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Investment for Growth and Development in the Western Balkans

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Executive Summary

CHAPTER 1. WESTERN BALKANS URGE MORE INVESTMENT

1.1. Macroeconomic data analysis

1.2. Infrastructure: state and needs

Transport

Energy

Environment

Social Sector

1.3. Private sector and SMEs

CHAPTER 2. CONVERGENCE, INVESTMENT, DEBT, EMPLOYMENT: ALL PIECES OF THE SAME PUZZLE

2.1. Convergence to EU-level living standards – still a long journey

2.2. Investment stimulus needed to achieve development goals

2.3. Consequences for debt

2.4. Employment: the ultimate goal...

CHAPTER 3. COORDINATION TO ACHIEVE POLICY SYNERGIES AT REGIONAL LEVEL

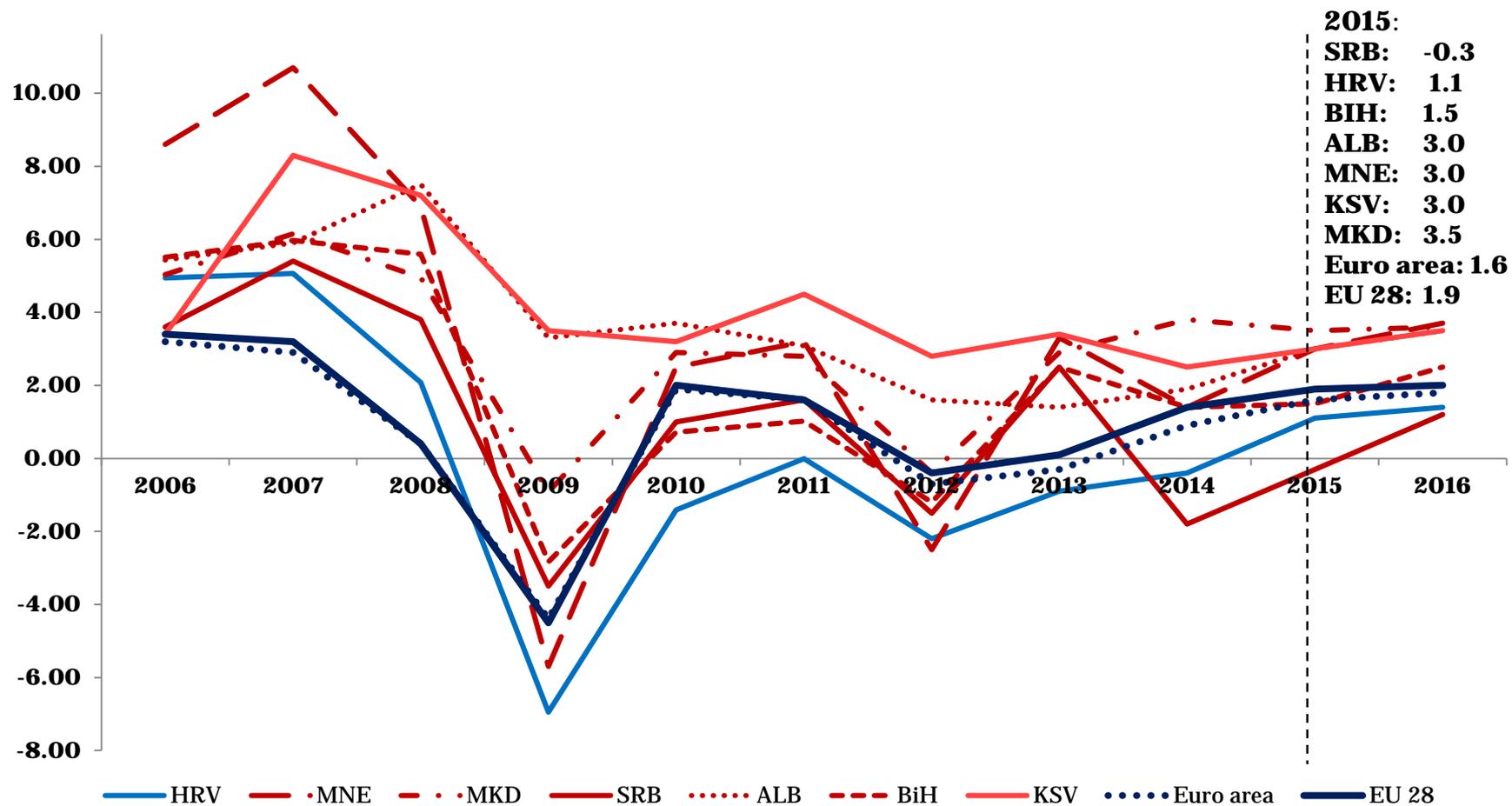
3.1. Demand coordination and multipliers

3.2. Three independent small open economies

3.3. Trade interdependence without policy coordination

3.4. Trade interdependence with policy coordination

CONCLUSION. INVESTMENT NEEDS AND FINANCING – MIND THE GAP

*GDP growth: from double-deep recession to slow recovery***Real GDP growth rate (%)**

Invest in infrastructure: How much ?

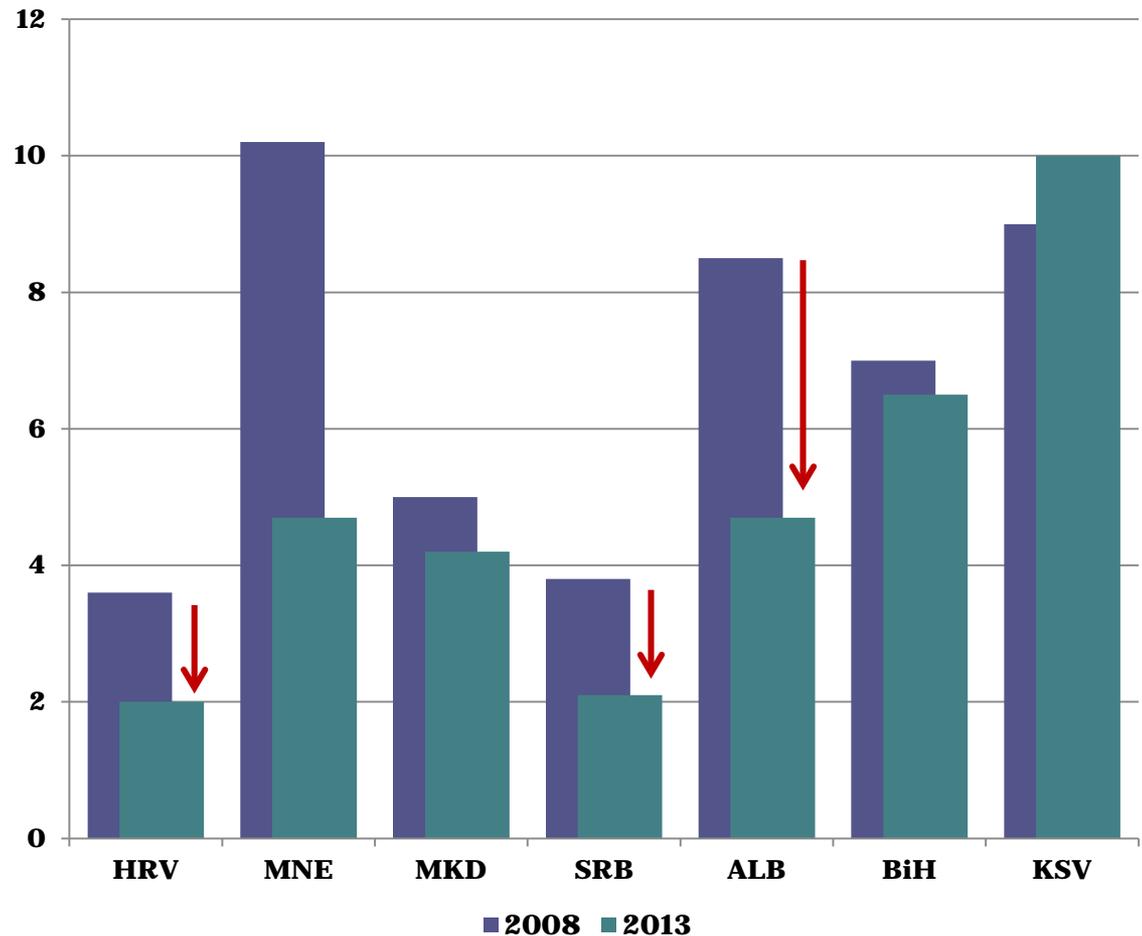
*For developing countries, the **minimum required increase in the stock of infrastructure** corresponds to about **6-8% of GDP per year** (investment net of maintenance and depreciation costs).*

[Bhattacharya et al. (2012)]



WB6+HRV:
EUR 8 – 10 bn per
year

Public Capital Expenditures (% of GDP)



Transport

2 – 2.5% of GDP
per year
EUR 1.6 – 2 bn

Ten-T

Urgent needs
EUR 12.4 bn

Road
3.1

Rail
9.3

Priority projects
EUR 9.6 bn

Road
6.9

Rail
2.6

Other
0.1

SRB:
22 bn

- Taking into account the accumulated lags in the development of networks in the Western Balkans, it is reasonable to estimate the sector investment needs of **2-2.5% of GDP per year**. It corresponds to **1.6 – 2 EUR bn** per year for the WB6 (**2.6 – 3.3 EUR bn** if Croatia is included) till 2020 if medium growth scenario is assumed.
- Since 2004, the total amount of investment in Ten-T infrastructure reached **EUR 12 bn** with road infrastructure representing more than 80% of the total investments in the Ten-T Comprehensive Network, rail representing 13.5%, air infrastructure – 3.6%, inland waterways and seaport – only about 1%
- SEETO: Urgent investment needs for rehabilitation of poor condition segments and bottlenecks removal (rail and road infrastructure only) were estimated at **12.4 EUR bn** (9.3 EUR bn for rail and 3.1 for road network)
- For 48 priority projects stated in the 2016 Multi-annual Plan **9.64 EUR bn** are needed
- Serbian General Master Plan for Transport 2009-2027 estimates total costs of infrastructure needs as over **22 EUR bn** or more than **1.2 EUR bn per year**



- The main features of energy sector: low and aging power generating capacity, low energy consumption, high energy intensity, low energy efficiency, high reliance on coal and hydro in the energy mix, electricity import dependency, low electricity prices, high transmission and distribution losses.
- The need for a more diversified energy mix: potential development of gas infrastructure and renewables.
- Taking into account the development potential of the energy sector, a reasonable estimate of energy investment needs in GDP terms for the Western Balkans would be **1.5% - 2.7%**. It corresponds to **EUR 1.2 -2.2 bn** per year for the WB6 (**2 – 3.5 EUR bn** for WB6 + Croatia) till 2020 if medium growth scenario is assumed.
- Minimum costs scenario (modest development in an attempt to move towards partial compliance with energy efficiency and renewable energy targets; electricity demand would be met fully) requires **EUR 35 bn** of investment;
- Low emissions scenario (ambitious development assuming that the energy efficiency targets will be met and that renewable energy resource targets are also achieved; “gas ring” is introduced allowing both gas supply for distribution and gas supply for power generation) requires **EUR 60 bn** of investment;
- PEICs list foresees **EUR 14.2 bn**

Environment

**at least
1.5 % of GDP
per year
EUR 1.2 bn**

Waste

Water
20 bn

Urbani
sation

Climate
change

MKD
**2.3
bn**

SRB:
**10.6
bn**

- Western Balkans benefit from rich natural land and water resources. To preserve and take plain advantage of them will be an important challenge for the future;

- Main features: insufficient solid waste and waste water infrastructures; high climate change vulnerability in some countries; potentially high future urbanisation costs.

- Investment needs in the environment sector of the Western Balkans can be estimated as **at least 1.5% of GDP** or **EUR 1.2 bn** (**EUR 2 bn** if Croatia is included) per year.

- Water and waste water infrastructure alone requires **EUR 20 bn**.

- The negative impact of 2014 floods was estimated to be 4.7% of GDP in Serbia (**EUR 1.5 bn**) and 15% of GDP in Bosnia and Herzegovina (**EUR 2.1 bn**) in terms of output loss and damages

- Serbian environment approximation strategy foresees the investment costs of **10.6 EUR bn** (5.6 EUR bn for water sector, 2.8 EUR bn for waste and 1.3 EUR bn for industrial pollution) in the horizon of 2030 (or *1.7% of GDP per year*). Macedonian National Strategy for Environment Approximation estimated the investment needs at **2.3 EUR bn** over period from 2015 to 2023 what corresponds to the average annual investment of more than *3 % of GDP*.

Social sector

1.2 % of GDP
per year
EUR 1 bn

Investment in
human capital

Education
6% of
GDP per
year

Health
6.4% of
GDP per
year

Physical capital
investment only
About 10% of
total spending

- *Social sector, and especially education, was not among governments priorities during the transition.* The consequences in terms of *enrollment ratios are alarming* in some countries of the region (Albania, Kosovo and Bosnia and Herzegovina). Education and health expenditures are much lower comparing to the European level. Taking into account high unemployment rates, social sector should not be neglected (especially when a particular focus is given to Connectivity agenda) and should be a priority.

- It would be desired to increase public investment in education (both in physical capital and human resources) to at least European level. **6% of GDP** as targeted by Serbian Strategy for Education Development 2020 seems reasonable figure in this perspective.

- If applying this 6% target to all the countries of the region, the regional investment gap can be evaluated on average as *2.1% of GDP*. Considering current GDP level, it implies that education expenditures should attain **4.6 EUR bn** per year in WB6 (**7.3 EUR bn** for WB6 and Croatia). The same reasoning can be applied to the health sector.

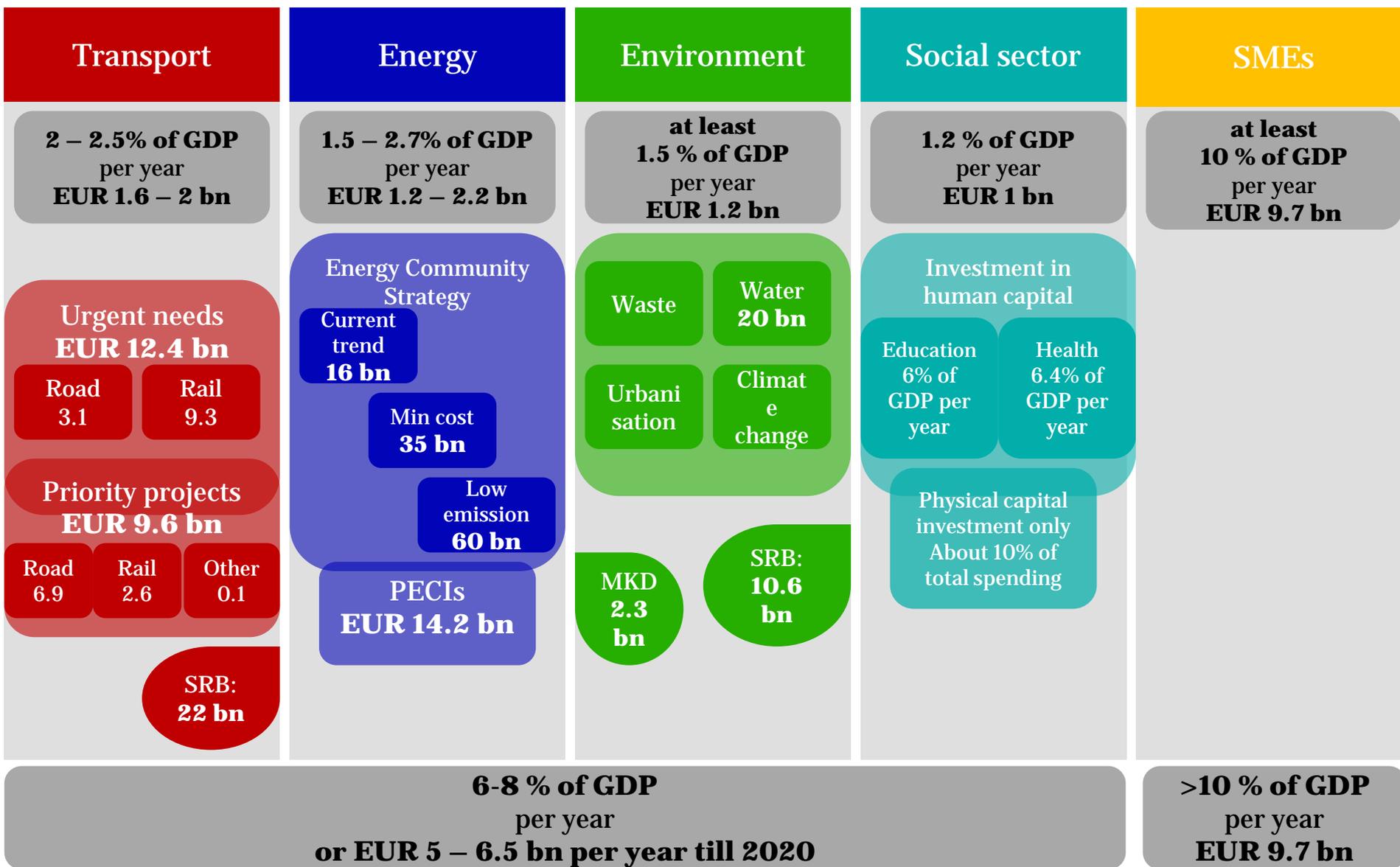
- As for physical capital investment only, one can take as a target 10% of total expenses in social sector, i.e. **1.2% of GDP** or around **EUR 1 bn** per year for WB6.

SMEs

**at least
10 % of GDP
per year
EUR 9.7 bn**

- For planning purposes, future investment needs for the SME sector could be projected (under assumption of relatively stable share in the value added in the close future) depending on growth objectives
- SMEs investment needs in the WB6 region could be estimated as **9.7 EUR bn** (low bound) - **12.5 EUR bn** per year (upper bound) till 2020 if medium growth scenario is assumed.

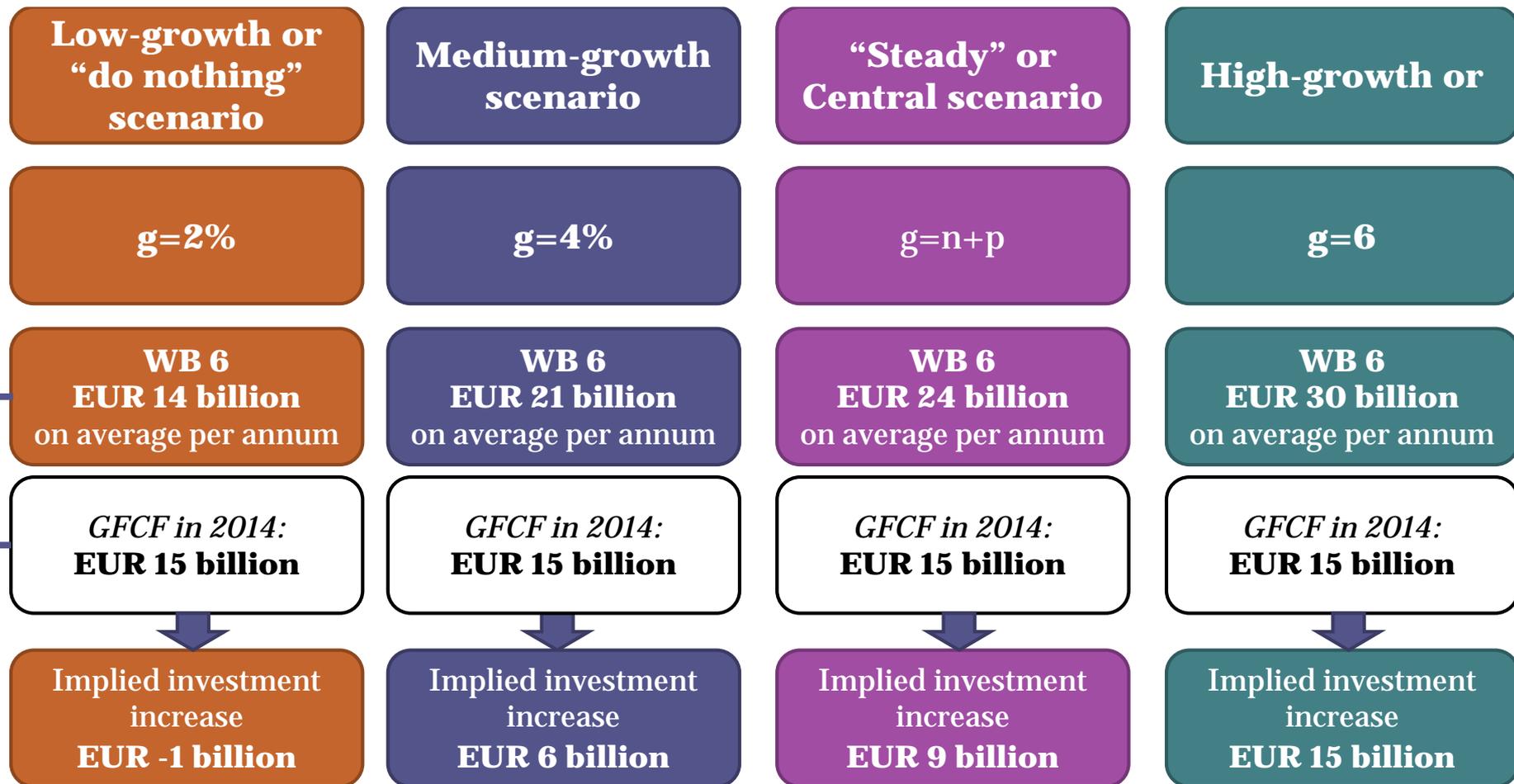
Investment needs estimates by sector till 2020, WB6





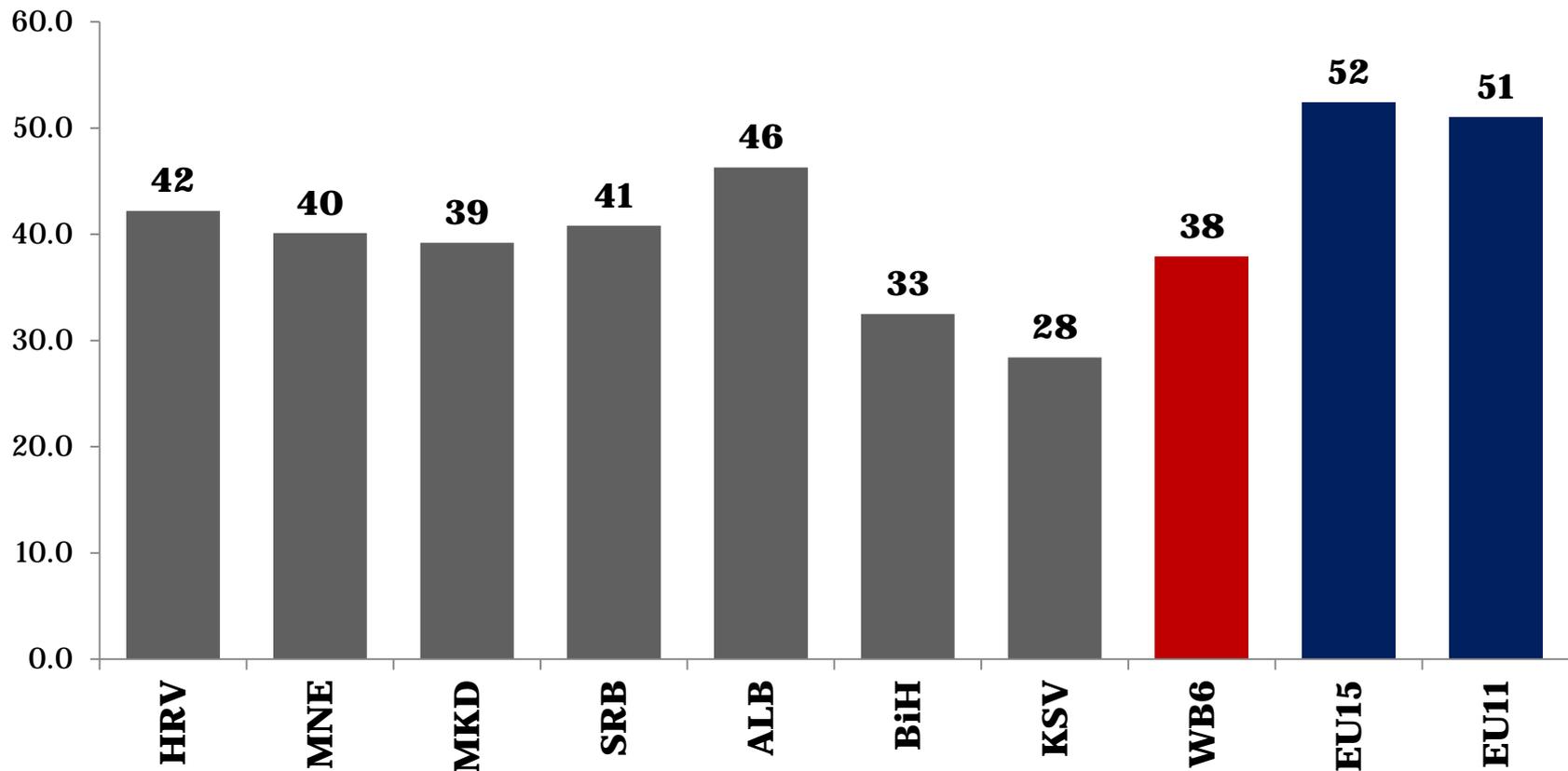
How much investment needed?

Time horizon: till 2020



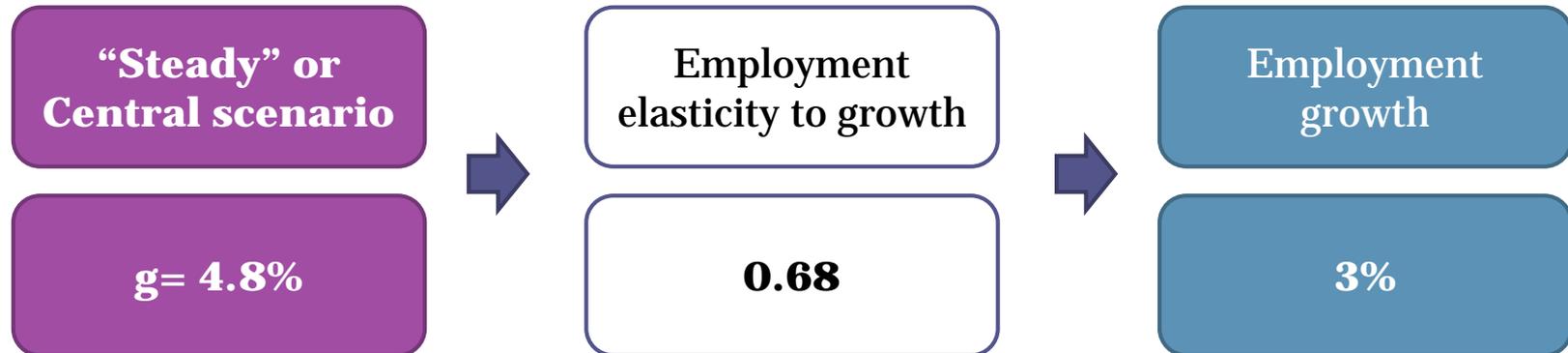
Employment: critical situation

Employment-to-Population ratio in 2013 (%)

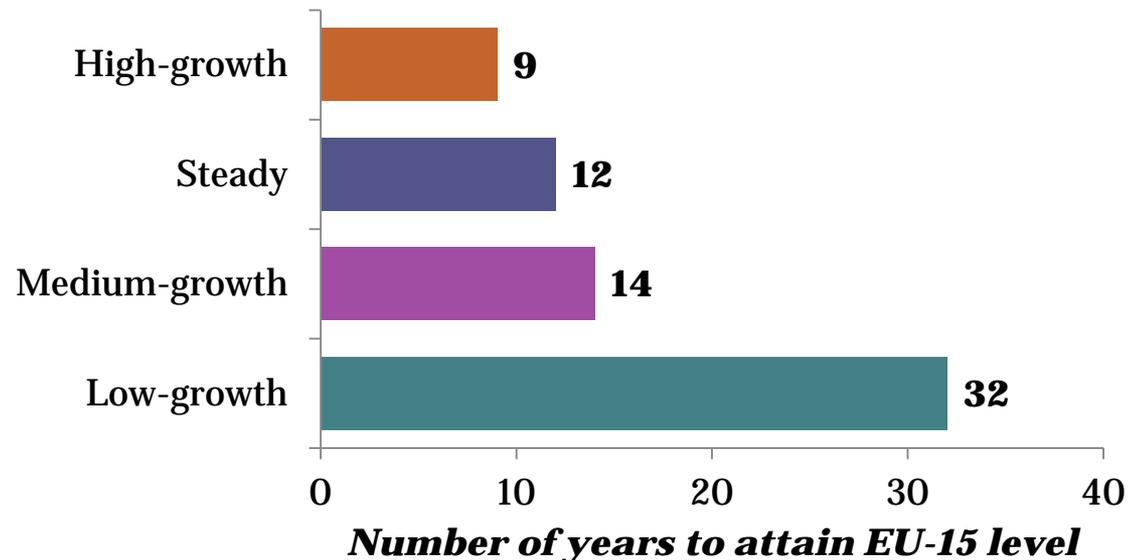


Source: International Labour Organization KILM 8th edition, World Bank (2013) Results of the Kosovo 2012 Labour Force Survey, World Bank (2014) Results of the Kosovo 2013 Labour Force Survey.

Employment: the ultimate goal

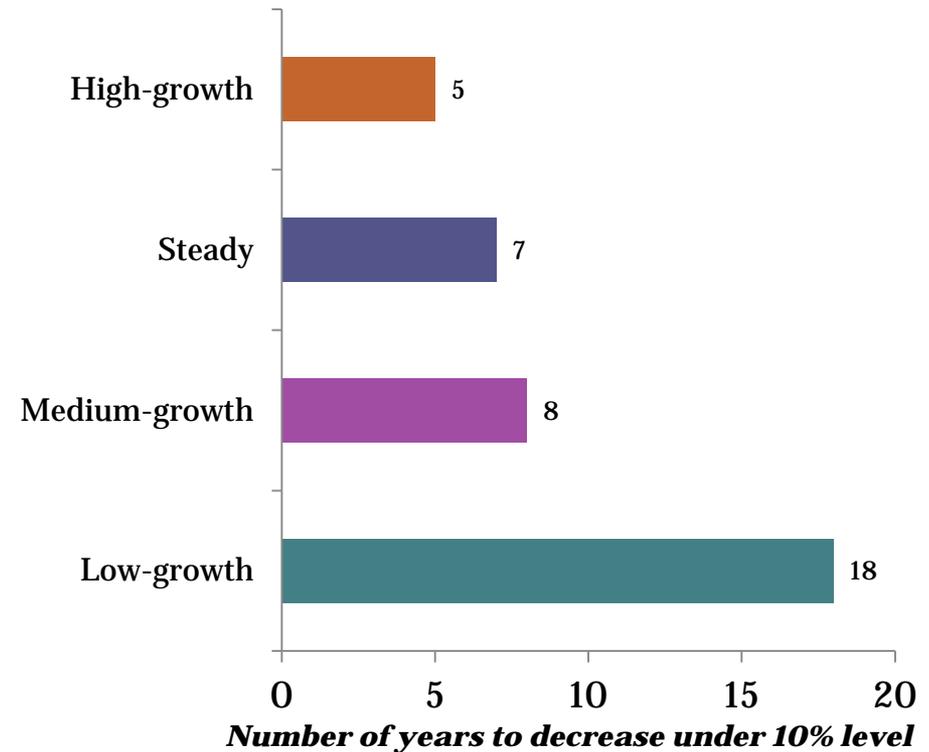
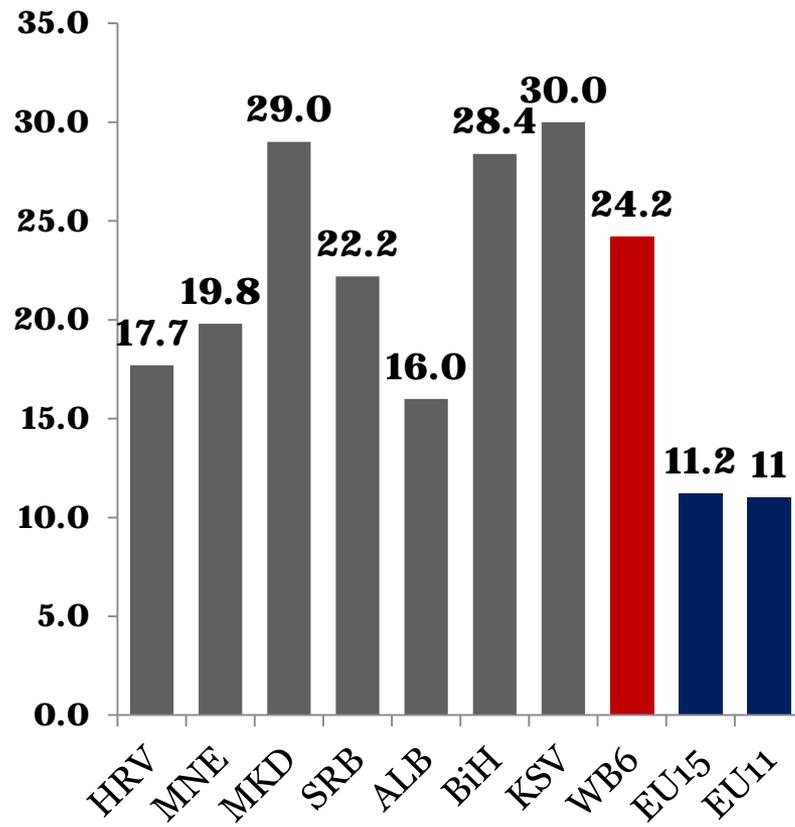


To attain the EU-15 level of the employment-to-population ratio (52%), 3 million jobs should be created



Employment: the ultimate goal

Unemployment rate in 2013 (%)

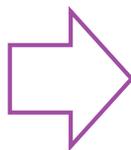


Source: International Labour Organization KILM 8th edition, World Bank (2013) Results of the Kosovo 2012 Labour Force Survey, World Bank (2014) Results of the Kosovo 2013 Labour Force Survey.

Consequences for the debt

“Steady” or
Central scenario

WB 6
EUR 28 billion
on average per annum



Total Debt increase

WB 6
EUR 24 billion
on average per annum

Private Debt
increase

WB 6
EUR 17 billion
on average per annum

Public Debt
increase

WB 6
EUR 7 billion
on average per annum

The proposed “central” investment stimulus scenario is **consistent with EUR 24 bn average total debt increase**. This corresponds to 86% of the initial investment stimulus, therefore the **total debt accumulation is less than proportional to the investment effort** and this is due to the growth dynamics created by the investment multiplier-accelerator process. **Public debt increase is only EUR 7 bn.**

Low-growth rates arising from low investment levels, would have disastrous consequences for the countries’ public debt sustainability thus conducting to a **vicious circle: low growth – high debt – high unemployment.**

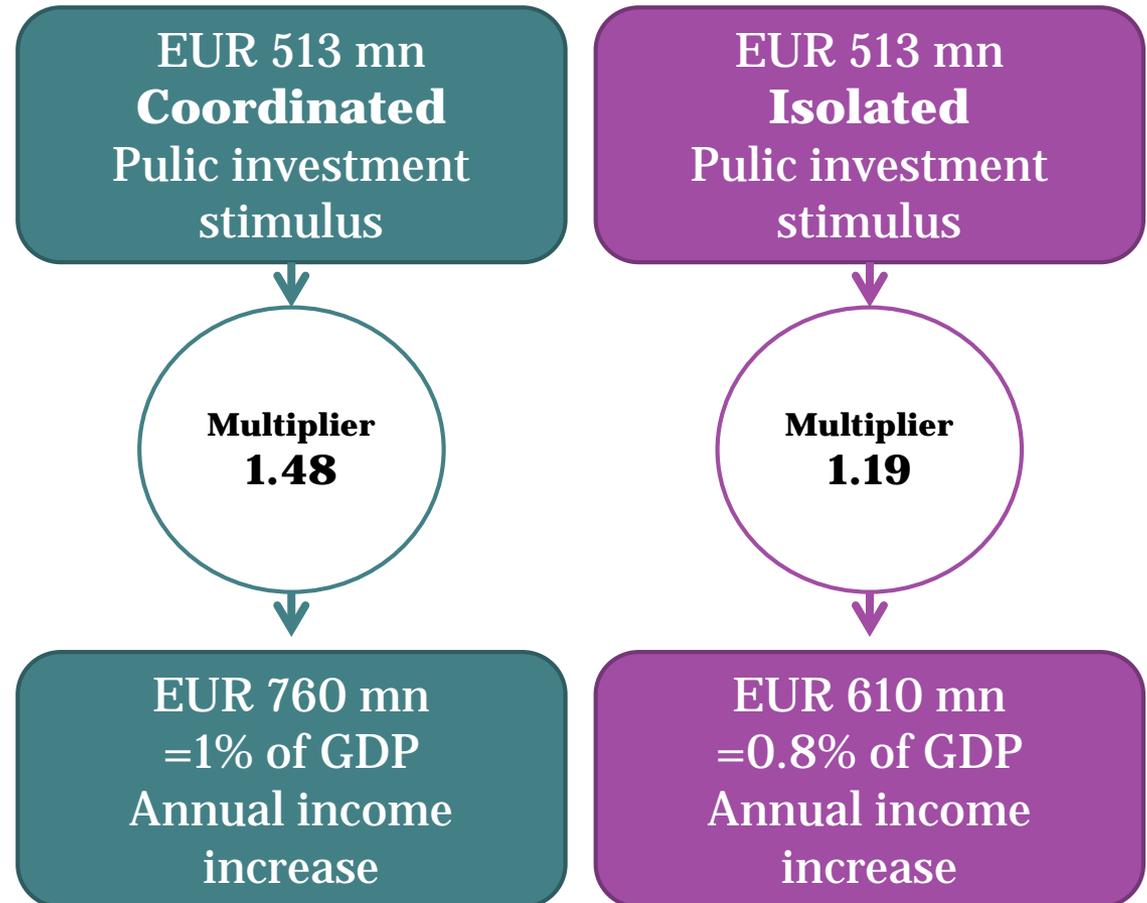
Employment: the ultimate goal

Growth Scenario	Employment elasticity	Employment growth rate	Number of years needed for attaining EU level
"Steady"	0.3	WB6: 1.45% WB6+HRV: 1.27%	29 years
	0.5	WB6: 2.41% WB6+HRV: 2.12%	16 years
	0.68	WB6: 3.02% WB6+HRV: 2.89%	11 years
High growth	0.3	1.8%	21 years
	0.5	3%	12 years
	0.68	4.08%	8 years
Medium growth	0.3	1.2%	35 years
	0.5	2%	19 years
	0.68	2.72%	13 years
Low growth	0.3	0.6%	94 years
	0.5	1%	45 years
	0.68	1.36%	30 years

Coordination to achieve policy synergies at regional level: Example

Connectivity agenda within the “WB6/Berlin process” and implementation of priority projects.

Assuming that all the projects will be realised in the following 15 years, they imply an **annual investment of EUR 513 mn**. Applying coordinated policy multiplier (**1.48**) to this annual additional investment suggests **EUR 759 mn income increase per year**, which represents **1% of regional GDP**.



Coordination to achieve policy synergies at regional level

Coordinated action on autonomous demand via increasing simultaneously public investment in several or all the countries of a regionally integrated area **is more effective than isolated action by a single country.**

Coordination of investment policy, as promoted under the *Western Balkans Investment Framework*, fully fulfils the requirements of the policy coordination framework considered in the developed theoretical models and is thus **beneficial**. These benefits can be achieved, particularly, by **focusing investment on a network of regional investment projects** which can be financed in all countries at the same time and contribute to improve supply conditions.

Such **active policy coordination towards growth and employment creation** offers an alternative to competitiveness sought through austerity only.

CONCLUSION. INVESTMENT NEEDS AND FINANCING – MIND THE GAP

Official support coordinated by the WBIF and the NICs though insufficient to cover all the needs, represents a critical mass (some 16% of the estimated public and private investment needs) that, if suitably planned and coordinated, could also influence choices on the other 84%.

WB6, possible coverage of financing needs by external flows (WBIF) 2015-20 (EUR mn)

	Total	Lending imputed to infrastructure	Lending imputed to SMEs	Infrastructure	SMEs
Investment needs estimate	24 271			6 510	12 467
IPA II annual grants for investment	716	95%	5%	680.2	35.8
EIB annual lending	1000	50%	38%	500	380
EBRD annual lending	1000	50%	30%	500	300
CEB annual lending	200	100%	0%	200	0
WB annual lending	500	40%	0%	200	0
KfW annual lending	300	60%	20%	180	60
Other lending and grants	100	50%	50%	50	50
Total official flows	3816			2310	826

- Additional investment effort is essential to achieve growth in the Western Balkans.
- Growth can be (and should be) effectively stimulated through investment but the capacity to borrow should be increased by adapting the concept of fiscal space to the shared development vision agreed by the donors and the final beneficiaries for the region.
- *National Investment committees (NIC)* defining strategies, should establish investment selection criteria which take into account also of potential effects on growth, labor and cross-border effects. Their capacity to program the use of IPA resources and combine them with IFI loans for the development of the region in an efficient and effective way, will be a key determinant of the success of the reform of the WBIF that we are going to approve in June in Oslo.
- Despite clear tendency to prioritize energy and transport projects following the Berlin process, social and environment sector are in crucial need of investments which are essential to achieve long-term development of the region, they should thus be fully integrated in the programming of the resources invested to satisfy the needs of the region, taking advantage of the fact that the NICS are responsible also to make proposals for the national budget.