Industrial upgrading in Western Balkans and policy implications: pointers for discussion

Prof. Slavo Radosevic

Sarajevo Norway project

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Foreign led modernisation (FLM): pre-crisis growth model of the CEE/SEE

- EU integration as the driving force > institutional convergence to the EU
- Integration of product markets through trade in goods and services
- Capital mobility through large-scale foreign direct-investment flows,
- Labour mobility

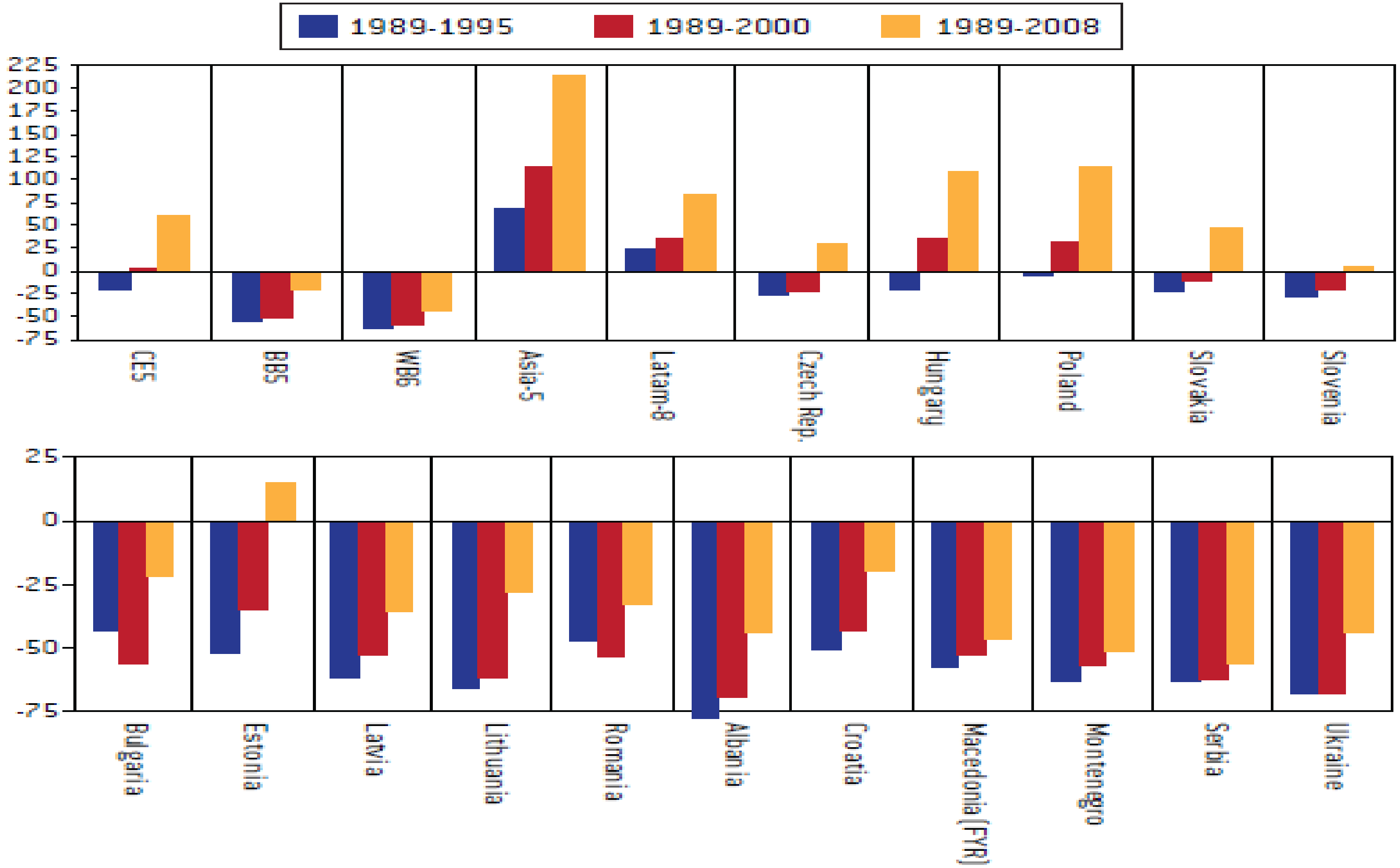
The outcome of the pre-crisis development model for the SEE/WB

- A very rapid and unsustainable real appreciation of ER during the 2000s that far outpaced the expansion of GDP per capita > a weak competitive position
- The extreme credit growth, and a sharp fall in real interest rates led to CA deficit > fast-rising external debt
- The trade balance deteriorated continuously in SEE before the crisis.
- SEE and Baltics: the composition of FDI biased in favour of banking, real estate and other domestic sectors.

- 'Deindustrialisation' and weak tradeables sector
- Outcome: spurt not catch-up (?)

A protracted ‘deindustrialisation’ of SEE

Figure 2.2: Industrial production, cumulative change



A consensus on FLM model at the time of its emergence ....

- Institutional anchoring (was a way of reducing trial and error in the process of building up economic institutions from scratch;
  - **Foreign Direct Involvement** (Bruszt and McDermott, 2008): the inclusion of a large diversity of external state and non-state actors in assisting and monitoring domestic institutional change
- Trade provided markets for growth and a framework for revealing comparative advantage;
- Capital flows from rich to poorer countries were a textbook response to the scarcity of modern equipment and infrastructure;
- FDI substituted the lack of management experience and helped address technological backwardness;
- Finally, labour mobility helped to limit the social cost of transition.
- Source: Becker et al, 2010, *Whither growth in CEE? Policy lessons for an integrated Europe*, Bruegel Series

GFC as a shock to this integration model (?)

- **Post-GFC wisdom**: ‘The benefits of EU integration for countries that are catching up are not and cannot be unqualified, but are conditional on the quality of national policies and the EU framework itself’ (Becker et al, 2010, *Whither growth in CEE? Policy lessons for an integrated Europe*, Bruegel)

- **... backed by the lessons from history**
- The growth of periphery is inextricably linked to its international economic integration (Berend and Ranki, 1982).
- ‘Essentially, it was the domestic forces (national system of political economy) which enabled the external influences to have spin off effects’ (Berend T. Ivan and Gyorg Ranki, 1982, *Industrialization and the European Periphery.1780-1914*. Cambridge, p. 135)
- Catch up with the EU core = f (the relative roles of exogenous and endogenous forces * the nature of their interaction)

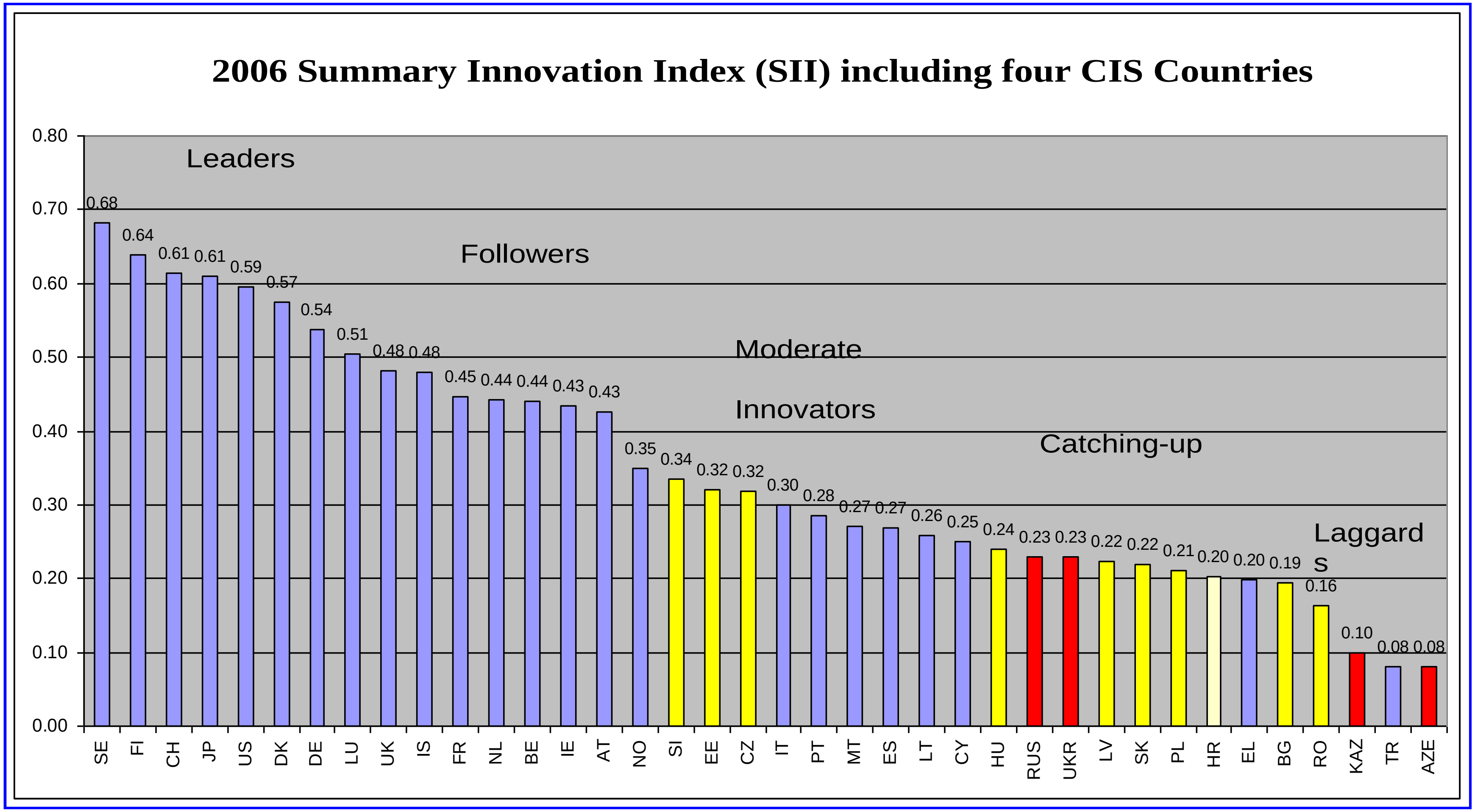
Is market integration sufficient for growth?

- **The division of labour is limited by the size of the market (Adam Smith 1776)**
- How do you understand the theorem?
- If the **size of the market** is the key: the extent of trade and competition, and lower prices for consumers are main policy goals > market integration
- If **division of labour** is the key: the creation of knowledge and technological diversity, and the producers with its capabilities are main policy goals > industry integration > important weakness of SEE/WB when compared to CE (?)

... followed by the new policy perspective: 2010 Bruegel 'Whither growth in CEE' study team

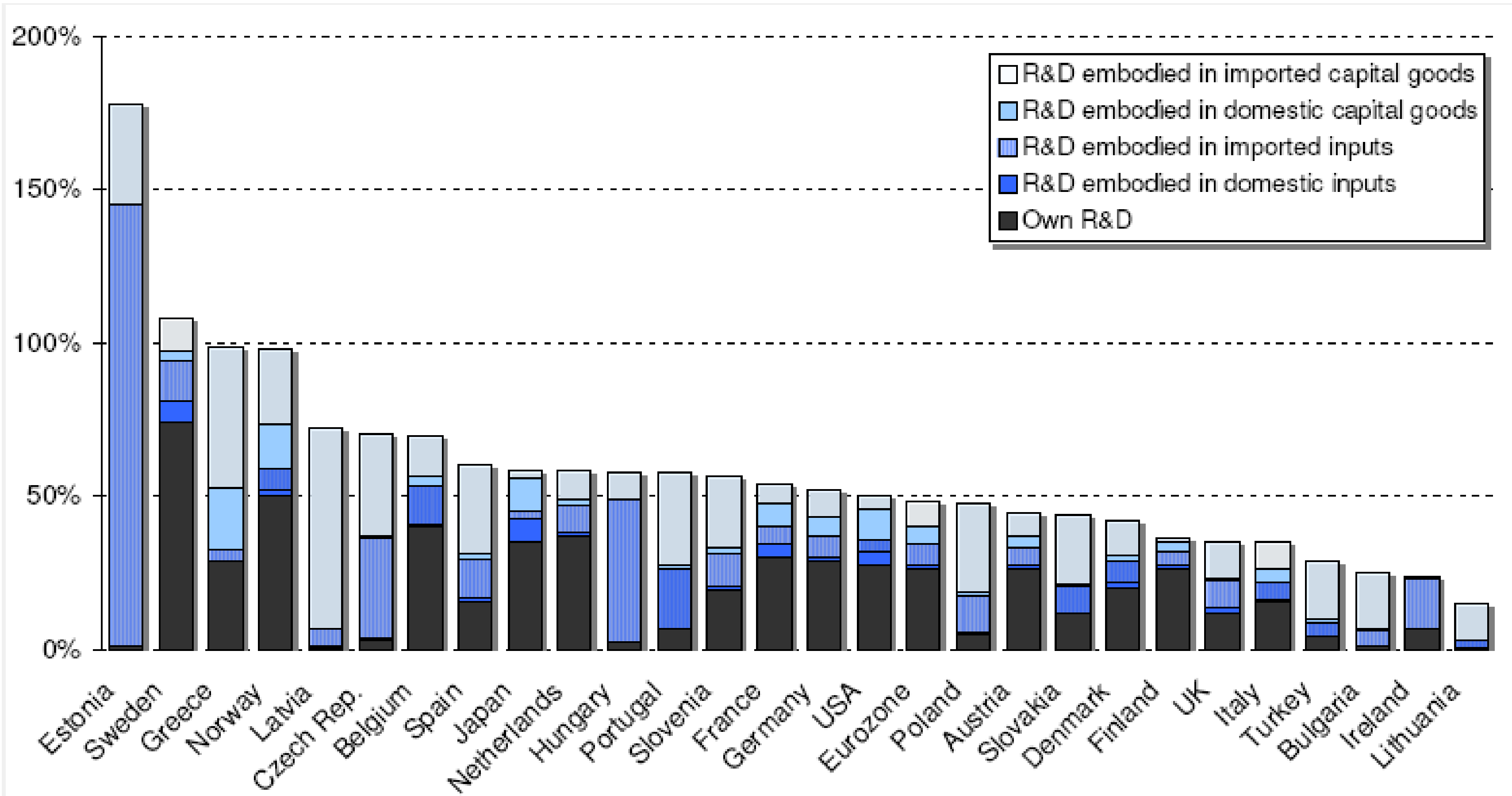
- **The (i)relevance of Lisbon strategy** as framework for growth for CEECs and for WB in particular? Barcelona 3% target as meaningless for the CEECs
- **Structural Funds were not made part of a comprehensive growth strategy**
- **Financial integration in CEE/SEE led to massive misallocation of capital**, and the macroeconomic costs of massive capital inflows and/or borrowing in foreign currencies, were seriously underestimated
- **Policy solutions:**
- **Supply side: Industrial upgrading as the core policy focus (our topic today)**
- SF and EIB financing should be integrated into national growth strategies (cf. Barca Report) based on conditionality
- Appropriate real exchange rates and much lesser priority to EMU entry

EU10- CEE: ‘moderate innovators’ and ‘catching up’ countries



An indirect R&D content dominates in the EU 10 CEE:

Percentage share of total R&D content in the manufacturing of ICT equipment



Source: Knell M. (2008), Embodied technology diffusion and intersectoral linkages in Europe. Europe Innova Sectoral Innovation Watch deliverable WP4. European Commission, Brussels.

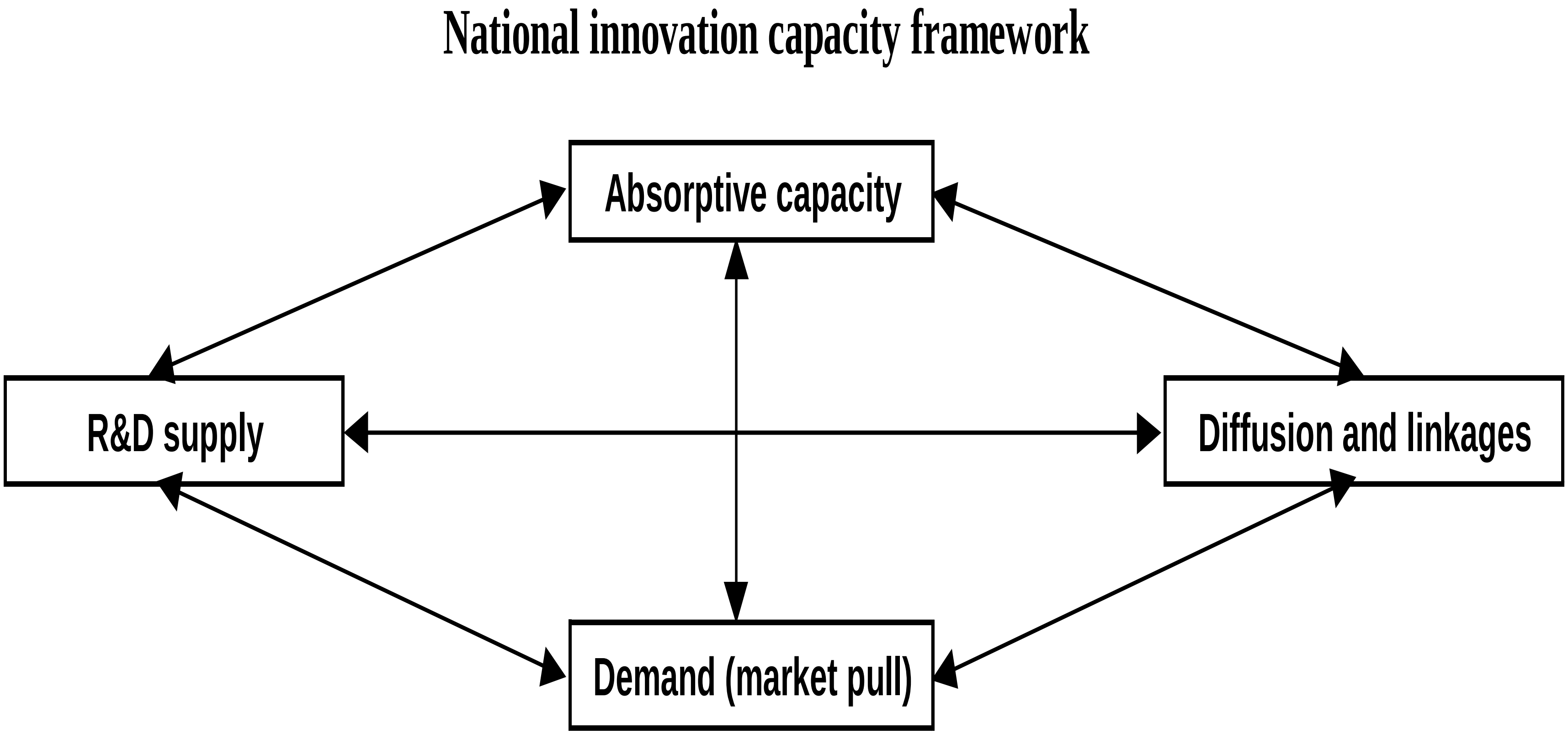
Direct and indirect R&D content: policy implications

- A majority of the NMS and all WeBa are technology users and have a high indirect technology intensity

Non-EIS pattern of technology upgrading:
-> low overall technology intensity -> high indirect technology intensity -> average direct and indirect technology intensity -> high direct technology intensity

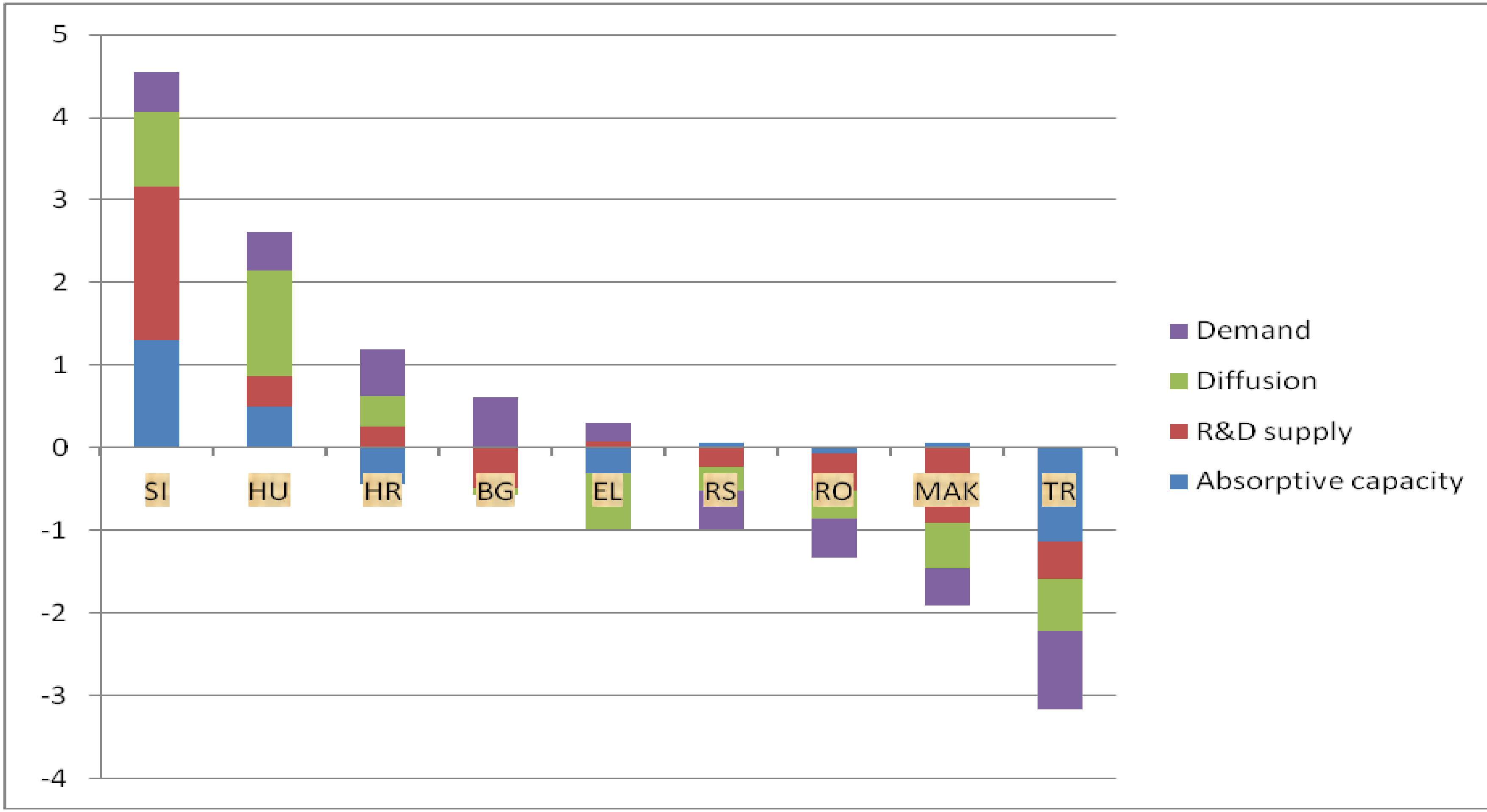
Policy implication: integrate FDI / technology transfer into innovation policy
(increase R&D but in interaction with imported and indirect domestic R&D (embodied in capital goods and inputs)

The concept of national innovation capacity



National innovation capacity of the SEE countries

(Kutlaca and Radosevic , Handbook of IB in SEE, 2011)

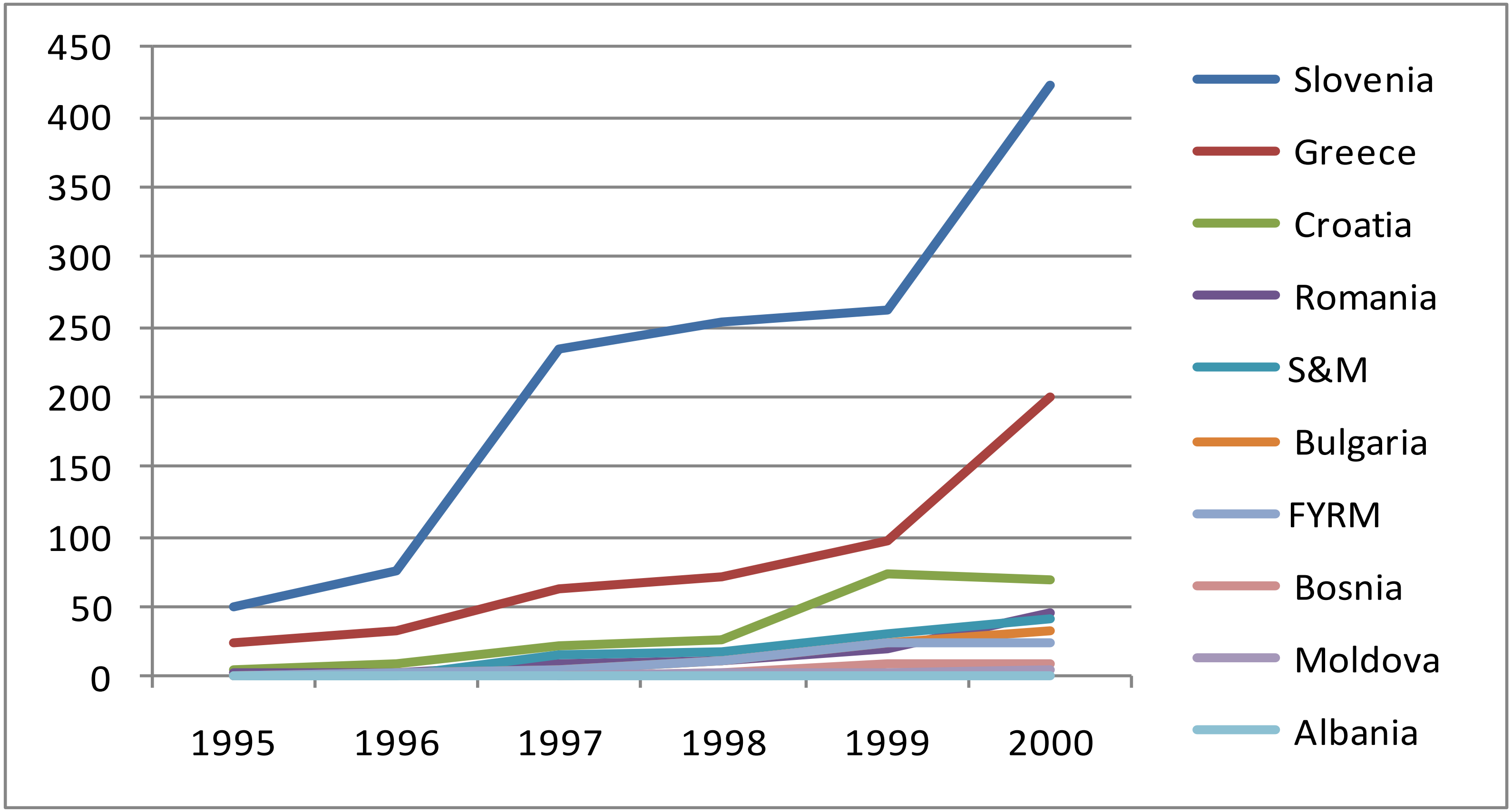


Industrial upgrading: how to move up along value chain?

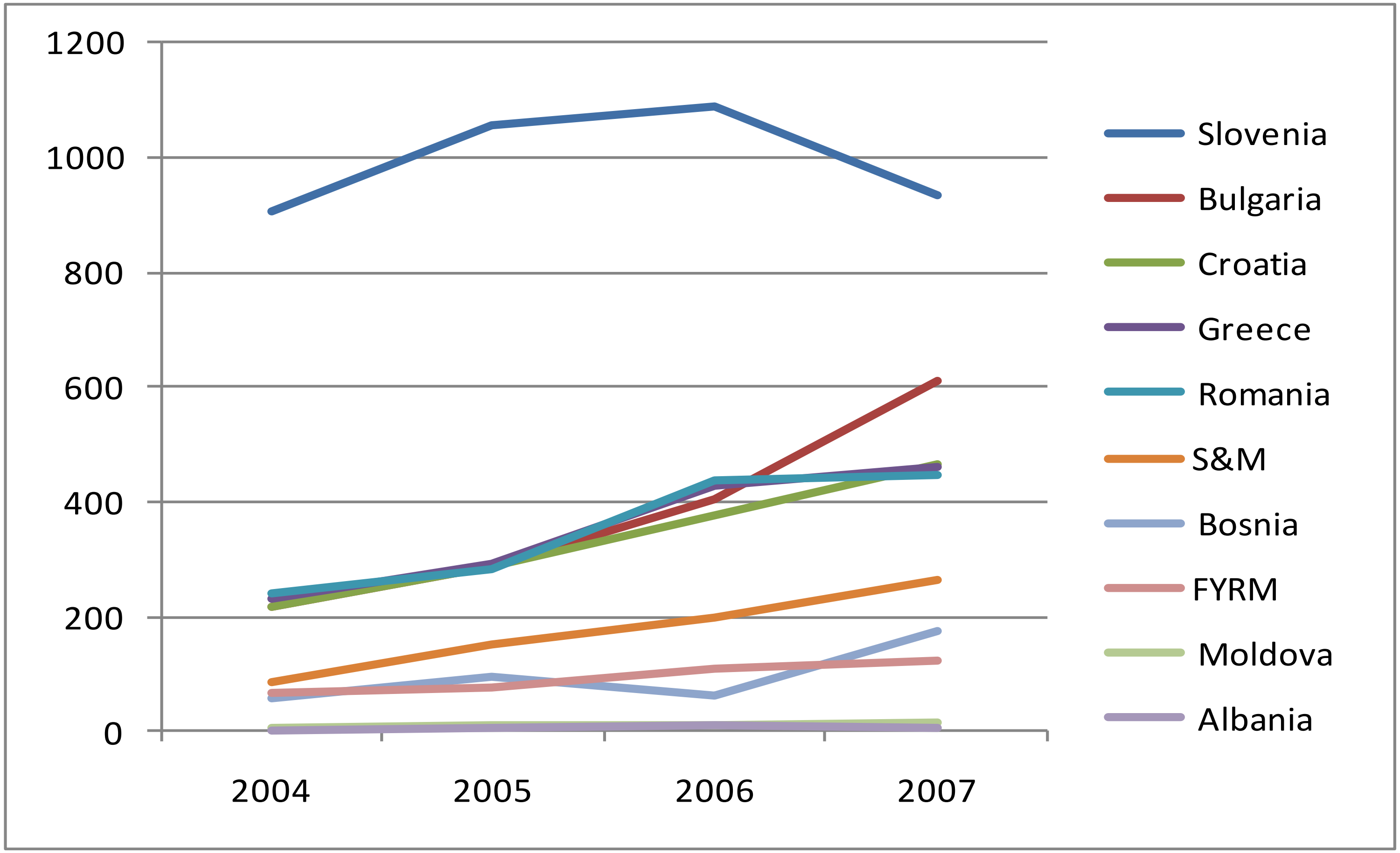
- Cost vs. quality vs. technology based competition
- Requirements for technology based competition
  - competition based on product/process innovation
  - sophisticated demand
  - user requirements
  - certificates and standards
  - marketing barriers (brand)
  - after sale services and warranty
  - IPRs
  - affordable access of NTBFs to technical infrastructure
  - available finance to upscale production
- For the time being, upgrading in WeBa is about production not innovation capability

A majority of technology effort > absorption of foreign technologies and mastery of production capability:

ISO 9000 certificates per capita, 1995-2000



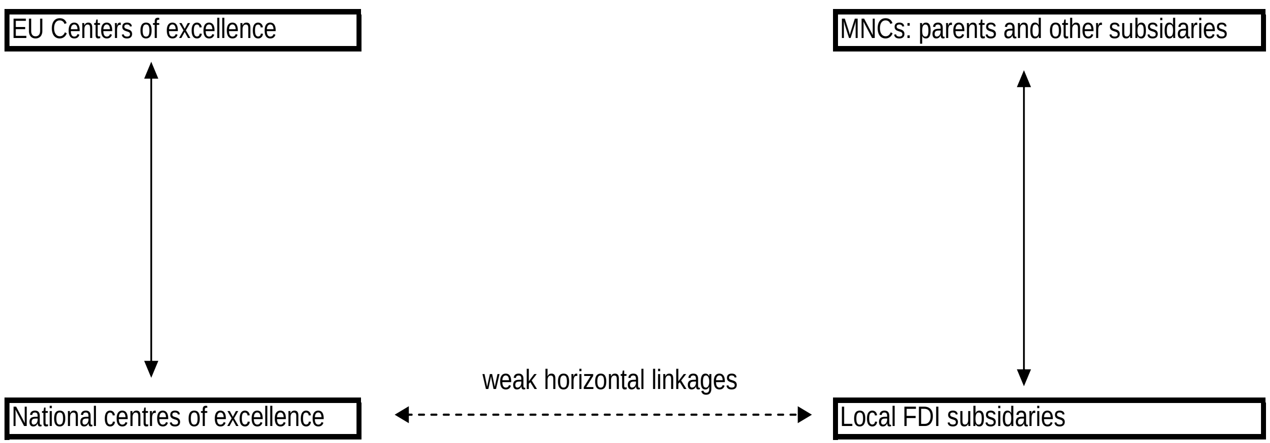
Production capability /capacity to produce at international levels of management efficiency/ is an area of increasing importance for the WB countries.



The sources of productivity improvements in CEE: *Global value chains and production capability improvements*

1. Productivity of FDI subsidiaries is significantly explained by ‘quality control’ (production capability) (Majcen, Radosevic and Rojec, 2009)
2. Production capability: upgrading quality in existing products seem to be a more automatic process. Countries converge in quality (measured by unit prices) with the international leaders at an annual rate of 5-6% unconditionally (Hausman, Hwang and Rodrik, 2007)
3. This ‘automatism ‘ in the case of CEECs is actually FDI assisted or subcontracting driven mastery of production capability
4. Some CEECs (Hungary, Croatia, Lithuania, Romania, Slovenia) have lesser scope for further quality improvements and must instead move to new products (EBRD, 2008)

The challenge for ‘periphery’: Missing levers to growth?



Weak vertical integration & horizontal fragmentation

Vertical and horizontal links do not work in WeBa ?

Policy focus:

- Support to the weakest agent: local business R&D
- Transfer function on supply side (R&D)
- Transfer function on demand side (FDI/local firms)

R&D: excellence vs. relevance

- Legacy in science: excellence in 6 areas around physics and chemistry > a slow or not shift towards life sciences
- Overall improvement has been made by introducing peer-review based funding mechanisms that are geared towards scientific excellence. However, the exclusive use of excellence criteria may actually ‘freeze’ science specialisation
- Funding systems are still inadequate in terms of ensuring industry and social relevance > a stronger involvement of users in evaluation and funding
- Stronger science vs. weaker innovation constituency

Germany's MNCs relocations to CEE: boost to productivity improvements and decreased unit labour costs in Germany

- Productivity gains from offshoring to CEE > Germany and Austria experienced only minor job losses
- German offshoring to CEE boosted not only the productivity of its subsidiaries in CEE by almost threefold compared to local firms, but it also increased the productivity of the parent companies in Germany by more than 20% (estimates by Hansen 2010 and Marin 2010).

SEE by type of production networks

Type of network relationship	Producer driven value chains (Largely equity relationships)		Buyer driven value chains (Largely subcontracting)	
2003	FDI stock in manufacturing per capita ($)	Networks' exports per capita (%)	Share of clothing export in manufactured export	Average annual growth rate of clothing export 1996-2003
Hungary	**1694**	**1847**	4.1	3.8
Slovenia	**824**	**1094**	3.5	-7.5
Croatia	694	69	15.5	-0.9
Bulgaria	428	22	**34**	**27**
Romania	262	59	**29.8**	18.5
Serbia & Montenegro	217	15	14.5	-4.4
FYROM	60	11	**44.9**	7.3
Albania			**41.1**	17.2
Turkey			**26.3**	7.3

Source: Based on World Bank (2005), From Disintegration to Reintegration: Eastern Europe and the Former Soviet Union in International Trade, Edited by Harry G. Broadman, 2005, The International Bank for Reconstruction and Development / The World Bank

SEE: largely outside of German MNCs value chains?

Table 1

Multinationals' imports from eastern European subsidiaries (% total imports)

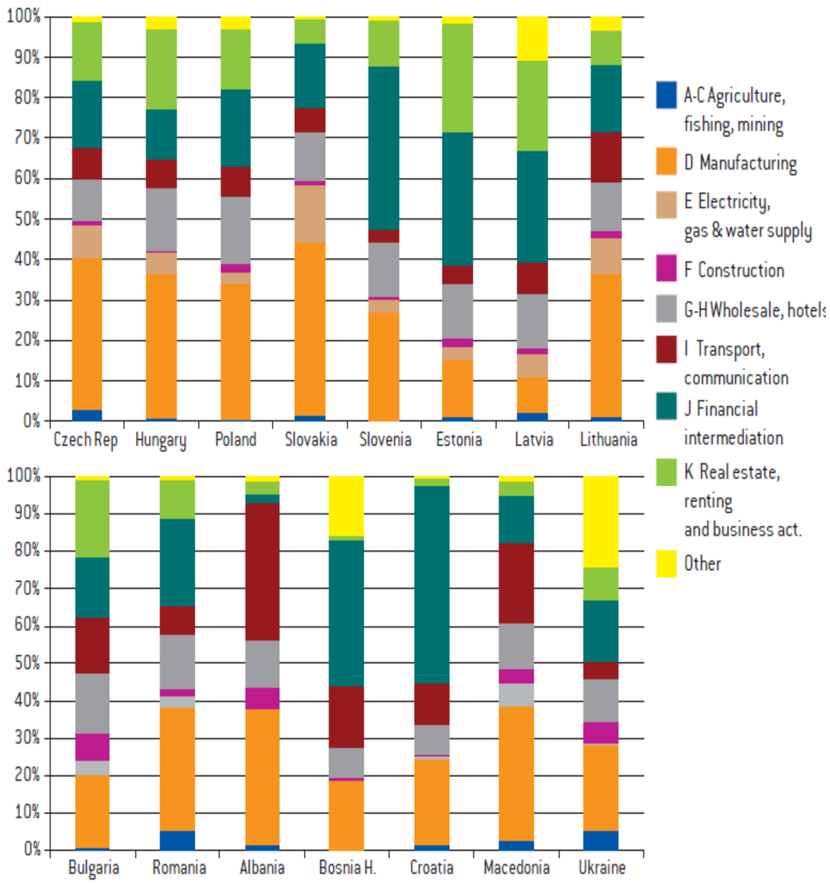
	Austria	Germany
Baltic States	0	14.41
Czech Republic	42.17	15.64
Hungary	100	40.46
Poland	64.91	15.34
Slovakia	54.71	64.98
Slovenia	48.36	9.38
Bulgaria	11.32	4.2
Romania	57.46	7.17
Croatia	40.4	1.95
Russia	26.7	1.67
Ukraine	21.52	2.44
Eastern Europe	68.52	21.56

Source: Author's calculations.

Source: Marin 2011

SEE: integrated into EU economy as markets but not as production location

Figure 2.5: FDI stock by activities, as of December 2007, shares in %



Source: wiiw FDI Database. Note. Data for Slovakia refers to 2006, data for Albania refers to 2004.

- SEE: FDI are focused on non-tradeables (market seeking)
- FDI in SEE contributed much less towards the build-up of a competitive and sufficiently sized tradable sector than it did in the CE5.

SEE post-2008: In search of new sources of growth

- From growth based on **externally financed consumption (consumer durables) and investments in real estate towards** growth driven by **investments and improvements in productivity**
- The **foreign led modernization** growth model based on deeper integration with the EU in terms of finance, trade, labour markets and institutions (‘foreign direct involvement’) seems **inevitable** given economic and political constraints …

WeBa 2010: how ‘to extend transition agenda’?

- Policy package of the last 15-20 years: focus on business environment (market automatism) + add well functioning state (EBRD TR 2009)
- Meagre results: slower X than of CE; large trade and CA deficits; appreciating ExRat; quality of life worse in 2009 than in 1989 (except Rom and Alb)
- Add dimension of industrial upgrading into analysis and policy coupled with FDI/industrial networks
- How to address demand shock? Further opening of regional (EU/SEE) market (cf. ‘jugosfera’ as the remaining lifeblood of local businesses). EBRD/EIB and regional projects?

Current factors of SEE competitive advantage …

- **Proximity:**

12-14 hours from WE; apparel- 22% cheaper than Chinese; 'nearshoring' (language capability and cultural understanding)

- **Costs of labour**

15-50% of Hungarian wages; except HR

… can they reignite growth ????

SEE: rethinking conventional views on growth and industrial upgrading in the region

- Good institutions are not enough for growth (ex. eastern Germany ……. Belarus)
- New thinking: **follow your (current or potential) comparative advantage** in industrial development + tap into **latecomer advantages** in industrial upgrading (Li Jufin)
- SEE: Goose without ‘**the flying geese’ or searching for ‘leading dragon’** (Germany or Slovenia) > theory of tandem growth

SEE post-2008: Three policy scenarios and how to achieve it?

- **Continue and speed up structural reforms**
- **Back to ‘big push’ thinking**
- **New strategic policies for growth: triple L (linkage, leverage, learning)**

‘Speed up structural reforms’ dilemmas

- What is mechanism by which structural reforms affect growth? via openness? FDI? ... a ‘shot in dark’
- A long ‘laundry list’ of reforms
- A danger of reform fatigue in conditions of stagnant economies hence ....
- So, which areas of structural reforms should be priority ?

The good governance reform agenda

- Market-enhancing governance reforms
  - *Protect and Maintain Stable Property Rights*
  - *Enforce a Rule of Law and Effective Contract Enforcement*
  - *Minimize Rent Seeking and Corruption*
  - *Achieve a Transparent and Accountable Provision of Public Goods in line with Democratically Expressed Preferences*

- Source: Is 'Good Governance' an Appropriate Model for Governance Reforms? The Relevance of East Asia for Developing Muslim Countries, Mushtaq H. Khan

Growth-enhancing governance capabilities

Goals are to achieve institutional-governance capabilities to:

● Organize and enable **transfers of land and resources to productive sectors** in a context where land and asset markets are generally inefficient

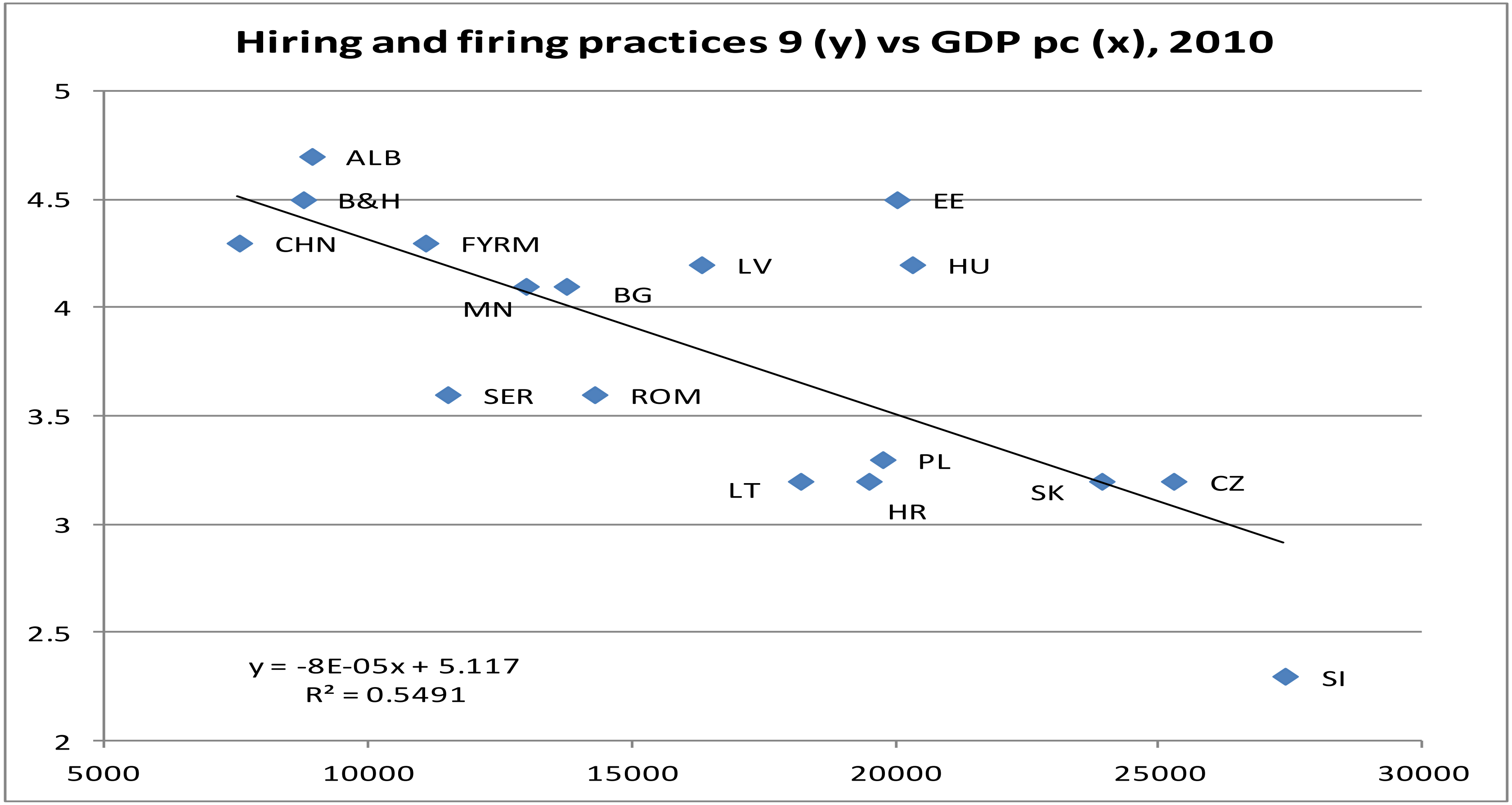
● Address labour market failures that result in inadequate **training and investment in human capital**

● Address failures in capital markets that result in inadequate **savings and investment**, and inadequate investment in learning and adopting new technologies

● Maintain political stability and acceptable **redistributive justice** in a context of rapid social transformation

- Source: Is ‘Good Governance’ an Appropriate Model for Governance Reforms? The Relevance of East Asia for Developing Muslim Countries, Mushtaq H. Khan

Labour market flexibility does not seem to be region-wide problem?



Structural reforms: move from generic to sector specific reforms

- Generic barriers vs. Sector specific barriers
  - Sector level market distortions: by creating a non-level playing field, they allow low productivity companies in Russia to be more profitable (on a cash flow basis) than their high productivity competitors (McKinsey Russia)
- Market distortions are sector specific and take many different forms.
- 'Governments and international financial institutions should rely much more **on in-depth industry level analysis to uncover product market competition issues and set reform priorities**' (Palmade, McKinsey)

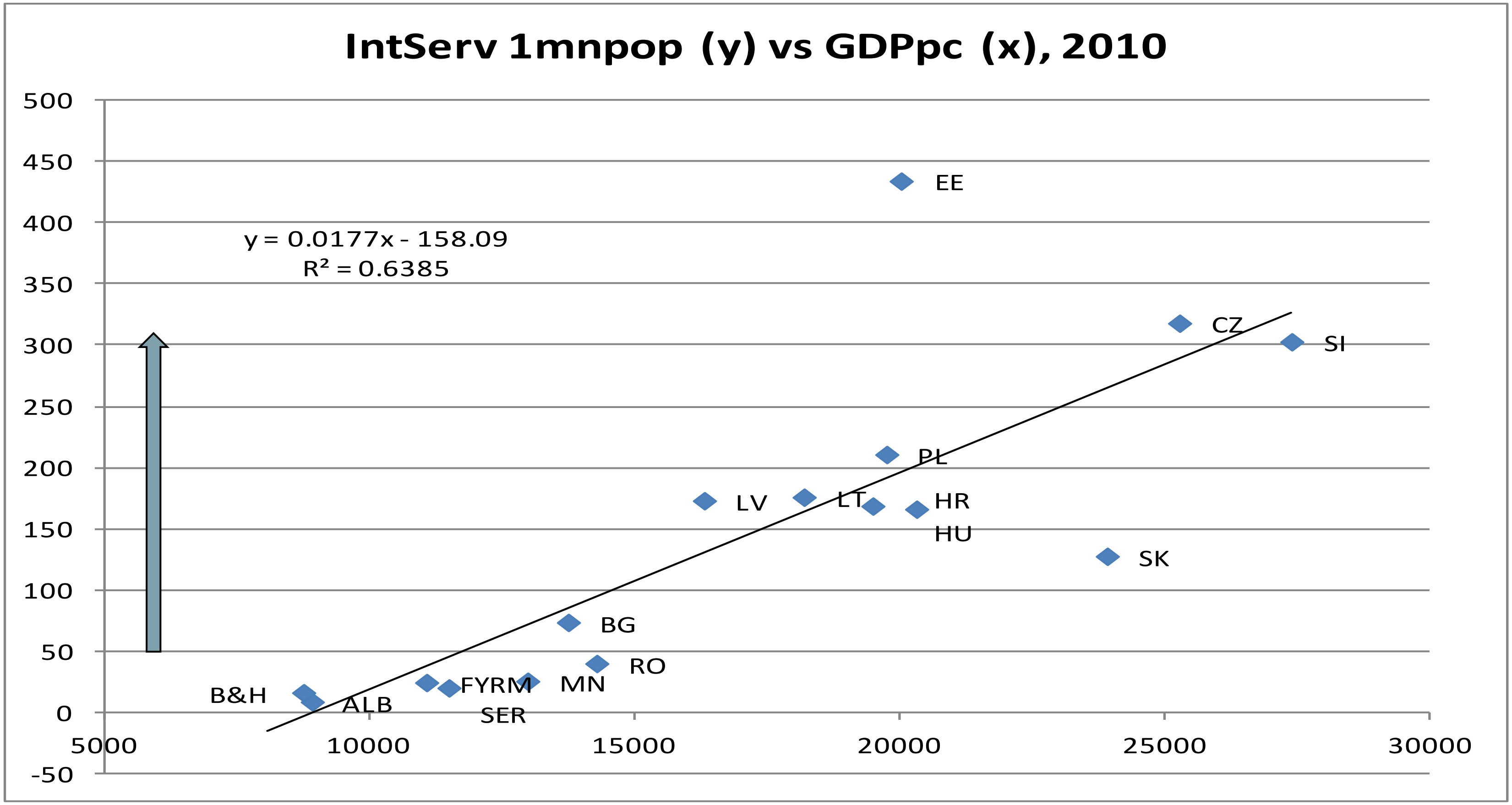
‘Big push’: SEE version of ‘green growth’ idea

- The strong positive impact of public investments in e.g. infrastructure and education boosting overall productivity and hence also economic growth.
- A need for active fiscal policy based on the idea of ‘big push’ (Rosenstein Rodan; Murphy, Shleifer and Vishny)
- New Deal for the Balkans: Euro-Balkan bonds covered by the EU Guarantee Fund for the Western Balkans to finance cross-border infrastructural projects/energy, railways and roads (Fikret Causevic)

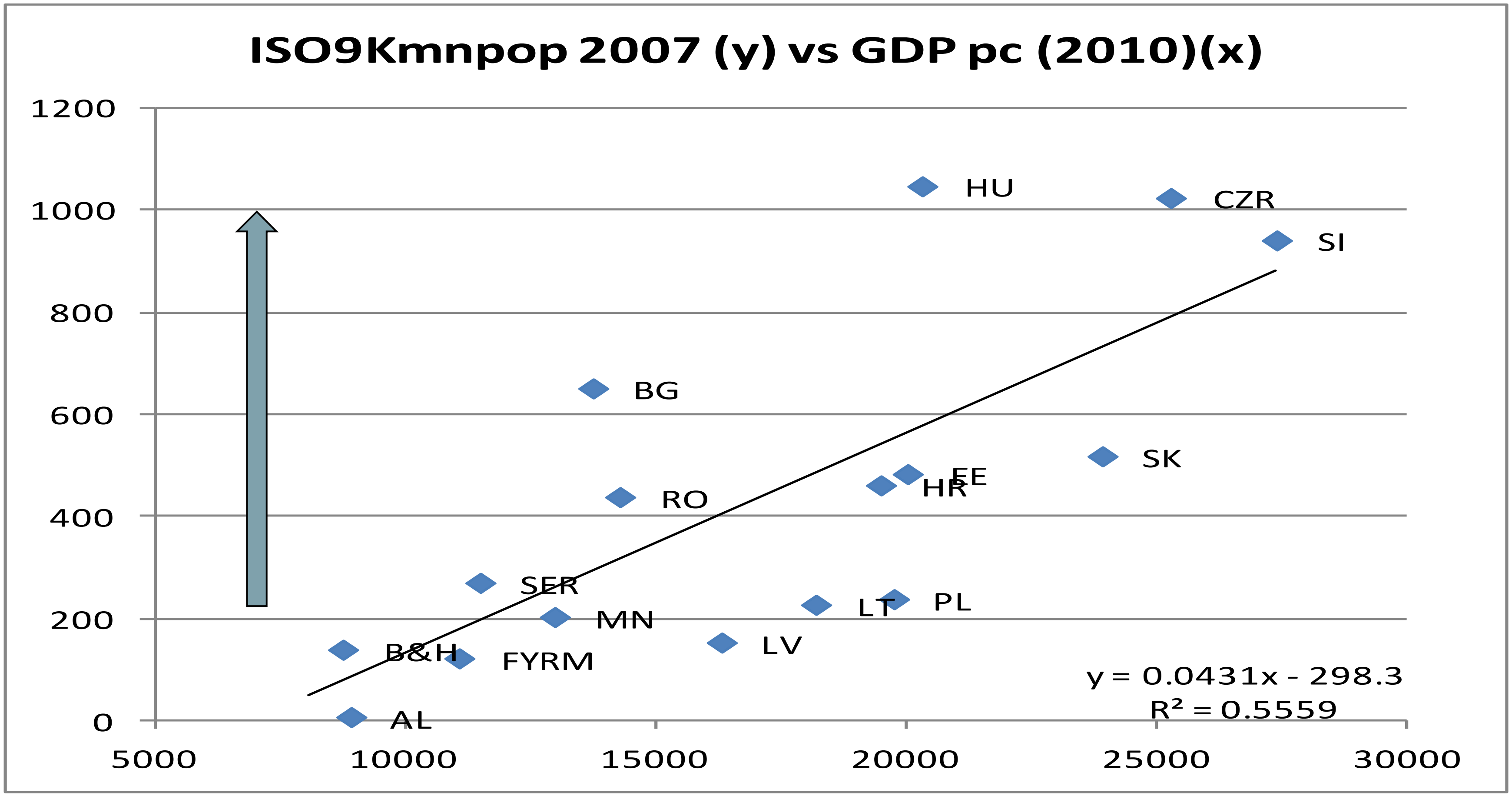
Challenges of the ‘Big push’

- A key challenge is not only mechanism – is there political will in EU? and in Balkans? ...
  - Could EU be motor of modernization .... when Structural Funds are in need of reform?
- ... but how to coordinate demand between using sectors (complementarities effect) in inter-regional context > how to ensure market size effects? How to avoid ‘white elephants’?
- Cross-regional focus is essential
  - Roads, railways .... but maybe more ICT infrastructure of regional character

An opportunity gap in infrastructure: a shift from 50 to 300 Internet secure servers per 1mn pop



Production capability opportunity gap: how to increase ISO9000 from 200 to 1000 per mn pop



Upgrading paths are industry specific …

- **Apparel**: from only CTM (42%) services to gradual introduction of VA services (OEM/OBM) + beyond imitation (design schools)
- **Automotive suppliers**: to move out of subcontracting ‘cost trap’ towards improved quality standards, design and supply chain management skills
- **BPIT Outsourcing**: from fragmented, diversified and local market oriented firms towards focus on core competencies (specialization) and creation of BPITO champions

… and so should policies which should go beyond the EU shelf of policy toolbox

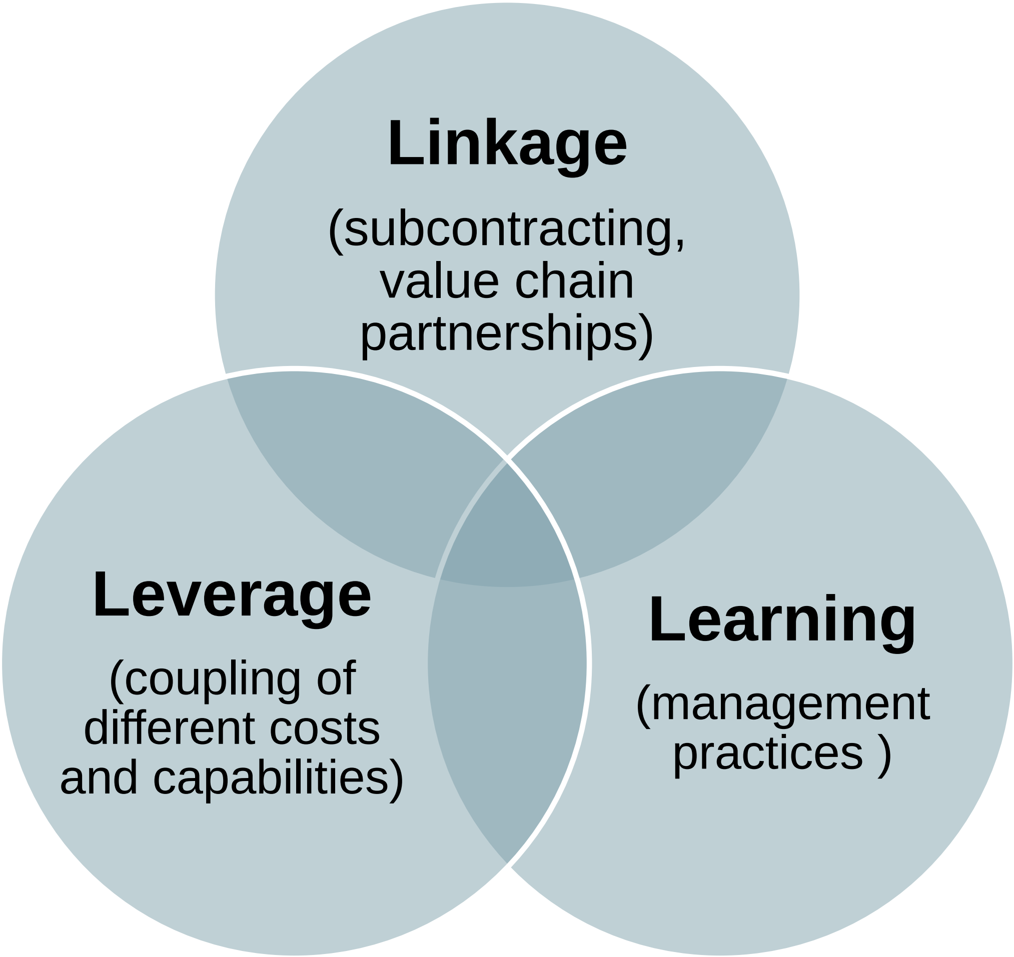
- A gap between traditional S&T policy and requirements for industry upgrading
- EU FP7 without other supportive activities may de facto increase the existing structural gap (cf. Greek case)
- Think how your policy can enhance LLL – related activities

In nutshell, enhance foreign led modernisation in SEE by ..

- **Integrating SEE into German industrial system !**
- **Enhance linkages with CEE industry networks ! > leveraging pan-European networks > multi-tiering > 'tandem growth'**

  (cf. Automotive components : SEE - only 4% customers in CEE)

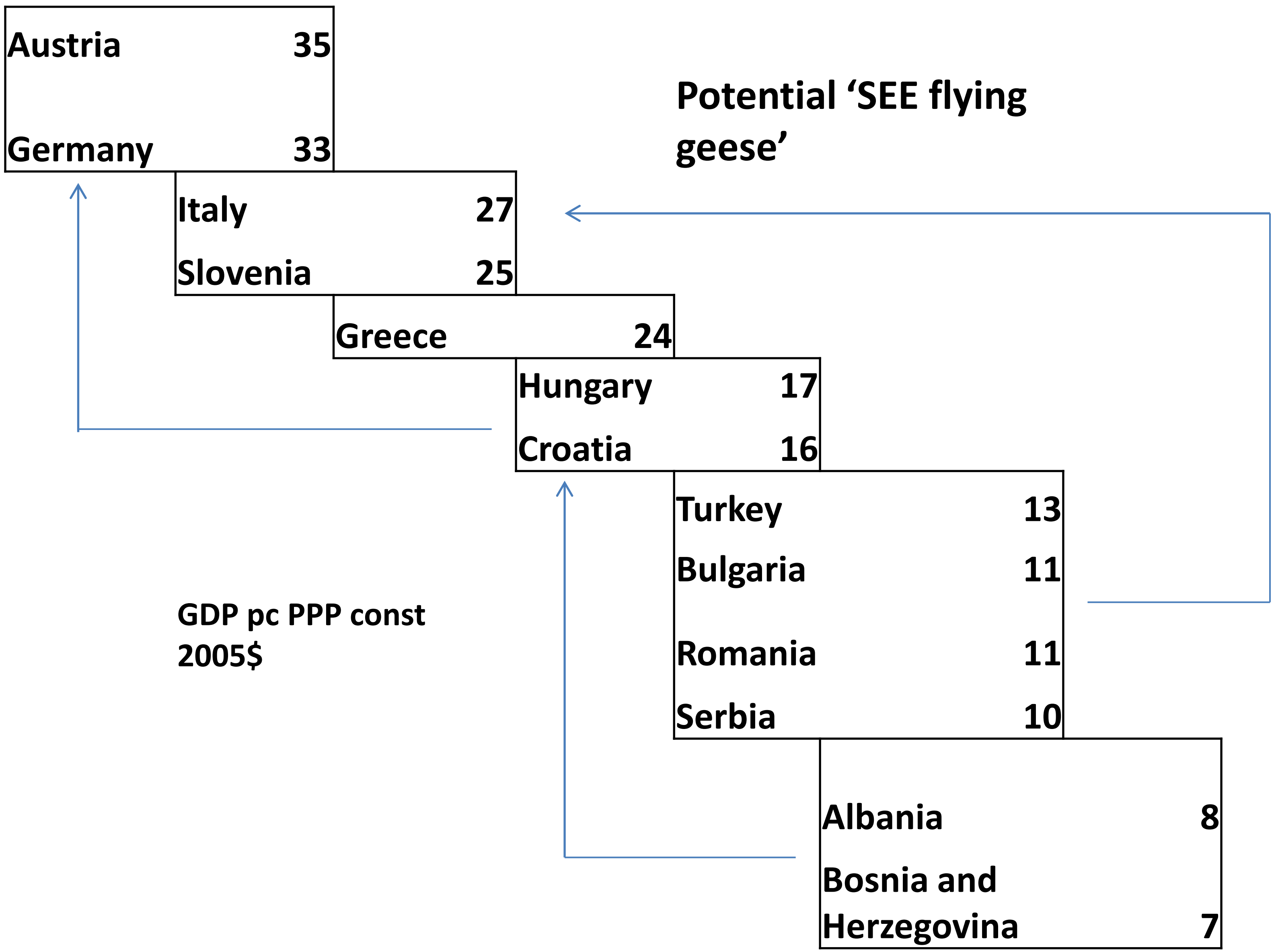
Building ‘organisational capital’ through linkages, leverages and learning (Mathews, 2002, 2006)



LLL weaknesses in SEE automotive components

- **Learning** management practices (ISO9001 75% /TS16949 standards 12% – quality at source; ERP): Skills gaps in design and engineering)
- **Linkages** (B2B/16% on line procurement, links with FDI; skills gaps in supply chain management; sectoral linkage programmes)
- **Leverage** (partnerships with 2nd tier suppliers; collaborative innovation FDI/SME/RDI)

Potential 'SEE flying geese'



Potential agents of modernization

- SEE tycoons
- Small and medium privatised companies/ clusters
- State led export development
- Transnational companies
- Chambers of Commerce
- Business Associations
- ????

Looking into the future?

- Europeanization of the production in the Balkans is proceeding only according to business as usual …….
- ….. driven by the general demand of its trade partners
- The ultimate constraints are **political**
- In search of potential modernisers which can create Growth-enhancing governance capabilities

Issues for discussion

- WB countries are operating far behind technology frontier? How is this fact taken into account in local industrial and innovation policy? Or, we see large scale ‘surrogate modernization’ (JK Galbraith)
- Who are potential modernisers in specific areas? Enterprises? Organisations? Any successful examples?
- What is the level of understanding sector specific competitivness issues at national level?
- What is the potential of regional cooperation initiatives in terms of willingness to participate at different levels? Why business sector does not contribute more to self-organisation at regional level? Potential of IO to enhance self-organisationn at regional level?
- Potential or regional foresight as a tool of collective action? Anyalternative mechanisms? Twinning inititatives and their potential?
- How to expand innovation policz beyond narrwo focus on high tech based growth (sector)? Limits of generic IP tools vs potential of sector (technology) specific regional platforms?