

THE ROLE OF EU INTEGRATION IN ENHANCING CREDIBLE STRUCTURAL REFORMS IN THE WESTERN BALKANS

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The Context

Enlargement process and conditionality

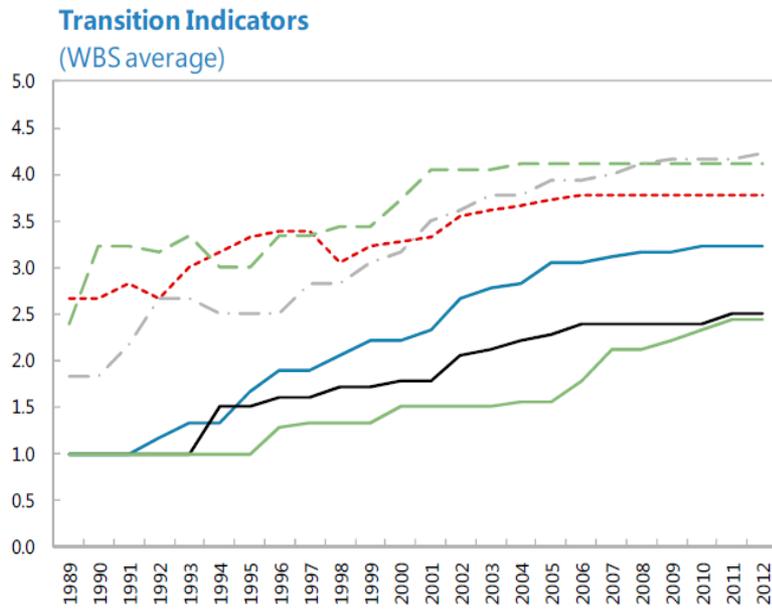
- Treaty of European Union
 - Article 2 (*The Union is founded on the values of respect for human dignity, freedom, democracy, equality, the rule of law and respect for human rights, including the rights of persons belonging to minorities. These values are common to the Member States ...*)
 - Article 49 (*Any European State which respects the values referred to in Article 2 and is committed to promoting them may apply to become a member of the Union.*)
- Copenhagen Criteria
 - Political
 - Economic
 - Acquis
- Stability and Association Agreement
 - the membership candidates must also engage in regional cooperation and good relations with neighbouring countries (the so-called 'Stabilisatio and association process conditionality').
- Candidate / Potential Candidate
- Accession Negotiations
- Screening and Negotiation positions
- Benchmarking (opening, interim, closing)
- Reporting / Monitoring
- Accession Treaty
- Acceding State
- Membership

EU Enlargement and the Western Balkans

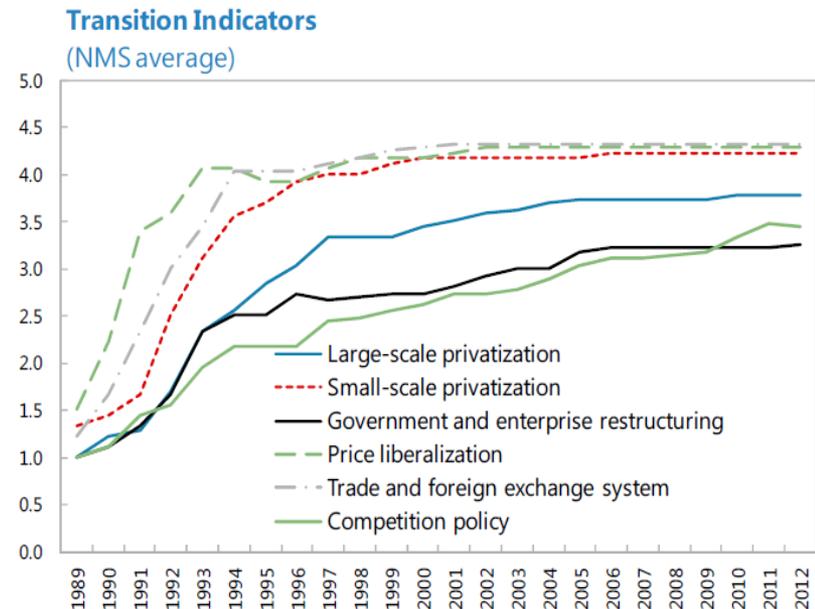
- Stability and Association Process (SAA)
 - Aims
 - Political stabilization and transition to market economy
 - Regional cooperation
 - Eventual EU membership
 - Tools
 - trade concessions (duty-free access to EU markets)
 - economic and financial assistance
 - assistance for reconstruction, development and stabilisation
 - stabilisation and association agreement.
- ‘New Approach’
 - Chapters 23 and 24 (opening first and closing last)
 - Focus on implementation
 - Five steps strengthening negotiations (action plans, opening, interim, closing benchmarks, concluding negotiations)
 - Intensive monitoring
 - Living document / Corrective measures
 - Assistance /Monitoring Instrument
 - Disequilibrium clause (if there is a lag with implementation in Ch 23 and Ch24)

The Evidence and Literature Review

Initial progress and slow down of structural reforms

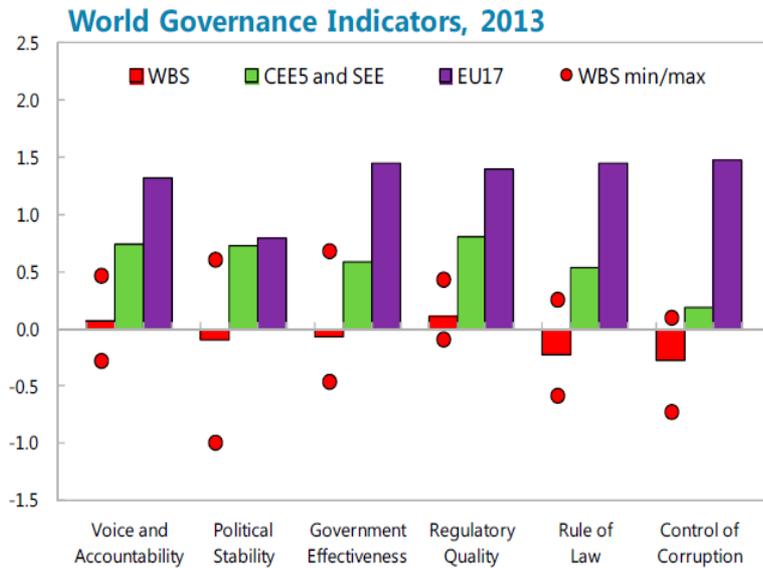


Source: EBRD Transition Indicators.
 Note: NMS average excludes Czech Republic.

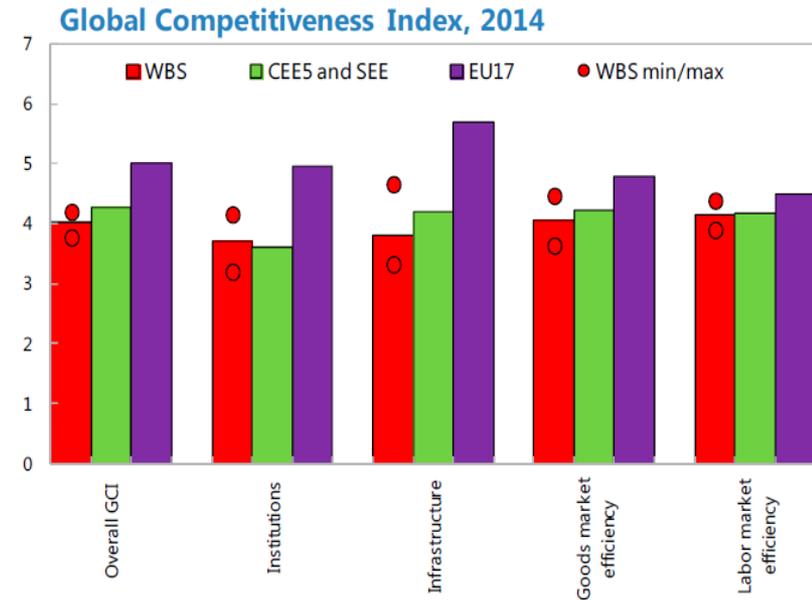


Source: EBRD Transition Indicators.
 Note: NMS average excludes Czech Republic.

Comparative WB, WB, CEE, SEE

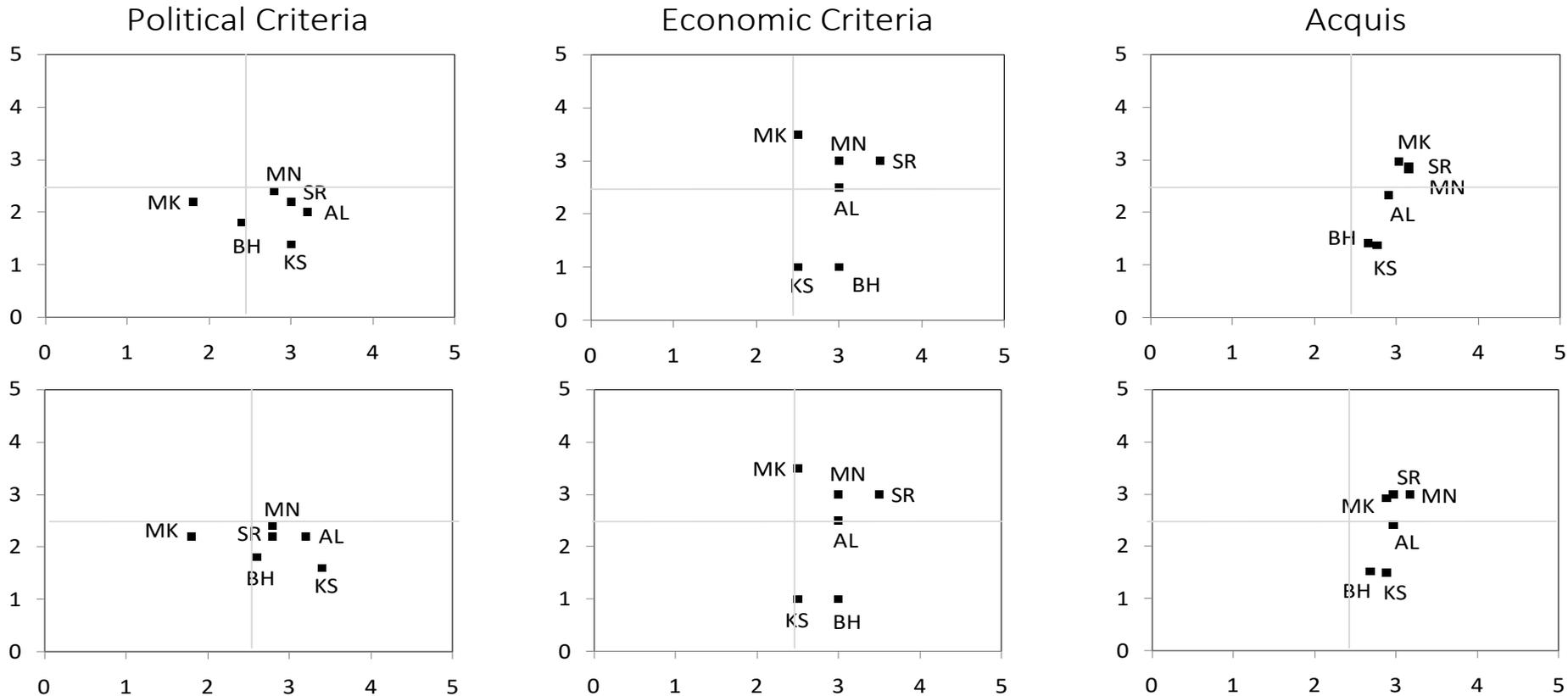


Sources: World Bank, World Governance Indicators, and IMF staff calculations.
 Note: Estimate of governance ranges from approximately -2.5 (weak) to 2.5 (strong) governance performance.



Source: World Economic Forum Global Competitiveness Indicators; and IMF staff calculations.
 Note: Scale 1-7, 7 is best. Data not available for Kosovo.

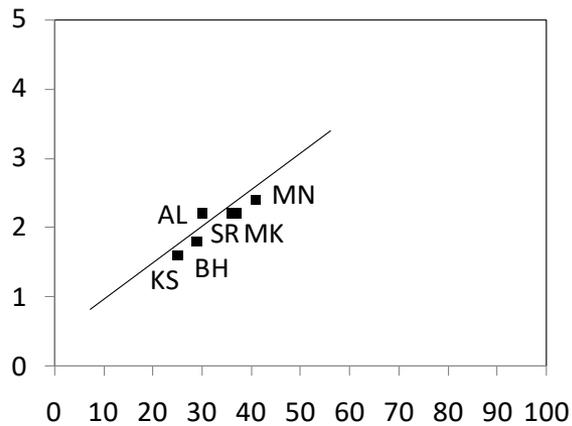
Copenhagen Convergence Criteria: Progress and Readiness



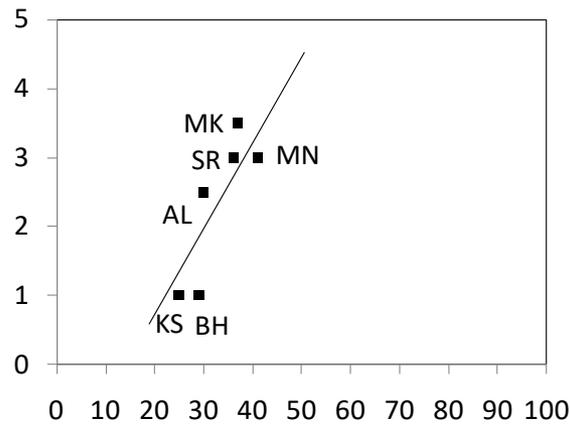
Readiness (vertical axis): 1 – early stage; 2 - satisfactory; 3 - moderate; 4 - good; 5 – advanced
 Progress (horizontal axis): 1 – backsliding; 2 - stagnating; 3 - moderate; 4 - good; 5 – very good
 First row (2015) and Second row (2016)

Copenhagen Convergence Criteria: GDP per capita as a share of EU-28 average

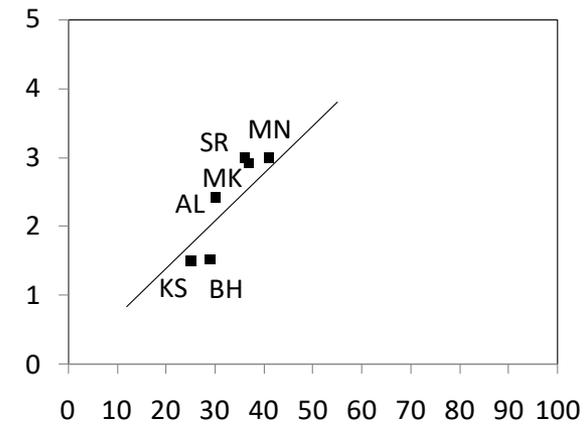
Political Criteria



Economic Criteria
2016

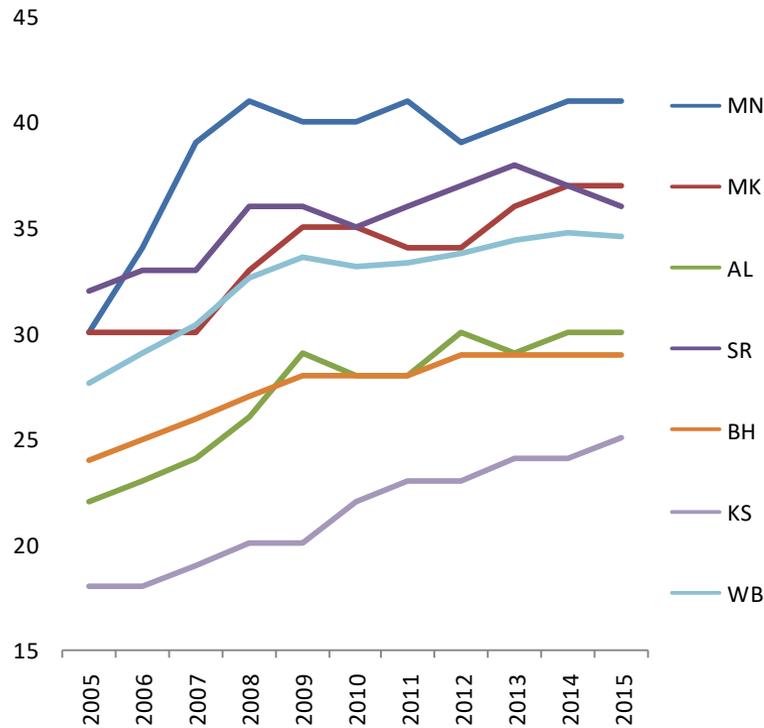


Acquis

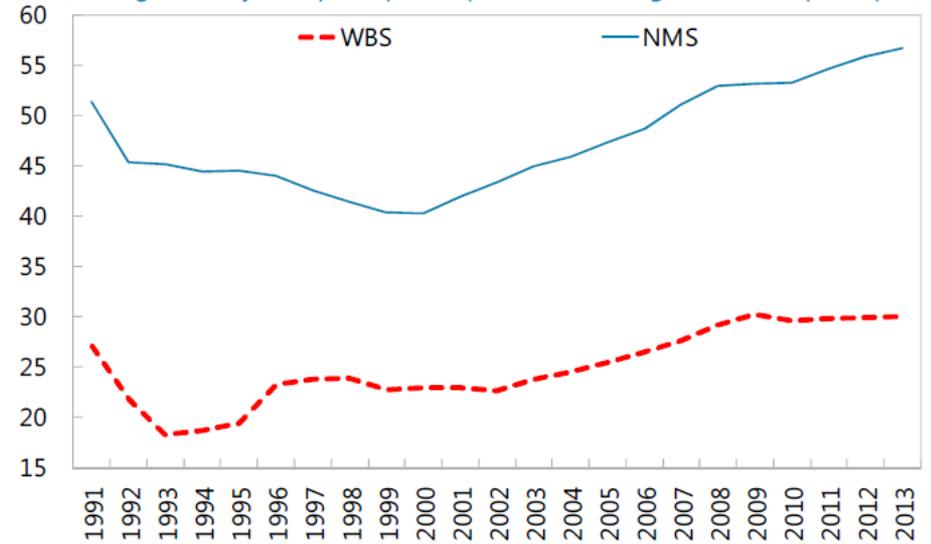


Readiness (vertical axis): 1 – early stage; 2 - satisfactory; 3 - moderate; 4 - good; 5 – advanced
 GDP per capita (PPS) as a share of EU-28 average (horizontal axis)

GDP per capita Convergence and Catching up



Catching up with Advanced Europe
(Average country GDP per capita as percent of average EU17 GDP per capita)



Sources: Penn World Table; and IMF staff calculations.

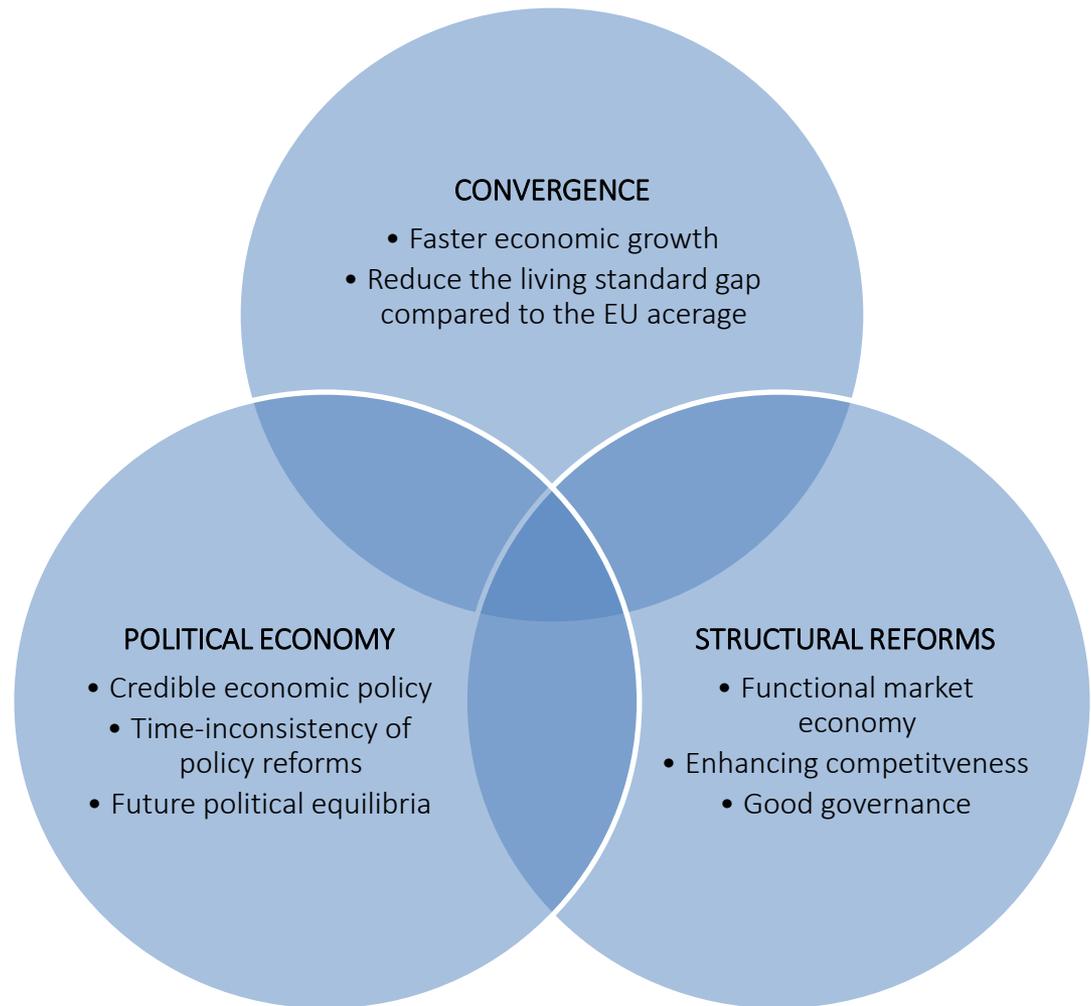
Source: Eurostat [Left graph] & IMF (2015) [Right graph]

Structural reforms and convergence

Wide inconclusive discussion about the causality between structural reforms, growth and convergence.

There is statistical evidence of convergence of the Western Balkans with the EU and positive correlation of reforms and growth.

We consider the political economy implications.



Overview

- Evidence
 - There has been a progress
 - However, in the recent years the pace is slowed down
- Literature review
 - EU integration remains important perspective for the Western Balkans
 - Challenges
 - Catching-up with the EU standard
 - Structural reforms
- Possible contribution to the discussion
 - Introducing the political economy effect of the structural reforms
 - Increasing the credibility of the structural reforms
 - The role of EU integration for sustainable reform process and growth

Research objective and methodology

- The objective:
 - The role of EU integration in enhancing credible structural reforms in the Western Balkans

- Methodology:
 - Introducing an economic model that considers the political economy effect of structural reforms in a dynamic world with rational expectations
 - Implementing Kydland and Prescott (1977) and Barro and Gordon (1983) Model on policymaking with rational expectations that take into consideration credibility and time-inconsistency of policy decisions
 - Insights from the Model on the EU reform leverage and costs of structural reforms Monastiriotis (2016)

The Model

Model Set-Up

Government's objective is to maximize (W):

$$W(s_t, r_t)$$

$$W = -\frac{1}{2}(s_t - ks^*)^2 - \frac{1}{2}\gamma r_t^2$$

Subject to the constraint in the society with the trade-off between reforms (r – reform gap) and support (s – support loss) due to the lost of rents/status (political economy effect):

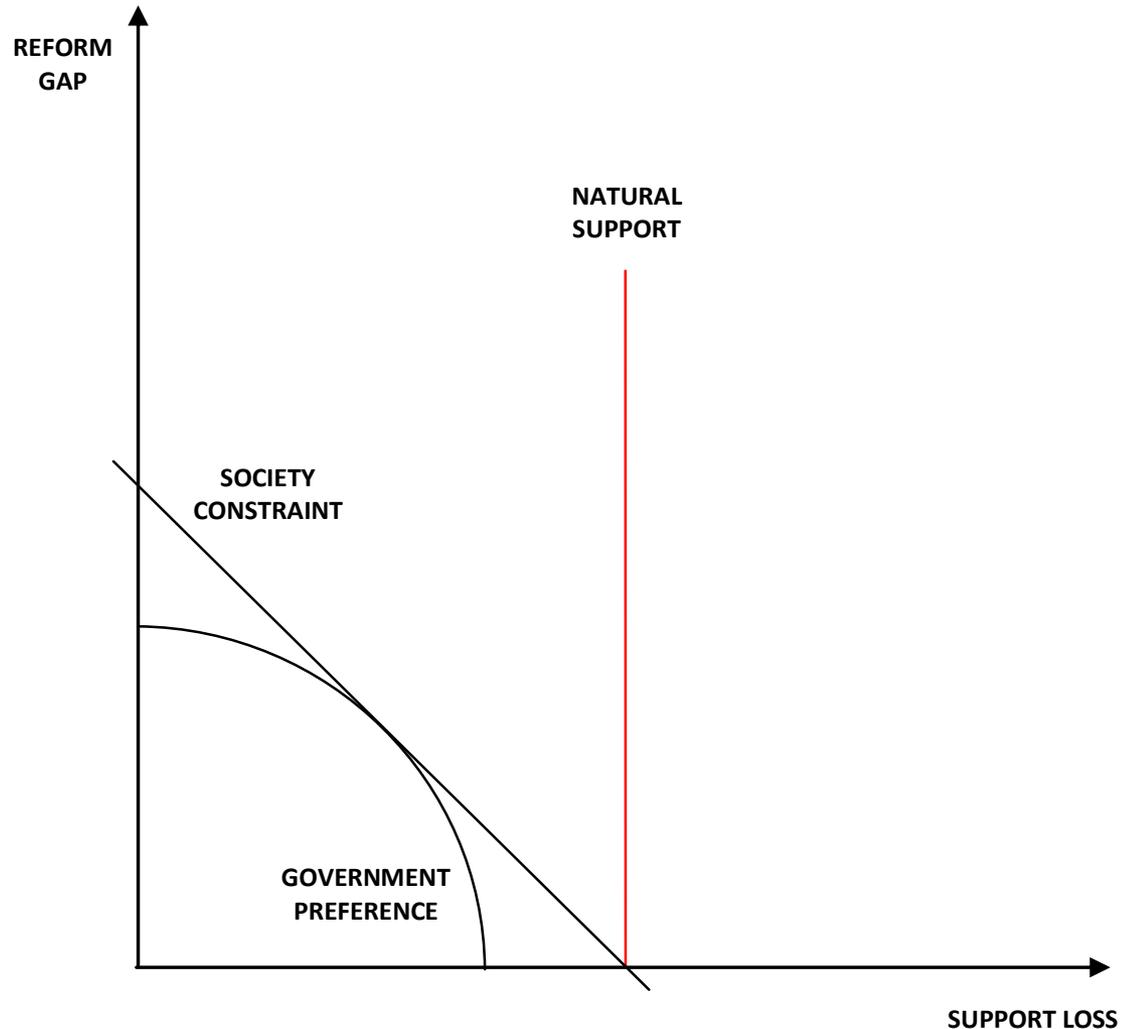
$$s_t = s^* - \alpha(r_t - r_t^e)$$

Rational expectations:

$$r_t = r_t^e; s_t = s_t^e$$

Natural support:

- EU skepticism
- Lack of credibility of EU integration process
- Corruption of Government



Public reaction (α)

Reform neutral:

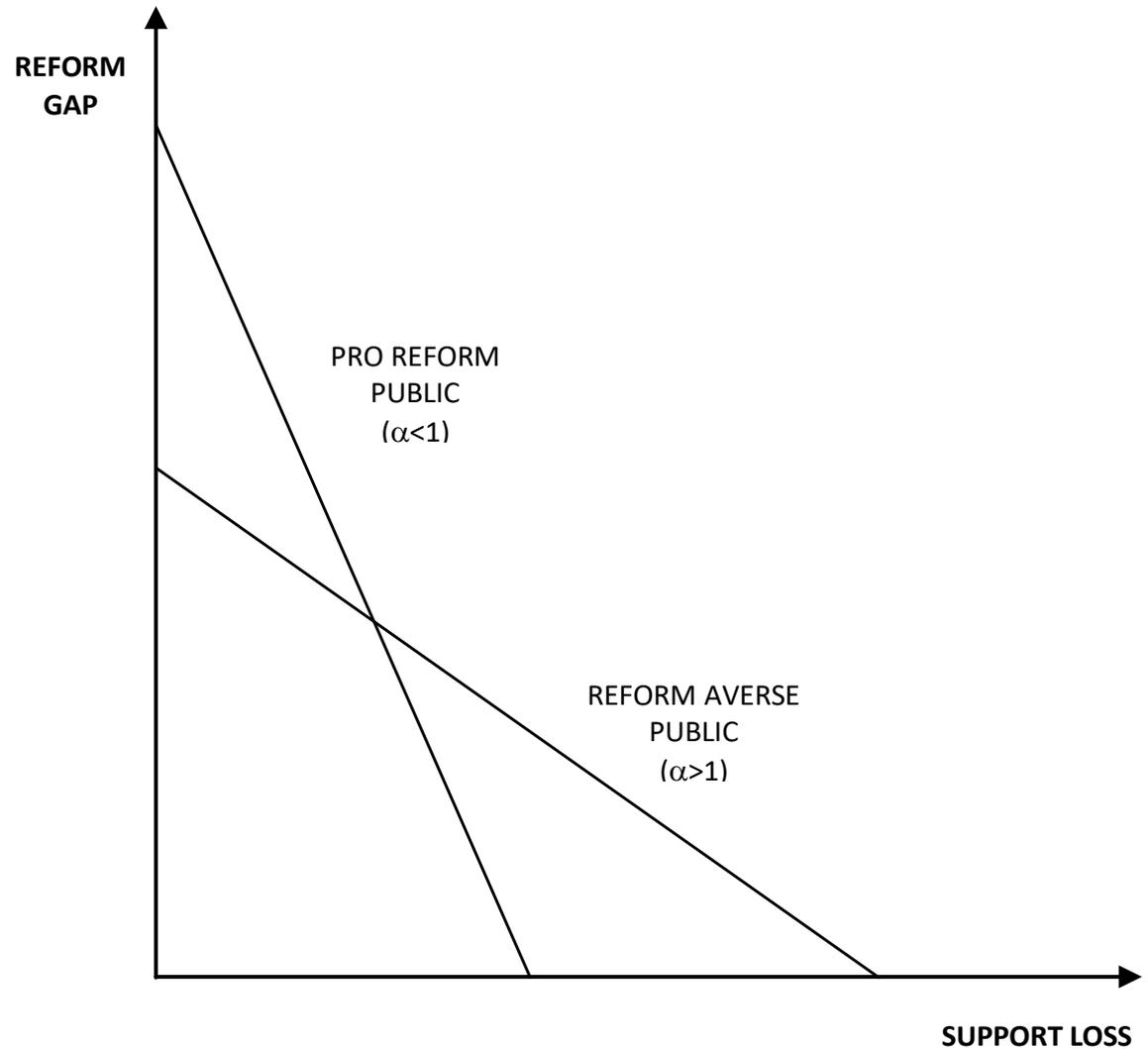
$$\alpha=1$$

Pro reform:

$$\alpha<1$$

Reform averse:

$$\alpha>1$$

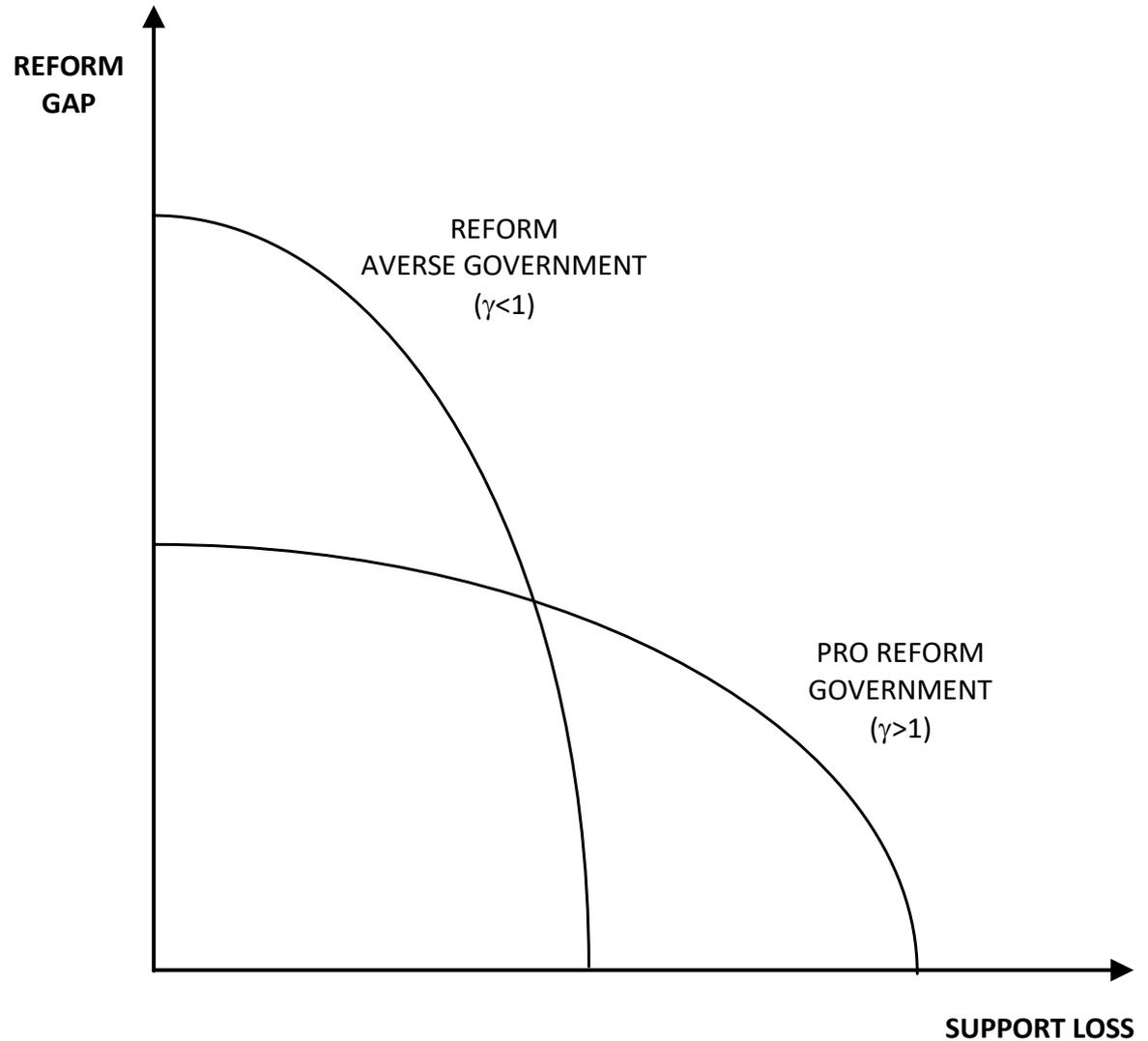


Government preferences (γ)

Reform neutral:
 $\gamma=1$

Pro reform:
 $\gamma>1$

Reform averse:
 $\gamma<1$



Credibility (k)

Natural credibility:

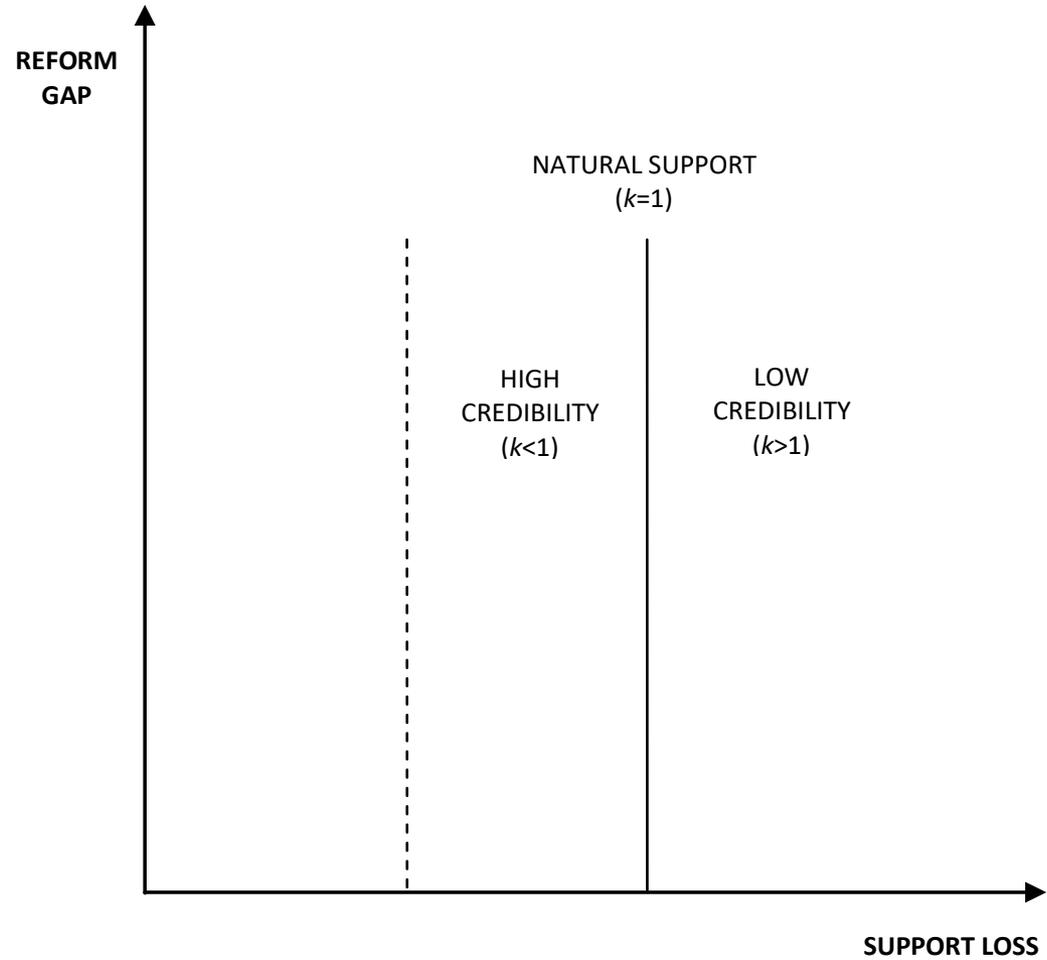
$$k=1$$

High credibility:

$$k < 1$$

Low credibility:

$$k > 1$$



Policy choice $E(s,r)$:

Commitment (Policy rule)

Ex-ante optimal policy:

$$E_{eu}(s_{eu}, r_{eu}) = (s^N, 0)$$

[optimal, but time-inconsistent]

No commitment (Discretionary policy)

Ex-post optimal policy:

$$E_{cc}(s_{cc}, r_{cc}) = (s^N, R_{cc})$$

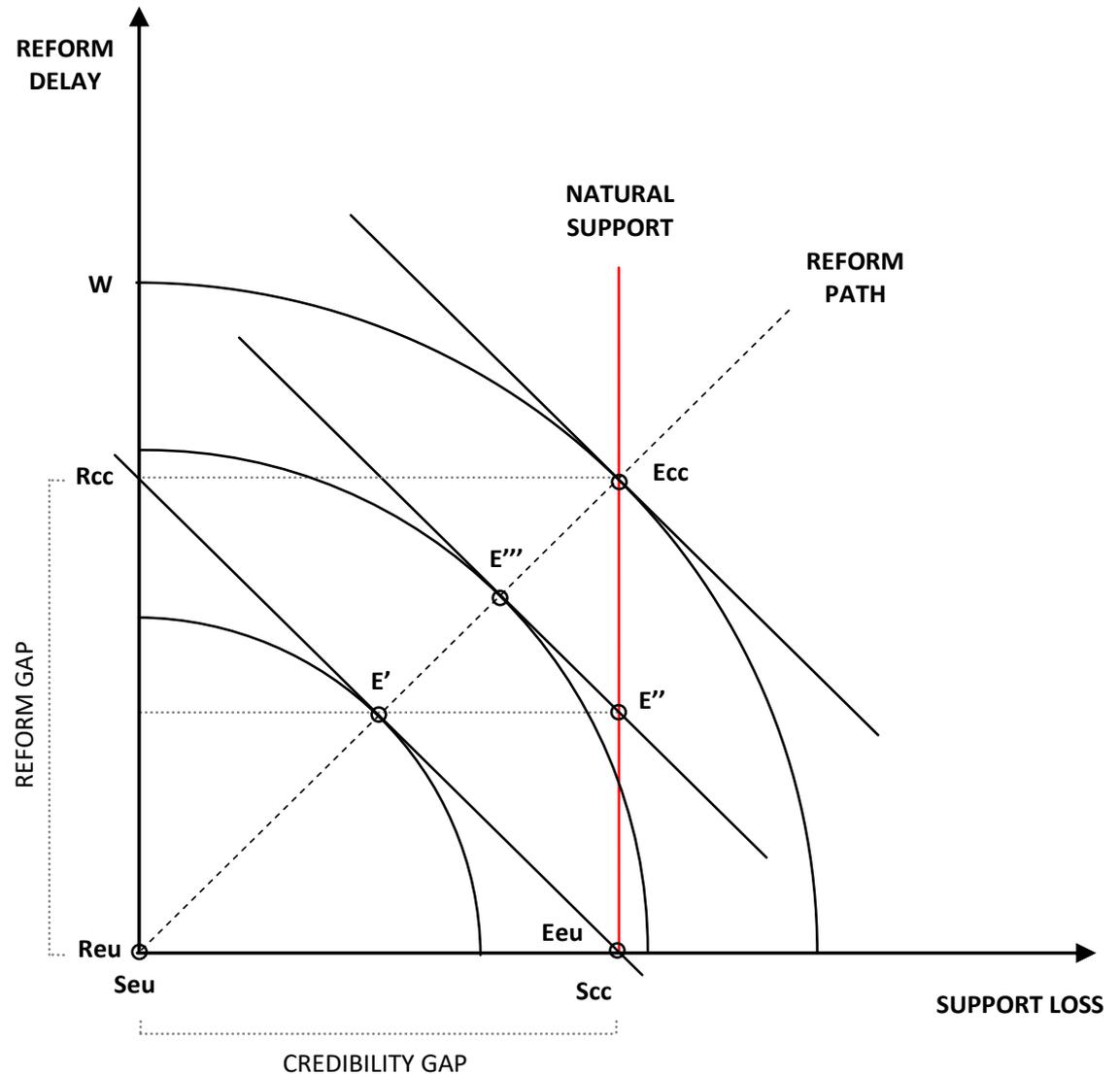
[time-consistent, but sub-optimal]

Subject to:

$$\alpha \frac{\partial W}{\partial s} = \frac{\partial W}{\partial r}$$

Equilibrium reform (gap) under lack of commitment:

$$r_t = \frac{\alpha(1-k)s^*}{\gamma}$$



Policy Implications and Recommendations

Policy implications

Reform gap (r) is higher when:

- the difference between the Government's support (loss) target and the natural support (loss) is larger (k lower, or s^N higher),
- the weight it assigns to reform gap is lower (γ lower), or
- the responsiveness of support loss to rent loss is greater (α higher).

Governments that care more about political support than reform, end up with higher reform gap [$R_{cc} > R_{eu}$] and without higher political support than do governments with a stronger preference for reform relative to political support. This outcome is due to the lack of commitment.

Under commitment, the ex-post temptation to reform gap is absent, and rational expectations dictate the same outcome for any preference parameters.

Policy recommendations

1. The political economy can help explain the reform gap, which implies that there should be considered the political implication of the reforms, namely the cost that policymakers face in implementing reforms. Ignoring this, the political economy effect, when setting the reform package (agreement) will lead to non-credible reform policy which will result with a reform gap.
2. In order to achieve a credible reform policy it is required to have consistent policy rule with commitment taking into consideration the rational expectations of the policymakers and economic agents (and public). This will increase the credibility of the reform process and that will reduce the reform gap.
3. The reform path in our model, or putting it differently as the pace of the reform process, will depend on the Government preferences (reform-averse or pro-reform), the public stance (reform-averse or pro-reform) and the level of natural support (credibility of the reform process, governance and corruption). Hence, accelerating reform process may require increasing Government's reform preferences, public stance pro-reforms or increasing the level of natural support (rule of law, good governance and fighting corruption).

Policy recommendations

4. Accordingly, in order to increase the credibility of the reform process and reducing reform gap, it may be considered:
 - Compensation of the country for the loss of the economic agents (interests groups) that are affected by the reforms;
 - Investments to increase the reform capacity of the countries and the region as a whole through a promotion of regional cooperation;
 - Promoting an inclusive and open process which will increase also the ownership and the reform preferences.

5. Finally, the increased transparency also will help improving the credibility of the reform process. This creates the opportunity for discussion, participation and better monitoring of the process.

Policy recommendations

6. The 'New Approach' is consistent with the above policy prescriptions:
 - may consider also political economy implications which assumes flexibility into setting-up conditionality, while being strict in implementation
 - transparent and cross-country competitive and comparative process
 - enhancing regional cooperation.
7. Financial support, investments and promoting new initiatives that enhancing reforms and regional cooperation as well as support for EU integration
 - Berlin process
 - Regional connectivity investment projects
8. Overall, EU optimism vs EU scepticism in the EU member states and the Western Balkans.

Conclusions

Conclusions

- Findings
 - The credible reform process should consider the political economy effect and the time-inconsistency of the policymakers
 - Ignoring the political economy effect implies sub-optimal reform policy
 - EU integration can play a role in enhancing credible structural reforms

- Limitations
 - The Model is considering only the case where there is a trade-off between reforms and political support
 - While the default assumption is that reforms have positive correlation with the political support

- Further work
 - Empirical investigation of the model may be helpful to evaluate the findings of the model
 - The model can be extended also for structural reforms within the EU member states

Thank You!