend to be bigger than those of other fiscal stimulus measures. This is due to the labour-intensiveness of these projects, meaning that much of the expenditure goes directly back into the economy through wages, as well as firms’ productivity enhancements that benefit from improved transport links. This is why increased infrastructure spending is also a desirable policy option for governments searching for ways to boost overall GDP growth. According to current National Economic Programmes, all Western Balkans countries except Kosovo plan to have higher public capital spending in the next two years in comparison to the previous two years. But in order for the benefits to be realised, there are three important pre-conditions: institutional capacity, regional coordination and appropriate form of funding.

First, the effectiveness of infrastructure spending depends on a country’s institutional capacity to design, select, procure and implement infrastructure projects. In this respect, the region’s limited institutional capacity could be an important barrier to progress. Chart 24 illustrates this point by plotting Western Balkans countries and EU countries where the EBRD invests, in terms of their EBRD infrastructure transition scores and World Bank governance indicators, both being highly correlated with the degree of development of each country’s economic institutions. The chart shows that countries can be broadly divided into three groups: central European and Baltic countries have high institutional capacity (having high EBRD transition scores and high World Bank governance indicators). South-eastern European EU countries, including Romania, Bulgaria, Greece and Croatia, have medium institutional capacity, and the Western Balkans countries have just limited institutional capacity. In this regard, the European Union’s Instrument of Pre-Accession Assistance (IPA) funds can provide vital help. In addition, these funds come with targeted technical assistance, including the development of an adequate legal and regulatory framework, strengthening the capacity of regulators, and advancing procurement procedures in line with best international practices. Currently, the amount of money budgeted for this purpose, bilaterally, for the period 2014-20 amounts to €376 million for the Western Balkans region. However, at the recent Western Balkans Vienna Summit the region has been promised a financial envelope up to €1 billion for key connectivity related investments over the 2015-20 period.26

Second, to make full use of the assistance available, close regional cooperation and coordination are required. The Western Balkans region has in recent years achieved notable progress in this respect. The main platform for regional cooperation on the transport connectivity agenda is the South East Europe Transport Observatory (SEETO), the regional transport organisation established in 2004 for the development of the Core Regional Transport Network. The main aims of SEETO are to promote regional cooperation regarding the extension of the Trans-European Transport Network to the Western Balkans, improve and harmonise regional transport policies and technical standards and enhance local capacity for the implementation of investment programmes. SEETO’s Flagship Axes Initiative identifies physical and non-physical barriers for selected corridors/routes from the SEETO Comprehensive Network, and the development and analysis of plausible remedial measures for reducing travel times and transport costs. From those measures, implementation should be sought for those with the highest cost-benefit ratio.

Third, financing for these projects must be found. Earlier we highlighted the severe fiscal constraints facing the region. It would therefore benefit the region to explore private sector participation in the provision of new infrastructure. However, so far there have been no successful public-private partnerships (PPPs) in the road or railway sectors. Several projects have been attempted, most recently in Bosnia and Herzegovina, but efforts so far have been unsuccessful. The reasons for failure are complex, but in essence boil down to the inability to reconcile the limited risk appetite of private investors with the capacities of governments in the region to make credible, long-term commitments. For this reason, it will be important in the coming period to explore innovative ways in which donors and international financial institutions could mitigate the risks to private sector investors. One way is perhaps through some sort of guarantee fund that would back governments’ commitments to private investors.

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27 www.seetoint.org.
without unduly burdening the budget or increasing the stock of government debt (including contingent debt liabilities).

China is also playing a major role, and one that will only increase in the coming years, in developing transport infrastructure in the region. In the roads sector, the Chinese are financing three major road projects with a combined amount of approximately €2 billion in Montenegro, Bosnia and Herzegovina and FYR Macedonia. In railways, modernisation across the region, such as the €1.5 billion high-speed railway between Belgrade and Budapest, is part of the overall Balkan Silk Road plan discussed earlier. This would not only provide infrastructure to transport Chinese manufactured goods to Europe, but would also improve regional connectivity.

**Energy sector**

Similarly to transport, the energy sector in the Western Balkans has been plagued for many years by under-investment, poor management and a non-commercial approach to operations. The combined picture from WEF rankings and the EBRD’s energy sector transition scores paint a similar picture to those from transport, pointing to a significant gap with respect to central European countries.

The ownership of the electricity system is almost entirely in state hands in all countries. But numerous initiatives and projects are under way or in preparation that, taken together, have the capacity to transform the region’s energy supply and foster economic growth. Modernisation of the existing energy infrastructure and the building of new energy facilities, along with an increased inclusion of renewable energy sources (RES), as private sector involvement increases, will help overcome the severe obstacles faced by businesses in the region and will make the region far more attractive to investors.

Chart 25 summarises the current situation regarding electricity supply. At present, the region has a net maximum electrical capacity of about 17,000 MW, almost evenly divided between hydropower and thermo-power plants (coal-fired and gas/oil-fired). Power production from renewables, other than certain types of hydropower plants, is negligible. Serbia has the largest production capacity (about 7,000 MW), with almost two-thirds of its installed capacity being based on coal-fired power plants. Bosnia and Herzegovina is the region’s second largest electricity producer, with an installed capacity of about 4,000 MW, equally divided between hydro and coal-run power plants. Bosnia and Herzegovina is at the same time the largest electricity exporter in the region, with substantial electricity resources still unexploited.28 Albania and FYR Macedonia each have a production capacity of about 2,000 MW. However, while Albania gets its power almost entirely from hydro, the production mix in FYR Macedonia is more diverse, including hydropower plants as well as coal-run and gas/oil-run thermo-power plants. Kosovo (with an installed capacity of around 1,200 MW) gets almost 100 per cent of its production from coal power plants, while Montenegro (which has around 900 MW) relies on coal for almost one-third of power supplies, with the rest coming from hydro resources.29

The potential for increasing power production capacity and energy efficiency lies in three directions. First, several significant energy projects are under construction or in the pipeline.

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28 Albania, FYR Macedonia and Kosovo are electricity importers, Montenegro and Serbia have a relatively even electricity balance, while Bosnia and Herzegovina is the only power exporter in the region.

29 The region has low annual capacity utilisation of the production capacities, ranging from 30 per cent in Albania and FYR Macedonia to 50 per cent in Serbia.
The construction of a high-voltage underwater electrical cable connecting Italy and Montenegro will open up the region’s markets for exporting electricity, fostering further investments in the sector. This €775 million project, led by the Italian transmission system operator Terna and the Montenegrin electricity company, and supported by the EBRD, is expected to be operational by 2017.

Second, major improvements can be expected in the coming years in energy efficiency. Losses in distribution account for at least 10 per cent of gross electricity consumption in all Western Balkans countries, but the problem is especially dramatic in Albania and Kosovo, where the losses in distribution (mostly due to theft and mismanagement) account for around 30 per cent of gross electricity consumption (see Chart 26). Losses in transmission are also significant, though they are lower than losses in distribution. They are highest in Montenegro and Serbia and account for 2-3 per cent. Getting electricity is regarded as a key obstacle by businesses in Albania and Kosovo (outages are frequent) and the region ranks poorly on this indicator in the World Bank’s Doing Business global rankings.

Third, regional cooperation in the energy market is yielding tangible benefits. Until recently, fragmented markets and uncompetitive practices were impeding progress. However, countries in the region are increasingly coordinating common energy needs and there has been substantial legislative harmonisation in recent years with the Energy Community having the central role in promoting sectoral reform and integration into the EU internal energy market. In addition, the efficiency of the regional electricity market has recently been enhanced with the creation of the regional Coordinated Auction Office in Montenegro (see Box 5, p42). The development of a full regional market will be supported by strengthening inter-country linkages, establishing power exchanges and a regional balancing market. Following the Vienna Summit in August 2015, the Western Balkans countries have agreed to a list of four investment projects, including power interconnectors and reinforcement to the region’s power transmission system, to be proposed for inclusion in the IPA multi-country programme.

In addition to improving power supplies, the Western Balkans region is increasingly being viewed as a potential transit region of gas supplies to the European Union, with implications
for developing gas infrastructure in the region. The key project is the Trans-Adriatic Pipeline (TAP) project, which is designed to bring in around 10 billion cubic metres (bcm) of natural gas from Azerbaijan via the Trans-Anatolian Natural Gas (TANAP) pipeline through Greece and Albania, and across the Adriatic Sea to Italy. The TANAP/TAP pipelines could also be upgraded to almost double the capacity with compressor stations. In addition, the construction of the proposed 5 bcm Ionian Adriatic Pipeline (IAP) from Albania through Montenegro and Bosnia and Herzegovina to Croatia would have the capacity to add further supply to markets throughout central and south-eastern Europe. The plan is to link the pipeline to a liquefied natural gas (LNG) terminal (with a possible capacity of 15 bcm) on the island of Krk in the Northern Adriatic, a project that has been seen by the European Union as a priority with respect to energy security.

Lastly, the region has significant potential in offshore resources, which could come into play in the longer term. Montenegro opened its first offshore bidding round in 2013 with three international oil and gas consortia replying to a tender. Private companies, including Petromanas Energy and Royal Dutch Shell, are currently also exploring oil and gas production onshore in Albania, while three other companies (San Leon Energy, Emanuelle Adriatic Energy Ltd and Orion Energy) are exploring offshore.

Innovation

Are companies in the Western Balkans countries innovative? At first sight, it would appear that the region lags behind in this respect too. The WEF’s analysis in the GCR gives an average ranking for the five included Western Balkans countries of 95 out of 144 countries, with particularly low scores on company spending on R&D and the availability of scientists and engineers. Overall spending on R&D in the region is close to negligible; Chart 27 shows that, in per capita terms, it is just one-fifth of that in the EU-11, and way below EU levels.

Chart 27: Spending on R&D in per capita terms, in euros, 2013

![Chart showing spending on R&D in per capita terms, in euros, 2013](chart)

Source: UNESCO Science, technology and innovation database.

Note: Data for Albania are from 2008, and for Ireland from 2012; Kosovo is not included.

In broader terms, however, innovation is about much more than just spending on R&D. It also involves adopting and adapting to existing products and processes and introducing organisational and managerial changes. As a matter of fact, most productivity improvements come from adopting technology that has been developed elsewhere with,

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30 See the EBRD’s *Transition Report*, 2014: Innovation in Transition.
occasionally, some adjustments to the local market. It is not realistic to expect Western Balkans countries to be world leaders in terms of new inventions, but the potential lies in companies moving closer to the technological frontier by learning from others.

In this respect, evidence from the BEEPS paints a more encouraging picture of innovation in this region. Charts 28 and 29 show the percentage of firms – by region – that are engaged in either product/process innovation (Chart 28) or organisational/marketing innovation (Chart 29) in the three years prior to the survey (roughly 2010-13). By this measure, the region performs well relative to others: around 18 per cent of firms are engaged in either product, process, or both product and process innovation, and 29 per cent in organisational, marketing, or both organisational and marketing innovation.

![Chart 28: Percentage of firms engaging in product and process innovation](image1)

![Chart 29: Percentage of firms engaging in organisational and marketing innovation](image2)

Source: EBRD: BEEPS V, MENA ES and authors’ calculations, 2013.

Note: Data represent weighted cross-country averages. EEC stands for eastern Europe and the Caucasus.

How can innovation be fostered further? The BEEPS contains further insights into the obstacles faced by innovating firms. An analysis of the results shows that innovators face two key difficulties in growing their business: obtaining access to finance and hiring skilled workers. Neither problem is easy to solve, but there are steps governments in the region can take to alleviate the problem. When it comes to access to finance, one way to address this problem is to establish a dedicated fund for innovation so that promising firms can be targeted and supported. In this regard, the experience of the Serbian Innovation Fund could serve as an instructive example for other countries in the region (see Box 6, p43).

Regarding the lack of available skills, all countries have a strong diaspora of often highly skilled individuals, some of whom could perhaps be persuaded to bring their skills home and apply them in their home countries. For example, in a recent survey of the Bosnia and Herzegovina diaspora, conducted by the International Organisation for Migration (IOM) in December 2010 to January 2011, 51 per cent of the respondents said they were interested in returning to Bosnia and Herzegovina either temporarily or permanently and only 5 per cent of the respondents were not interested in ever returning. The same survey revealed that most

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31 See the EBRD’s Transition Report 2014: Innovation in Transition.
33 However, one should be careful when interpreting the results as the survey was available online to people in the diaspora originating from Bosnia and Herzegovina and returnees, and filling it in was voluntary. Therefore, there is a possibility of selection bias where respondents that are more likely to want to return to Bosnia and
of those who intend to return have work experience (mostly between one and five years), typically in management, IT, research, financial services and science and pharmaceuticals. Additionally, a large number stated their interest in starting a business, but only a small number did so after returning. This suggests that improving the business environment would carry significant innovation potential, as returnees could apply the skills and knowledge acquired outside of the country in Bosnia and Herzegovina, and likewise for other Western Balkans countries.

Herzegovina are the ones that answered the survey in the first place, so in reality a lower share of emigrants is likely to return.
4. Conclusion – what are the long-term challenges and risks?

This paper has provided a number of reasons why the Western Balkans should be seen as a region of investment opportunities and growth potential. In this concluding section we look briefly at some of the long-term challenges facing the region.

In our view there are four main areas that require long-term vision and commitment to head off the risks:

- reform fatigue
- financial sector fragility
- inclusion and demographic trends
- climate change.

However, recent years have seen an increased willingness to cooperate at a regional level, as all countries recognise it is in everyone’s interests. Provided this spirit prevails in the future, there is every reason to expect the Western Balkans region to return to robust, sustainable growth and continue to converge towards EU levels of competitiveness and standards of living.

Reform fatigue

The past seven years have been difficult for reformers in the region. First, it is always harder to reform when economies are in recession or stagnation. The EBRD’s annual Transition Report has been observing for years the slowdown in reform agenda across most transition countries, including those in the Western Balkans, and the instances of reform reversals in selected cases. In 2013, the report asked whether the transition region as a whole was “stuck” and concluded that this adjective indeed characterised many countries, arguably including those in the Western Balkans. Second, as reforms are painful initially, popular support for the market economy has declined in the aftermath of the crisis. The second round of the EBRD-World Bank Life in Transition Survey, carried out in late 2010 when memories of the global financial crisis were fresh, showed that people in the Western Balkans were generally sceptical of markets and democracy and had little faith in most public institutions.

In the face of these difficulties, most politicians in this region can be commended for maintaining a broad commitment to reforms, even if implementation in recent years has been patchy. What is unique to this region relative to other emerging markets is the EU anchor – the promise that, eventually, all countries will be part of the EU club. Even though the strength of the EU anchor has been diminished by both the internal problems of the European Union and the fact that full membership for Western Balkans countries is clearly a long way off, EU approximation is advancing and still represents the best hope for institutional reform.

Financial sector fragility

One of the principal achievements of Western Balkans countries throughout the crisis has been the avoidance of a banking crisis or the collapse of any systemic bank. Few would have predicted that, especially in late 2008 when several countries in the region experienced significant deposit outflows from their banking systems. But firm and prompt action by domestic central banks and regulators, combined with strong support from IFIs and a
commitment by foreign parent banks to maintain their exposure to subsidiaries in the region, meant that the system as a whole stayed stable.\textsuperscript{34}

These events have illustrated the importance of foreign banks as a stabilising force throughout the region. As Chart 30 shows, foreign ownership of banking systems ranges from about two-thirds in FYR Macedonia to nearly 90 per cent in Kosovo. Italian and Austrian banks have the most dominant presence, 18 per cent of the total banking assets in the region, each. They are followed by Greek banks (11 per cent), which are systemic in FYR Macedonia (23 per cent), Albania (17 per cent) and Serbia (13 per cent). French, Slovenian and German banks account for 7, 6 and 4 per cent of overall assets, respectively. However, the importance of French banks is greater in Montenegro (12 per cent) and Serbia (10 per cent); importance of the Slovenian banks is much greater in Kosovo (17 per cent), FYR Macedonia (16 per cent) and Montenegro (16 per cent), while the German Procredit Bank is the largest bank in Kosovo (30 per cent). Turkish and Russian banks are the largest non-Eurozone banks, having regional market shares of 6 and 2 per cent respectively, with Turkish banks being systemic in Albania and Kosovo, and Russian Sberbank in Bosnia and Herzegovina.

However, the 2011 eurozone crisis and the following cross-border risk aversion triggered a renewed wave of deleveraging from the region. In March 2012, in response to this deteriorating international credit environment, the Vienna II initiative was launched. While the initiative helped, the withdrawal of funds from the region could have not been prevented. In the three years since the crisis through 2014, the Western Balkans lost US$ 7.2 billion in external bank funds, or around 8 per cent of the region’s GDP (Chart 31). Nonetheless, this loss was smaller in comparison to the EU-11, where it amounted to 18 per cent of the region’s GDP.

\textbf{Chart 30: Ownership of banking assets per country, per cent (out of 100)}

\textbf{Chart 31: External positions of BIS-reporting banks, US$ million}

The main negative legacy of the crisis is the high share of non-performing loans (NPLs), which on average account for about 18 per cent of total loans. Only in Kosovo is the share below 10 per cent, while it exceeds 20 per cent in Albania, Montenegro and Serbia. In general, provisioning levels for NPLs are quite good and most banks, and regulators, have adopted a rather \textit{laissez-faire} attitude to NPL resolution, hoping that, as the economy picks up, the problem will gradually dissipate over time. But this attitude may be changing: a new

urgency has been given to NPL resolution within the Vienna Initiative framework, and Western Balkans countries are now coming forward with detailed action plans, within a coordinated regional framework, to tackle the problem.

A further positive development on cross-border coordination was the signing in October 2015 of a memorandum of understanding between the European Banking Authority (EBA) and the supervisory authorities of the banking systems in five of the six Western Balkans countries (excluding Kosovo). This non-binding agreement establishes a framework of cooperation and information exchange to strengthen banking regulation and supervision of banks operating in the European Union and in the region. The Western Balkans countries have committed to provide the EBA with regular updates on developments in their banking systems and to bring their own regulatory and supervisory standards and institutional arrangements in line with those in the European Union.

Inclusion and demographic trends

The Western Balkans region has a number of worrying demographic and employment trends that, if not addressed, will severely hinder the region’s long-term growth potential. Chart 32 shows the population structure in the Western Balkans countries and EU EBRD countries. It highlights the share of people in the labour force who are either (i) employed, (ii) unemployed, (iii) those who are economically inactive, such as students or pensioners, and (iv) children aged 14 or younger.

The share of employed among the population of working age in the Western Balkans countries is low, ranging from just 27 per cent in Bosnia and Herzegovina to 37 per cent in Albania. High unemployment is a common problem, especially long-term unemployment (more than one year) as many of these become discouraged and drop out of the labour force indefinitely. On average, every 10th person is unemployed, out of which at least three-quarters more than one year. What is even more worrisome is large youth unemployment exceeding 40 per cent in every country of the region. In parallel, some of these countries experience a high level of inactivity with a third of young people “not in employment, education, or training” (NEET). Paradoxically, high unemployment rates often coexist with a widespread shortage of skilled workers for available entry-level jobs, suggesting a skills mismatch.

Chart 32: Population structure, per cent of total population in 2013

Source: World Bank World Development Indicators.
The economically inactive share of population (that is, aged 15 and older) mostly consists of pensioners and people in school (either secondary school or university). The primary reason people are economically inactive is retirement. The population of age 65 or older accounts for about 10 per cent in Albania to nearly 15 per cent of the total population in Bosnia and Herzegovina. Although this is a good proxy for the share of population that is retired, there are also people who retire before the age of 65, and this number is quite high in some countries, for example, war veterans in Bosnia and Herzegovina, or the ones who, discouraged by prevailing labour market conditions and enabled by loopholes in the system, entered early retirement as beneficiaries of disability pension schemes. The second-biggest reason people do not work is school. The share of the working youth (of age 15 to 24) is very low in the countries of the region, ranging from 29 per cent in Serbia to 36 per cent in Albania. This might be an indicator of high secondary school attendance as well as university enrolment among the youth in these countries. Members of this group will eventually enter the labour force, and will help to boost economic activity in the near future.

The remaining category is children under the age of 15. They represent a source of future growth, as they will ultimately enter the labour force. The share of children as a per cent of the total population ranges from 16 per cent in Serbia and Bosnia and Herzegovina to 21 per cent in Albania. What is striking, however, is the decline in the share of children over the past 25 years, while the share of inactive population went up. This is an obvious indicator of an ageing population.

Unemployment, inclusion and ageing remain major issues across the countries. Therefore, understanding the demographics of the region is necessary for creating optimal social policies, including reforms regarding labour markets and pension systems.

**Climate change**

Countries in the Western Balkans are vulnerable to the negative consequences of global warming and climate change well beyond their contribution to these trends. A number of recent authoritative studies have shown that, along with the Mediterranean region, countries in south-eastern Europe (SEE), including the Western Balkans, are likely to be the most vulnerable in Europe. The SEE region is becoming warmer and, with the exception of Serbia, is receiving less precipitation. The incidence of extreme weather events and climate-related hazards has increased noticeably during the past two decades. The expectations are that such trends will continue and accelerate in the coming decades. Natural ecosystems, individuals and economic growth will be affected by these changes. As an example, agricultural produce will be severely affected during alternating episodes of drought and flooding, and adapted crops may be required over the long term due to less water availability. Energy demand is expected to flatten throughout the year as cooling needs increase in summer and heating needs decrease in winter. The recurrent floods that affected SEE in recent years had a very high economic cost in terms of damaged infrastructure and housing, and more generally the disruption to economic activity across all sectors.

The problems of climate change require a cooperative and coordinated approach. The recent agreement emerging from the United Nations Climate Change Conference in Paris (the so-called COP 21) is a dramatic example of how willingness of countries to reach mutually beneficial outcomes can be harnessed towards concrete actions.

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35 See, for example, *Climate Change Adaptation in South Eastern Europe: A Background Report*, UNEP and ENVSEC, 2011.
The problem of informality is long-standing in the Western Balkans economies. In September 2015 the Albanian government initiated a high-profile campaign to tackle informality. The programme is at an early stage but has already yielded some results.

Informal activities are pervasive in Albania and other Western Balkans countries, holding back the development of legitimate businesses, depressing tax revenues and hindering labour protection. In the fifth round of the EBRD-World Bank Business Environment and Enterprise Performance Survey (BEEPS V), more than 40 per cent of the firms surveyed in Albania reported competing against firms in the informal sector. The problem is particularly acute in the agricultural sector, where obtaining value added tax (VAT) receipts has been very difficult. This leads to tax revenue losses and undersupply of public goods.

The informal sector is an important contributor to employment in Albania. For instance, according to the International Labour Organization, 30 per cent of the total workforce in the construction sector is employed informally. These workers typically suffer from a lack of labour protection.

On 1 September 2015 the government of Albania launched a comprehensive campaign against informality. The main purpose of the campaign is to promote formal activity in order to increase payment of taxes and formal employment. Teams of trained “awareness raisers”, including tax inspectors, have been visiting businesses in the country to help bring them into the formal economy. The tax office has been showing businesses how to avoid incorrect reporting and implementation of legislation. The initiative was perhaps triggered by fiscal underperformance in the past year, and it will primarily aim to tackle tax evasion.

The campaign is based on three pillars: communication, legislation and location.

Communication activities are aimed at delivering a clear message to the general public on positive aspects of formality, making sure that the public understands the social losses associated with informality and encouraging them to take an active part in the fight against it.

The second pillar of the campaign is legislation, aimed at amending the law in order to put in place appropriate incentives, including harsher penalties on businesses breaking the law by non-declaration of turnover, registered employees, VAT coupons and so on. New legislation in this area was stopped by the Constitutional Court in December 2015 pending a final decision on the new procedures. The government also plans to reform the public administration – a key factor in the campaign’s success.

Under the third pillar, namely location, the authorities will identify the regions, sectors and businesses at high risk from informality and create a common task force, including tax and customs authorities as well as the economic crime police and labour inspectorate, that is able to fight informality effectively. The tax directorate is implementing a new IT system that will classify businesses according to their risk profile, which would decrease the number of unnecessary inspections and reduce costs for both tax administration and businesses.

The results of the first two months of the informality campaign include: a rise in the number of registered businesses (more than 27,000 in September and October 2015 alone); an increase of the registered workforce (more than 70,000 employees during September and October); and increased declared turnover from businesses. However, to maintain momentum it is important that the government formulates a clear, written plan for the medium term. This plan is in preparation and is expected to be published in early 2016.
Box 2

Bosnia and Herzegovina: reform agenda

In July 2015, after lengthy discussions, governments at state and entity levels in Bosnia and Herzegovina adopted a new reform agenda. This agenda includes six priority areas: public finances, taxes and tax sustainability; business climate and competitiveness; labour market; social protection and pensions; the rule of law and good governance; and public authorities. The agenda is aligned with the European Union’s new emphasis on economic governance in Bosnia and Herzegovina and other Western Balkans countries.

The adoption of a new reform agenda in Bosnia and Herzegovina is an important step forward for the country and has helped to put it back onto its EU approximation path. Encouraged by this progress, in April 2015 the Council of the European Union decided to unfreeze the Stabilisation and Association Agreement (SAA) with Bosnia and Herzegovina, signed in 2008 but not adopted because of the lack of progress in reforms. The SAA entered into force on 1 June 2015.

Implementation of the reform agenda has begun. Reforms can be broadly grouped into three areas: socio-economic; the rule of law and the fight against corruption; and – critical for the success of the entire project – the strengthening of administrative capacity. More specific action plans have been developed by the state and entity governments, and some significant legislative reforms (notably, new labour laws) have been adopted in both entities. Implementation is a joint process, with local institutions working closely with the European Union and supporting IFIs. A broad set of subject areas – as set out in the table – have been distilled into specific initial measures and undertakings that will be prepared and implemented during 2016 individually with each institution. The reform agenda includes six subject areas, with a lead international organisation (or two) for each area.

In the area of business climate and competitiveness, where the EBRD and the International Finance Corporation (IFC) are the

<table>
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<th>Subject area</th>
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<td>1 Public finance, taxation and fiscal sustainability</td>
<td>IMF and World Bank</td>
</tr>
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<td>2 Business climate and competitiveness</td>
<td>EBRD and IFC</td>
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<tr>
<td>3 The labour market</td>
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<td>4 Social welfare and pension reform</td>
<td>World Bank</td>
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<td>5 Rule of law and good governance</td>
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<tr>
<td>6 Public administration reform</td>
<td>European Union</td>
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lead IFIs to assist the governments, the actions agreed include: (i) for the Federation of Bosnia and Herzegovina (FBIH), a restructuring programme for mines and railways, and privatisation of companies with a minority share held by the FBIH government; and (ii) for the Republika Srpska (RS), a programme for restructuring loss-making public enterprises, and a privatisation and restructuring programme for RS Railways.

What can we expect in 2016? According to the latest EC Progress Report, Bosnia and Herzegovina is “at an early stage” in public administration reform, in developing a functioning market economy, approximation with European standards in general and in the ability to cope with competitive pressures and market forces within the Union in particular. However, Bosnia and Herzegovina may be allowed to formally apply for EU membership in early 2016 – a reward for beginning to implement the reform agenda. The official European Council formulation of the main conditions for inviting an application for membership from Bosnia and Herzegovina is the achievement of “meaningful progress” in the implementation of the country’s recently adopted reform agenda.
Box 3

Kosovo: Stabilisation and Association Agreement

On 27 October 2015 the European Union and Kosovo signed a Stabilisation and Association Agreement (SAA), two years after the start of negotiations. As the first contractual relationship between the two sides, the agreement is a milestone in Kosovo’s EU approximation. It serves as a framework for cooperation and political dialogue between Kosovo and the European Union, formalising the country’s preferential access to EU markets in exchange for commitments on required reforms.

The European Union has been active in Kosovo since 1999, following the end of the conflict between NATO forces and the then Federal Republic of Yugoslavia. The European Union has helped Kosovo with more than €2 billion of financial assistance, which makes it by far the single biggest donor. In addition, Kosovo hosts the largest community of EU civil servants outside of Brussels through the European Union Rule of Law Mission in Kosovo (EULEX), as well as the European Union Special Representative (EUSR).

Kosovo was formally given a “European perspective” in 2003 within the Stabilisation and Association Process (SAP), the EU policy framework designed to prepare all Western Balkans countries for potential membership. The European Commission launched a feasibility study for an SAA in March 2012. The report recommended that negotiations start as soon as Kosovo made progress in the areas of rule of law, public administration, protection of minorities and trade. Following Kosovo’s commitment to the necessary steps, and an agreement between Kosovo and Serbia under which both committed not to block or encourage others to block the other side in the EU integration process, SAA negotiations started in October 2013.

Kosovo has continued to address the priorities set out in the Progress Reports and the feasibility study for SAA, with most progress done in the area on EU-facilitated dialogue with Serbia and requirements for visa liberalisation, which continues to be one of the key priorities. Also, further arrangements for financial assistance have been carried out and the Financing Agreement for the Instrument for Pre-accession Assistance (IPA) II was signed in April 2015. Kosovo has been allocated up to €645.5 million under the European Union’s new IPA II for 2014-20, with €79.3 million already signed off for 212 projects. This assistance will support reforms in preparation for EU membership, socio-economic and regional development, social policies and rural development.

After a political stalemate following elections, which caused a slight delay, the European Commission adopted the SAA in April 2015 and it was signed on 27 October 2015. The agreement maps out a framework for political and economic dialogue and cooperation in several areas and sectors in which the country is obliged to meet European standards. The agreement is likely to enter into force in 2016. It was ratified by the European Parliament in January 2016 and all that now remains is final approval by the European Council.

Not only are things looking positive for the country politically in terms of a European future, but investors can also take comfort in the fact that Kosovo now has contractual obligations to adhere to certain standards in terms of regulations and the business environment.
**Box 4**

**FYR Macedonia: reforming the business environment**

Doing business in FYR Macedonia has become a great deal easier over the last nine years: in the World Bank’s 2007 Doing Business report, the country was ranked 96th in the world; in 2016 it was placed 12th. This improvement reflects a concerted effort by successive governments to tackle obstacles to doing business. These efforts have helped to improve the country’s image and achieve some success in attracting foreign direct investment (FDI).

During the past decade, FYR Macedonia has implemented a comprehensive package of policy reforms and capacity-building in the areas of business environment, institutional strengthening, land and real estate registration and the judiciary. The Business Environment Reform and Institutional Strengthening (BERIS) programme addressed many of the priority areas identified by the European Partnership (EP) and signed between the European Commission and the government in 2004. BERIS was designed and implemented in 2006-10 as a loan of €6.4 million (after revision) from the International Bank for Reconstruction and Development.

There were five main components of the reform programme. First, it focused on developing the government’s capacity and implementing business-friendly regulatory regimes in two phases: (i) launching a regulatory guillotine and (ii) setting the basis for a regulatory impact analysis system. The regulatory guillotine is a way of reviewing, streamlining, eliminating and updating laws and procedures by avoiding huge administrative, legal and political costs, as the unjustified procedures are eliminated in a single decision. It is usually used as a quick and efficient way of making procedures more business friendly. The regulatory impact assessment is an element of evidence-based policy-making as it uses a systematic approach to critically assess existing and new regulations. By the end of the reform programme, regulatory impact assessments were carried out for over 100 new laws, and the regulatory guillotine streamlined 564 laws and by-laws.

Second, the programme led to improvements in the national Metrology, Standard, Testing and Quality (MSTQ) System, making it consistent with EU regulations in order to help companies compete in both domestic and foreign markets. After a series of reforms, one of the consequences was an increase in the number of standards harmonised with the European Union from 18 in 2005 to 3,477 in 2010.

Third, a competition policy regime was introduced to strengthen capacity to implement a competition policy compliant with EU standards. This subsequently grew into an Industrial and Enterprise Policy and Competitiveness Support, mostly helping to increase FYR Macedonia’s compliance with Chapter 20 (Enterprise and Industrial Policy) of the EU’s *acquis communautaire*.

Fourth, an access to information component of the programme was designed to, among other things, address poor access to information by implementing a credit information registry. This would establish a “one-stop shop” for business registration and connect with the Employment Agency and health and pension insurance funds. This had the most visible impact on businesses as it not only drastically shortened business registration time but also allowed existing businesses to deal with employee-related issues electronically.

Lastly, a project coordination support scheme was set up to ensure that activities were properly implemented, coordinated and monitored.

FYR Macedonia has continued to improve the business environment. Starting a business was made easier by further improving the one-stop shop and simplifying the requirements and procedures, making online registration free of charge and carried out by certified agents. At the same time, FYR Macedonia lowered taxes for businesses, worked on making credit more accessible, developed more efficient frameworks for resolving insolvency and protecting minority investors, streamlined dealing with registering property and construction permits by decreasing the time and cost needed, and digitised the real estate cadastre.
Box 5

Montenegro: coordinated auction office in SEE

The coordinated auction office (CAO) in south-eastern Europe (SEE), established in March 2014 and based in Podgorica, Montenegro, is responsible for managing cross-border capacity for electricity trading in the region. Having a central point for cross-border capacity allocation makes trade in electricity simpler, cheaper and more transparent, and promotes the development of a regional power market.

The CAO came into being as a result of extensive discussions between key stakeholders such as the Energy Community Secretariat (established with the aim of extending the energy acquis of the European Union to the Western Balkans, Moldova and Ukraine), the European Commission and the transmission system operators (TSOs) from the region. IFIs, including the EBRD, have provided significant support in terms of technical assistance, procurement and grants for the IT platform necessary for capacity allocation. Current shareholders are the TSOs of Albania, Bosnia and Herzegovina, Croatia, Greece, Kosovo, FYR Macedonia, Montenegro, Romania, Slovenia and Turkey.

To understand the contribution of the CAO, it is important to understand that power traders wishing to export to another country must reserve transmission capacity in each of the countries through which they want to transport the energy. For example, to transfer power from Bosnia and Herzegovina to Albania, power traders must reserve capacity on the Montenegrin power grid. This capacity allocation used to be performed by each TSO, using a variety of methods such as bilateral auctions or even non-market-based methods, with the risk of a resulting lack of transparency and efficiency.

The creation of a coordinated single point to auction transmission capacity in the region – the CAO – enables efficient and economic access to cross-border transmission capacity through a transparent, market-based auction. This helps the region to comply with EU regulations on transmission capacity access and is a key step towards a functioning and integrated regional power market in south-eastern Europe.

The SEE CAO not only enhances the regional integration of energy markets but also, by doing so, it supports related investments in physical infrastructure. It increases efficiency for energy traders and sends a clear signal to investors that the region, characterised by many borders and different capacity allocation mechanisms, is moving in the right direction regarding the common energy market.

In technical terms, the creation of the CAO first required the development of a complete set of harmonised auction rules and internal procedures between all shareholding TSOs. This was followed by the implementation of the IT Auction Platform and the education of power traders, prior to the first auctions which took place in late 2014. Now, the region enjoys a single set of auction rules and the possibility for power traders to allocate cross-border capacity from Croatia to Turkey by using the SEE CAO as a one-stop shop.

During the CAO’s first year of operations, all yearly, monthly and daily auctions were successfully conducted, with no disputes or cancellations. The CAO has therefore proven its pivotal role for the development of an open and competitive SEE electricity market. Nevertheless, to complete the regional perimeter, it would be desirable to include the remaining SEE TSOs, in particular Serbia, into the SEE CAO auction process.
Box 6

Serbia: Innovation Fund

The Innovation Fund in Serbia was established by the Law on Innovation Activity in 2011, and is funded by the EU’s Instrument for Pre-accession Assistance (IPA) with expert support from the World Bank. The Fund’s main goal is supporting innovation in science and technology, and commercialising technology transfer in Serbian enterprises. In three years of functioning it has spent €6 million on 53 projects, and is continuing to work on new projects supporting commercialisation of R&D through encouraging collaboration among stakeholders.

The Innovation Fund provides financial help to research and development (R&D) and innovation in commercial enterprises in Serbia. It is among few sources providing risk financing, as other sources of private funding for businesses in initial stages of development, such as business angels’ networks, crowd funding and venture capital, barely exist in the country. It therefore complements existing government support for innovation projects.

The Fund operates through two different programmes: mini grants and matching grants. Both programmes require applicants to be majority owned Serbian enterprises, and the projects can be targeted at any field of science and technology, as well as other sectors.

Mini grants are aimed at early-stage micro- and small enterprises that have market-oriented technological innovation with a high potential for commercialisation. Projects must be designed to be completed in under a year, and those receiving awards get an unconditional grant amounting to a maximum 85 per cent (or €80,000) of the total funds necessary for successful execution.

Matching grants target existing micro-, small- and medium-sized enterprises (defined by the revenue ceiling in the last two years) looking to scale up their production and translate research efforts into commercial projects.

A project has to be designed to be completed in under two years and the Fund is willing to dispense a maximum of 70 per cent (up to €300,000), with the remainder having to be secured by a co-financer independent from the Fund.

Grants in this category are not unconditional. If the project is successful, the applicant will be required to pay royalties or pay back the grant with interest. The risk of not succeeding is shared between the applicant and the Fund and, in cases of unsuccessful commercialisation, no payment is required. In three years of functioning, the Fund went through four public calls for projects, with 471 applications, mostly from hi-tech companies in ICT, energy efficiency and nanotechnology, but also food and agriculture, machine and mechanical engineering and electromechanical device production. It disbursed all planned funds, equally divided between mini grants and matching grants.

By 2014 the results had been encouraging. Out of 53 awarded projects, 23 patent applications had been submitted (plus 8 trademark and 6 copyright applications), 13 companies had established new business relationships or partnerships, 11 companies had generated revenue from the sale or lease of products or services, and 7 companies had established strategic international cooperation.

Currently, the Innovation Fund is preparing a Serbia Research, Innovation and Technology Transfer Project, supported by €6.9 million from IPA funds, with the goal of promoting technology transfer and commercialising R&D efforts by stimulating collaboration between academia and industry, in addition to offering collaborative R&D grant schemes. The Fund is also actively representing the government of Serbia in the dialogue and designing of new financial instruments for private sector development within the framework of the Western Balkans Enterprise Development and Innovation Facility.