

**BALKAN RECONSTRUCTION
AND
EUROPEAN INTEGRATION**

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Preface

This paper is the product of a collaborative effort by the Hellenic Observatory of the LSE, the Centre for the Study of Global Governance (LSE) and the Vienna Institute for International Economic Studies (WIIW). It draws on ideas and discussions generated at a brainstorming meeting held in Vouliagmeni (Greece) on 8-10 July 1999. We are grateful to all those who participated, and also to those who commented on earlier drafts. (See Annexe for list of participants).

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We are, of course, entirely responsible for the analysis and value judgements expressed in this paper which cannot do justice to the wide diversity of views held by the large number of people associated with our project.

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Executive Summary

The process of ever deepening and widening integration in Europe, in which the EU has functioned as the main vehicle as well as a catalyst, contrasts sharply with the disintegration experienced in the Balkans during the 1990s. Balkanisation needs to be halted; and for this to happen, the international community, and the EU in particular, will have to assume greater responsibilities in direct co-operation with the peoples of the region.

The Stability Pact can provide the appropriate framework for the adoption and implementation of concrete measures aiming at stability, democracy and economic prosperity in the Balkans. This is the next stage which should be completed sooner rather than later.

This paper argues that reconstruction in the Balkans needs to be understood not just as physical and economic reconstruction but also as social and institutional reconstruction. It therefore combines an examination of security, political and economic issues, leading to the appropriate policy measures. The region is treated as a whole, although relatively more emphasis is placed on the Western Balkans which have been directly affected by the long and bloody process of dissolution of former Yugoslavia.

The Present Situation...

The aftermath of the war in Kosovo, has resulted in considerable political uncertainty in the whole area of the Western Balkans. This is further exacerbated by economic and social conditions which generate a vested interest in violence. The negative consequences of the war and the continuing political uncertainty tend to spill over in the wider region of the Balkans.

There are two major security problems in the Western Balkans today:

- no clear borders
- weak application of the rule of law

These are both closely related to the undemocratic character of regimes in the region. Formal democracy, through paper constitutions and relatively free elections, is not at all incompatible with what we refer to as 'soft totalitarianism'. The Milosevic regime in Serbia is a prominent example, although by no means the only one in the region. Democratic forces do exist; but they have been greatly weakened and marginalised in conditions of war.

On the economic front, there are important similarities among all the post-communist countries in the Balkans, despite the considerable diversity which is manifested, first and foremost, in levels of GDP. All transition countries in the Balkans are characterised by:

- unsustainable external deficits
- dangerously high levels of unemployment
- large and often unsustainable fiscal deficits
- low and spasmodic growth
- rapid de-industrialisation
- low credibility of the banking sector and the financial system in general
- slow and/or inefficient (indeed corrupt, in many cases) privatisation
- weak economic institutions and rules.

The economic performance of all transition economies in the Balkans has been worse than in Central Europe and the Baltic countries. The war in former Yugoslavia has undoubtedly had an important negative effect; but it has surely not been the only factor. The lack of political consensus and weak institutions have played a major role. The experience of post-communist transition in the Balkans suggests, among other things, that corporate governance can hardly function without proper functioning of public governance. The restructuring of state capacity should therefore be a central element in any reconstruction programme in the Balkans. A small state should not be confused with a weak state.

The experience of Bosnia-Herzegovina can provide some useful lessons in terms of the reconstruction effort likely to be undertaken by the international community, and the EU in particular, for the region as a whole in the context of the Stability Pact:

- The process of creating an economically and politically viable entity has proven to be long and painful. Even more so when the constitutional arrangements, most notably the multiple layers of government provided for by the Dayton agreement, tend to act as an impediment to reconstruction and development.
- Without the necessary conditions for private investment, both domestic and foreign, large inflows of foreign assistance lead to an aid dependent economy. This is clearly not sustainable. Availability of cheap credit and an active restructuring of existing enterprises are among the conditions necessary.
- The persistence of very high unemployment undermines political and social stability.

...And What Needs to Be Done

Reconstruction in the Balkans needs to be perceived principally as a conflict prevention strategy, which should focus on restoring the rule of law as well as strengthening the process of democratisation. The latter depends in turn on security, both physical and material: an atmosphere of fear and insecurity sustains extremist rulers and generates conflict.

For some time at least, security in the region will require the active involvement of the international community which should be expected to undertake both internal and external security tasks in Kosovo and Bosnia-Herzegovina, as well as elsewhere, if and when the need arises. This might well be in the form of an international civil presence or an OSCE security presence.

Temporary political arrangements, notably through the creation of 'hard' or 'soft' protectorates, are costly, especially in terms of reconstruction and sustainable economic development. Issues of status and borders in the Balkans need to be settled sooner rather than later; but they cannot be imposed from outside. Any number of solutions is indeed possible. What is absolutely crucial, however, is that a permanent political solution is both legal and legitimate: acceptable to the parties involved, the neighbouring countries and the international community. Unfortunately, the necessary conditions are not yet there; and they must be created gradually.

Reconstruction and regional co-operation in the Balkans requires the inclusion and active participation of Serbia. This means that a change of regime in Belgrade, combined with a deeper process of democratisation of Serbia, would have wider positive consequences for the region as a whole.

Through the use of selective sanctions and humanitarian assistance, the international community can do much to help in this direction. In order to do so, it needs to:

- distinguish between the regime and Serbian society
- provide help directly to democratic forces and representatives of civil society
- adopt a wide definition of humanitarian assistance which, while sidelining the central government, should help to minimise human suffering, especially during the difficult winter months.

The creation of a democratic and safe society - safe for everybody including, of course, the Serb minority - should be the aim for Kosovo. The UN has a very difficult task ahead of it. It should focus on the provision of security, minority rights, the organisation of elections, and support for civil society.

The process of democratisation in the Balkans will require the strengthening of civil society, which is generally underdeveloped in the countries of the region. This will be one way of countering the pervasive

tendencies of authoritarianism, extreme nationalism and criminalisation, which have become dominant elements in recent years.

Priorities for assistance to civil society throughout the region as a whole should include:

- investment in education, extensive reform of curriculums and the integration of higher education institutions in European networks of co-operation
- the development of independent mass media
- devolution of power and the strengthening of government at the local level
- the creation of appropriate regional forums for co-operation among entrepreneurs and trade unionists
- assistance to NGOs
- support for religious institutions in their advocacy of tolerance and their opposition to extreme forms of nationalism.

Economic recovery in the post-communist Balkans and the progressive integration of all the countries of the region into the European system present major challenges. There are no easy or simple solutions. Policy makers need to tackle, among other things, the dramatic decline, or even disappearance, of productive capacity; the small size of markets, whether national or even regional; and the high level of investment risks. The formulation of economic policy in the countries concerned will need to take some important factors into consideration.

Monetary policy should aim, first and foremost, at a low nominal and real interest rate, which should be convergent over a reasonable period of time, to that of the EU. Experience with currency boards is very mixed. A serious deflationary risk is involved. If central banks were to tie their hands, euroisation would then be preferable, especially if accompanied by domestic financial reforms and external financial aid.

Exchange rate policy, in conjunction with monetary policy, should aim at an optimal mix between exchange rate and interest rate flexibility in order to deal with internal and external shocks. Support for the export sector as a prime motor of development and integration into the EU should be a major consideration. Thus, fixed exchange rates (and euroisation) should ideally be long-term targets achieved after a period of transition and adjustment in order to avoid an excessive real appreciation of domestic currencies.

Fiscal policy should aim at lower and thus sustainable budget deficits. Taxes should be simple, business- and employment-friendly as well as convergent with the EU, and VAT should be progressively adopted. The long term sustainability of social security arrangements should be high on the agenda.

Trade liberalisation should extend both towards the EU and all the other countries of the region. There should be an asymmetry in favour of Balkan countries in any timetable of trade liberalisation with the EU. The protection of Balkan economies should as a rule not extend beyond 5-7 years and should aim to minimise special protection and rent-seeking in general. The main aims of trade policy should be allocational and developmental, not fiscal.

In view of the very high level of unemployment in the region, **labour market policies** will be essential. They will need to bring down barriers to employment, legalise black market employment wherever possible, and focus on training and development activities. Prime consideration should be given to tackling long-term and youth unemployment.

Investment policies need to address more effectively the persisting problem of high risk. They should be complemented by a more active restructuring of the industrial sector. Specific risks need to be identified and financial institutions set up in order to insure investors against these risks. This can be done either via the existing international financial institutions, through the European institutions or through a regional development bank that would be institutionally connected with the corresponding banks in Washington and Europe. Capital account transactions should also be liberalised gradually with the view of securing sustainable and long-term financial inflows rather than short-term capital movements.

Experience suggests that **financial reform** is of key importance for transition economies. Lessons can be learned concerning the methods and timing of bank restructuring and the sound development of other institutions of financial intermediation. Particular attention must be given to close monitoring and the setting up of regulatory agencies and to the building-up of the required expertise.

The process of reconstruction and development requires large investments in human and social capabilities. Significant resources should therefore be devoted to technical assistance and the building of institutions. External assistance will also be vital in supporting and reforming social security systems, which are close to collapse in virtually all countries in the region.

The reconstruction of the Balkans will require close and effective co-operation between the international community and the peoples of the region. In this respect, the role of the European Union is absolutely crucial.

Until now, the action undertaken by the EU in the Balkans has been too little and too late. The more remote the prospect of membership, the smaller the influence the EU can exert on other European countries. This has been particularly true of its influence to date in the Balkans. And furthermore, given the underdeveloped nature of the Common Foreign and Security Policy (CFSP), when the guns began to sound in the region, the EU had little or nothing to say.

This needs to change. Helping to create the conditions for security, democracy and economic prosperity in the Balkans should be a high priority for the Union. Reconstruction should also be intimately linked with the progressive integration of all the countries in the region into the European system, leading to full membership of the EU. This will inevitably be a lengthy process during which the EU will require:

- political will
- financial resources
- innovative ideas.

Key elements of the EU strategy for the Balkans may include the following:

- generosity and flexibility combined with conditionality and continuous monitoring
- a regional approach compatible with differential treatment of countries as a means of rewarding success, as long as this is based on generally applicable and transparent rules
- Progressive integration into the EU together with increasing co-operation at the regional level in the Balkans, viewed as mutually reinforcing processes.

In more concrete terms, EU policy towards the Balkans may include some of the following components:

Trade liberalisation: immediate tariff-free access for industrial exports from the region accompanied by a generous increase in agricultural export quotas, culminating in complete liberalisation. Balkan countries should be offered a relatively short transition period to liberalise trade with the EU. As regards intra-regional liberalisation, this could take effect more or less immediately.

Progressive **regulatory alignment** with the EU, viewed as part of institution building in the countries concerned and also as part of the necessary adaptation prior to full membership. It should not, however, end up imposing too high an economic cost for producers, especially in the early stages.

Euroisation could have considerable symbolic significance as a way of linking the Balkans with EMU. However, it should not happen immediately and without some important pre-conditions having been fulfilled. Otherwise, it would risk adding yet another heavy constraint on economic development for the countries of the region.

Economic aid should be an integral part of the package to be offered by the EU to all the countries in the region. Annual transfers of the order of 3-5 billion euros for the whole area of the post-communist Balkans should be within the limits of the financial perspectives extending to the year 2006. The **European Agency for Reconstruction** should have its responsibilities extended to the wider

region of the Balkans. It should also acquire a co-ordinating role among all the other donor institutions involved in order to ensure the efficient use of resources.

An indicative list of priorities for EU economic aid may include:

- investment in public infrastructure
- restructuring of the financial sector
- encouragement of private investment and the generation of new employment
- institution building
- development of civil society and NGOs
- promotion of Balkan co-operation, starting with areas of low politics.

Co-operation between the EU and the countries in the Balkans should extend to **justice and home affairs**, including notably visas and immigration as well the fight against organised crime and drug trafficking.

Last but not least, EU policy towards the Balkans should include a strong **institutional dimension**, with two different but closely interconnected elements, notably the bilateral (between the EU and individual countries), and the regional.

In conclusion, the reconstruction of the Balkans constitutes a major challenge for the international community, the European Union as well as the peoples of the region, who will be, of course, most directly affected. Reconstruction has different dimensions, physical and economic as well as social and institutional. Concentrating on one at the expense of the others would undermine the whole process. On the other hand, the reconstruction of the Balkans can only make sense if it is directly linked to the progressive integration of all countries in the region into the European system, leading eventually to membership of the EU. And this should be coupled with ever closer co-operation at the regional level.

* * * * *

I. Introduction

The 1990s have witnessed the unfolding of a new process of Balkanisation, that is to say, a process of seemingly endless conflict and ever smaller states and political units in this much troubled region of Europe. In contrast to the dominant trends towards integration in Western and Central Europe, the Balkans are characterised by fragmentation, war and economic decline. The process of Balkanisation poses significant security risks to the international community – the violence that characterises the region has a tendency to spread, through refugees, criminal networks, and through a nasty form of nationalism. Above all, it deprives the citizens of the region of responsive and responsible political systems as well as viable economic opportunities.

There is growing awareness that this process of Balkanisation will not in the end prove to be self-stabilising and a growing consensus that the international community will have to take greater responsibility for the region. In particular, there is a need to find ways to counter the process of fragmentation through integrating the region as a whole into the rest of Europe. This is the thinking behind the Stability Pact, announced at the European Council meeting in Cologne on June 10, 1999, and the various proposals for some kind of ‘Marshall Plan’ for the region. It goes, of course, without saying that stability, democracy and economic prosperity cannot simply be imported from outside. The international community, and the EU in particular, can help by providing the framework, the incentives, pecuniary or otherwise, as well as the technical advice needed. Still, the main responsibility for the stabilisation, democratisation and economic development of the Balkans will continue to lie with the peoples of the region.

The Stability Pact, undoubtedly, offers a way forward if the Balkan region is to break out of the cycle of violence and disintegration. But it is also fraught with difficulties. In this paper, we investigate the problems in different fields – security, politics and economics – and we try to develop an innovative approach towards the region that is distinct from previous experiences both of post-war reconstruction and of transition from communism.

The term ‘reconstruction’ tends to presuppose a decisive political settlement, as was the case after World War II. In the Balkans, this has not yet happened. Borders and sovereignty continue to be contested in several parts of the region. Indeed, the extreme nationalism that led to conflict in former Yugoslavia is, at the same time, nurtured by conflict. This kind of nationalism can be described as a social phenomenon involving an unhealthy alliance between nationalist leaders, various paramilitary and criminal gangs as well as parts of the security services – an alliance that thrives on instability and periodic violence. It could be described as a form of criminalisation in which laws and social norms are routinely violated over a whole range of activities. War crimes, human rights violations, looting and pillaging are

the extreme, albeit frequent, manifestations of this kind of criminalisation. But there is also widespread corruption, clientelism, as well as petty theft, illegal trading, and black marketeering.

In this context, reconstruction has to be understood not only as physical and economic reconstruction but also as social and institutional reconstruction. Indeed, the former is impossible without the latter. The primary goal of reconstruction, we argue, is restoration of the rule of law. This applies in all fields. In the case of security, it means that political agreement according to international principles has to supplant the use of violence in solving conflicts and that legal instruments must replace military instruments. In the case of politics, it means respect for human rights and for the establishment of a secure environment in which individuals can freely participate in political life. And in the economic field, it means creating opportunities for legitimate ways of earning a living, in particular, productive employment.

This understanding of reconstruction has implications for the way we think about transition. Reconstruction cannot mean restoration of what existed previously; it must involve transition to democracy and a market economy. However, as we argue, standard recipes for transition are inappropriate unless accompanied by other measures. Thus, several studies of Balkan reconstruction advocate trade liberalisation and even euroisation of the region (see, for example, CEPS, 1999). While we agree with many of the measures advocated, we believe that they may lead to further economic decline and criminalisation, unless accompanied by measures aimed at reforming the political and economic laws and institutions and at stimulating the productive economy.

In this paper, we treat the region as a whole, although we place greater emphasis on the countries more directly affected by the war in former Yugoslavia. We argue in favour of a regional approach to be adopted by the international community and the EU in particular aiming at the progressive integration of all the countries of the Balkans in the European system, of which the EU constitutes by far the most important part. Integration in Europe should proceed in parallel with regional co-operation/integration, the two processes being mutually reinforcing.

In the Balkans, there is always a problem with definitions: how people define themselves and how they are defined by others. In this paper, we define the Balkans to include all the successor republics of former Yugoslavia, Albania, Bulgaria and Romania. To all intents and purposes, Slovenia has already defined itself out of the region. It would, however, be advisable to include Slovenia in several projects of regional co-operation; and the same could apply to Hungary. The Republic of Moldova could also be added to the list, although this may involve a sensitive political decision concerning a country of the CIS. Last but not least, Greece and Turkey are also part of the Balkans: the former having been a full member of the EU since 1981, and the latter with a long and rather turbulent history of institutional relations with the Union. The EU is therefore already present in the region. The regional approach advocated in this

paper will concentrate on the former communist countries of the region, with the EU as an active participant in the reconstruction of the Balkans, although the involvement of other countries of the wider region and the international community at large will, of course, also be strongly desirable.

Multilateralism is not incompatible with the differential treatment of countries based on particular needs and also on progress registered with respect to goals jointly defined. The aim should be to provide the instruments and incentives for reconstruction and integration, but not to proceed at the speed of the slowest. Thus, countries which are already considered eligible for accession to the EU - or even ready to start accession negotiations - should have absolutely nothing to fear from a regional approach aiming at reconstruction and integration for the region as a whole.

The regional approach advocated in this paper will, however, be very difficult without significant change in Serbia. While the current regime in Serbia is not solely responsible for all the disasters of the last few years, it is very difficult to envisage any form of what might be called debalkanisation, unless it includes Serbia. Therefore, this paper pays special attention to the situation in FR Yugoslavia.

In this paper, we examine the impact of the Kosovo crisis, the main features of the Balkan political economy and the lessons of transition, including the lessons of reconstruction in Bosnia-Herzegovina. This examination of the present situation in the Balkans is followed by our proposals for a new approach towards the region, including external security, democratisation, as well as macro- and microeconomic policy. The next section concentrates on European and regional integration. It is followed by conclusions.

II. The Present Situation

II.1 The Impact of the Kosovo Crisis

Security Implications

The entry of NATO and other troops into Kosovo and the United Nations Security Council's authorising an international civil presence in Kosovo did not amount to a resolution of the conflict over Kosovo. There remains considerable uncertainty not only about the future of Kosovo but about the future of the whole region; several important issues continue to be contested and are, indeed, flash points for further tension. Many of these issues were sparked by the crisis over Kosovo. They include:

- The future of Kosovo itself. The UN Security Council resolution 1244, according to which KFOR entered Kosovo, provides both for ‘substantial self-government’ of Kosovo and at the same time, reaffirms the sovereignty and territorial integrity of the Federal Republic of Yugoslavia. Thus Kosovo’s future status remains unresolved. KFOR has been unable to prevent the flight of Serbs and other minorities, especially Roma, from Kosovo; those few Serbs that remain are confined to enclaves or divided cities like Mitrovica which could constitute a permanent source of tension. KFOR has also been unable to prevent the influx of criminal gangs from Albania, who also contribute to instability. In the medium and long-term, a peaceful resolution depends on whether the UN administration and KFOR are able to provide conditions of ‘normality’ in which the energies of the Kosovar population can be directed towards reconstruction and democratisation and respect for minorities.
- The future of the Milosevic regime in Serbia. New forms of opposition have developed as a result of the way Milosevic handled the war in Kosovo. These include the Orthodox Church which was openly critical of ethnic cleansing in Kosovo, reservists who have not yet received wartime pay, the families of war victims, as well as Serbian refugees from Kosovo who are hidden from public view. Despite pressure from the international community, the political opposition remains divided. There are, at the time of writing, new proposals for a non-political government of experts which could replace Milosevic and organise elections, and many individuals and groups appear to be mobilising in support of this concept. The possibility of a civil war in Serbia, especially in Szandjak or Voivodina, or of new conflicts in neighbouring countries cannot be ruled out as long as Milosevic tries to defend his political position using the instrument of instability, as he has done previously.
- The situation in Montenegro. Montenegrin society is polarised between those who support the process of democratic reform and those who remain loyal to the Milosevic regime. This division crosses most groups in society – political parties, the government, the security forces, and even families. The war provided an opportunity for a comeback by the pro-Milosevic groups that had been defeated in the elections. It also strengthened the conviction of many in the group favouring democracy, whose voices are becoming increasingly louder, that Montenegro cannot long remain hostage to the policies of Milosevic. At the end of August, the Montenegrin government put forward a proposal for redefining the relationship with the government in Belgrade, including a separate currency for Montenegro; so far, there has been no official reply. Tension currently centres around the presence of the Yugoslav Army in Montenegro which has not been reduced in size since the end of the conflict, and the proposal by the Belgrade government to establish a federal police force to counter the Montenegrin police force which is loyal to Djukanovic. Thus, developments in Montenegro, and the future of FR Yugoslavia, are very much linked to the process of democratisation in Serbia.

- The fragility of FYR Macedonia. Both the swelling of the Albanian population as a result of the huge influx of refugees, and the opposition to NATO bombing by the Slav population has been highly destabilising. The tension has been eased by the return of refugees to Kosovo, nevertheless the viability of the state remains in question.
- Continued tensions in Bosnia-Herzegovina. NATO actions were strongly opposed by the Serbian population. Some Serbian nationalists referred to the bombing as ‘criminal aggression’ and even hinted at the possibility of military action against NATO forces in Republika Srpska. The influx of refugees (Serbian draft dodgers and Muslims from Sandzjak), the cutting of economic links with FR Yugoslavia, and the recruitment of paramilitary forces to fight in Kosovo, all contributed to increased polarisation between those who favour the eventual partition of Bosnia and those, including the Prime Minister Dodik, who see the future of Republika Srpska as dependent on closer ties with the Federation.
- The absence of rule of law in Albania. Ever since the crisis of 1997, the Albanian state has been fragmented and unable to control the lawlessness of Albanian society and the widespread presence of organised gangs, especially in the Northern stronghold of former President Berisha.

Moreover, these contested issues have to be situated, in a set of social conditions typical of ‘new war economies’ which have been accentuated during the Kosovo crisis (Kaldor, 1999). The factors that generate a vested interest in violence include: high unemployment and high levels of criminality; extremist politicians whose power depends on an atmosphere of crisis; clan-based familial arrangements with long traditions of so-called heroic acts to be emulated and humiliations and tragedies to be avenged; the availability of surplus arms as a result of the failure to control arms caches built up during the Cold War period and the flourishing black market; and the existence of independent or private militias or paramilitary groups.

Furthermore, these social conditions cannot be contained geographically. The factors which are conducive to violence spread across borders via the black market and arms trade, through sanction busting, through refugees and minority groups, as well as through paramilitary and criminal networks. Thus local issues interact with broader tensions in the region as a whole, for example, between Greece and Turkey, and also broader international tensions between East and West.

Effects of the war on Kosovo, Serbia, and Montenegro

A number of estimates of the economic costs of the war in Kosovo, in Serbia and in Montenegro exist, but these are, as a rule, incomplete and the figures vary widely. For instance, the current official

Yugoslav projection for the decline of GDP this year is around 25% (it is not clear whether this includes Kosovo). Previously, official estimates put the decline at around 40%. Similar estimates of around 40% have been endorsed by the Group 17 in Belgrade and by the Economist Intelligence Unit. The Belgrade-based Institute of Economic Sciences has put the expected decline at around 35%. The same goes for all other estimates of current economic activities.

The estimates of physical damage vary considerably too. This is due to the lack of information available and also for methodological reasons, that is to say in considering what is and what is not to be included as 'damages'. The World Bank has commissioned a study to determine the (physical) damages in Kosovo and the outcome is an estimate of about USD 1.2 bn. Estimates of the costs of similar damages in the rest of Yugoslavia vary from less than USD 1 bn (Group 17) to USD 3-4 bn from a number of international observers to USD 30 bn from official sources.

The estimates of costs in the wider sense of lost wealth, lost GDP and losses that are the consequence of opportunity costs vary widely too. The early estimate by the Group 17 has the sum total of costs and losses at around USD 30 bn. The Economist Intelligence Unit has come up with the figure of around USD 60 bn. Some EU and World Bank officials have mentioned the figure of USD (or Euro) 30 bn, but these refer to reconstruction costs and not to damages and losses as such. Obviously, these figures are quite speculative and it is not really clear what they are supposed to mean¹. Moreover, estimates of the costs of the war do not seem to bear much relation to estimates of the requirements for reconstruction. The first donor conference on Kosovo held at the end of July 1999 estimated about two billion US dollars in pledges for reconstruction costs.

It is perhaps more useful to try to describe the current economic situation in qualitative rather than quantitative terms, relying on little more than anecdotal evidence. Available reports on Kosovo indicate that agricultural activity has resumed throughout a large part of the province. The same goes for trade and some services. However, whatever industrial production there once was has not seen a revival. The reasons for this stagnation appear to be the following:

1 Some of the calculations of the losses amount to the determination of the opportunity cost of the conflict in Kosovo. Mostly, the loss of GDP over the one that would have been achieved is taken to stand for the opportunity cost of the conflict. This definition of the opportunity cost is incomplete because for the opportunity cost to be well-defined the full set of alternatives should be considered. For instance, one way to calculate the opportunity cost of the conflict in Kosovo is to calculate the long-term growth rate before and after the conflict, e.g., on the basis of the one or the other version of the classical or new growth theory. Then, the difference between the two streams of GDP that they generate would be the opportunity cost of the conflict in Kosovo. In that case, however, it could be argued that the growth rate before and after the conflict should be the same, in which case the cost would be infinite. So, and this is the point being made here, this way of calculating the opportunity cost is not very enlightening.

First, some of the industry has been damaged and its reconstruction is not a matter of first priority. Second, there are serious problems with the determination of ownership. More generally, the entire legal structure is non-existent, which makes the rehabilitation of industrial production difficult. Third, there are problems with management: in many cases the managers of the firms were Serbs who have either fled or have been dismissed in one way or another, so it is not clear who is to run the companies in Kosovo. Fourth, the traditional markets have become inaccessible: Kosovo was formerly integrated into the economy of Serbia and Yugoslavia; new markets are yet to be found and this will take time².

However, the most serious problem is the lack of a political, legal and administrative infrastructure. Laws are yet to be written, and their enactment will have to wait for the creation of a political structure. Even when this is done, there will be the problem of implementation. It will take at least a year for some kind of order to be established.

Moving from Kosovo to Montenegro, the current economic situation there is much easier to describe, though again, little more than anecdotal evidence can be relied on. The damages of the NATO bombing campaign to the physical assets of Montenegro have been comparably small. Losses in GDP have been significant however, especially in trade and services, e.g., in tourism. However, Montenegro has received some financial help from the EU and the USA and has thus been able to lessen the pain of economic hardship on the population. Thus, pensions and wages are almost twice as high in Montenegro than in Serbia and are paid more regularly; there are no shortages of gasoline or of other goods; and finally, economic activities are conducted much more freely since Montenegro never introduced the laws of war economy that were introduced in Serbia.

Unlike Montenegro, the economic situation in Serbia is almost dramatic. During the conflict in Kosovo and for a few months after it ended, prices were kept under control so that inflation in the first half of the year was around 15%. In August, some prices were liberalised and some were corrected (e.g., the price of gasoline). The government is having difficulty meeting its obligations, especially to the army and pensioners, and has therefore been printing money, though not in an uncontrolled manner. Nevertheless, with the GDP shrinking, the increased money supply has led to the depreciation of the Yugoslav dinar which has increased pressure on prices. So, inflation has been picking up strongly in September and October amounting to more than 10% per month.

The Serbian government faces a difficult task in the coming months. It must find a way do as much as possible in order to restart at least some industrial activity. It must also find a way to ration goods such as gasoline, electricity, and heating. And finally, it must find sources for budget revenues. Since foreign

² Some data on the economy of Kosovo can be found in Mustafa, 1998. See also Mustafa, 1999.

finances are unavailable and the domestic financial system bankrupt, this will be a tough act to perform. Its immediate goal is to survive through the coming winter.

Anecdotal evidence suggests that the people in Serbia are indeed preparing for an adjustment to a significantly lower level of welfare. The government is planning to ration electricity and heating, so the majority of the population is planning to use coal and even wood to cook food and to heat apartments. The tariffs on goods such as second-hand cars, cigarettes and a number of other items that used to be smuggled, have been lowered. This indicates that, for the time being, the government has given up on the domestic production of these goods. More generally, except for some emergency repairs of the infrastructure, no significant economic reconstruction is possible. Thus, the emphasis is on the supply of food for the winter and on electricity, i.e., on survival. No significant revival in production and employment is planned or expected.

Slightly more structured anecdotal evidence suggests that the price level in Serbia fell significantly during the war. Given that inflation was subdued while the Yugoslav dinar continued to depreciate, prices were very low if calculated in German marks. Even the price of imported goods was often lower than abroad, indicating that many of the goods had been imported some time ago and their price had not been fully adjusted because of the low purchasing power of the population. In general, the price level in Belgrade for the most commonly used items found in the stores was roughly about a third of that in Austria for instance. If the price of services is included, the price level can be halved again. So, a rough estimate could put the price level in Belgrade at one-fifth or one-sixth of that in Austria. Prices in the countryside are of course even lower. This is not surprising since the average wage in Serbia has fallen to about DM 80 and is expected to fall further. The current acceleration of inflation may not reverse this significantly, because the depreciation of the dinar is speeding up too.

With incomes low and foreign finances unavailable, imports have decreased significantly. The official expectation is that imports will contract by almost 60% this year while exports will fall by about 50% (Yugoslav Survey, 1999). The trade deficit is expected to be more than halved (compared with 1998). This deficit will not be much smaller as a share of GDP because the latter is also expected to be almost halved this year. Therefore, the external equilibrium will be very difficult to sustain. The fall in imports as well as in exports will make it all but impossible for economic activity to recover any time soon.

All in all, the current economic situation in Serbia is grave. Work and business are scarce, money is in short supply, and reconstruction and recovery cannot be expected within the existing economic and political framework. The government is promising that it will work miracles, but the population is readying itself for a protracted period of hardship.

Regional Economic Consequences

The Kosovo crisis has had a significant economic impact on neighbouring countries and on the region as a whole. This has manifested itself principally in three ways: (i) costs of refugees and other costs directly connected with the war, (ii) losses in income and output due to falls in foreign trade, consumption and investment, and (iii) stability and development costs.

Initially, there were expectations that refugees would pose a long-term problem. However, it turned out that the repatriation process was swifter than anticipated, therefore the consequences for the countries in the region may prove to be negligible; although the problem of emigration from the whole region is a long-term and important one. Indeed, if the situation in Serbia continues to deteriorate, significant pressure on emigration to neighbouring countries and beyond may be expected. This, of course, would reach a level of crisis were civil war to erupt in Serbia, a possibility not to be dismissed altogether. In the case of both situations developing simultaneously (i.e. lack of positive political change and civil war), the consequences for the region in terms of the large movements of population may be quite significant.

Other important and enduring consequences are those associated with the worsening conditions for production, trade and investment. Trade in goods and services (e.g., tourism) have been affected significantly and these effects may, in some cases, be felt for quite some time due to the slow recovery of the Serbian market and the higher transportation costs through Serbia (both via land routes and via the Danube). Although data for the first half of 1999 is still not available for all countries, the preliminary assessment points to the widening of trade deficits of goods and services in Bulgaria, Croatia and Bosnia- Herzegovina. On the other hand, the merchandise trade deficit in FR Yugoslavia and FYR Macedonia is smaller because of the larger falls in imports than in exports. Trade and current account deficits of Hungary are increasing, but this is only marginally influenced by the Kosovo crisis. The development of Romanian external balances is ambiguous and also minimally affected by the Kosovo crisis.

With the worsening of economic circumstances, consumption, both private and public, has been adversely affected in a number of countries. The budget deficit in FYR Macedonia has deteriorated dramatically. The deficits in Albania and Bosnia-Herzegovina were already significant before the Kosovo crisis. The central government budget in Croatia is also under severe pressure, though the influence of the Kosovo crisis in this particular case is not decisive. The fiscal situation in Bulgaria is sure to deteriorate because of poor growth performance, to which the Kosovo crisis contributed. Other countries in the region have fiscal problems that are largely unconnected to the Kosovo crisis.

Finally, investment, especially foreign investment, has become even more scarce, which has aggravated the business conditions in the region. Again, data is hard to come by, but it is certain that more or less everything regarding foreign investments in the Western Balkans is on hold. In Bulgaria and Romania the situation is somewhat ambiguous since it is not yet clear whether some of the foreign investment planned will be realised before the end of the year.

The most enduring consequences may be those connected with the overall macroeconomic stability and with the speed of the reforms necessary for the region to move towards sustained growth. All of the countries in the region (Croatia, Bosnia-Herzegovina, FR Yugoslavia, FYR Macedonia, Albania, Bulgaria and Romania) have weak macroeconomic and even weaker microeconomic indicators. On the macroeconomic side, they run large trade and current account deficits (Bulgaria was an exception until this year), large or significant budget deficits and have high or catastrophic levels of unemployment. On the microeconomic side, they have weak or collapsing financial sectors, weak and bankrupt enterprise sectors and weak and corrupt public and private governance. Thus, most of the countries in the region are either coming out of a crisis, are in crisis or are falling into one. All of these problems tend to become aggravated, if growth disappoints or turns negative. According to various estimates, the marginal contribution of Kosovo in that respect (i.e., shortfall of GDP growth in 1999) ranges from 5% for F.Y.R Macedonia to 3% for Bosnia-Herzegovina (mainly in Republika Srpska), to 2% for Bulgaria and Albania, to 1% for Croatia and to 0.5% for Romania (and possibly also for Hungary). But the contribution to negative prospects for sustained growth may be much more important and enduring.

II.2 Main Features of the Political Economy of the Balkan region

Political and Security Characteristics

There are two major security problems in the Balkan region – no clear borders and the absence of the rule of law. The responsibilities of the central governments and other political entities are often conflicting because conflicting territorial jurisdictions remain. This is the case both in Bosnia-Herzegovina and in Kosovo, but it will increasingly be the case in Montenegro and in Serbia, as well as in Albania and possibly FYR Macedonia. Indeed, large parts of the so-called Western Balkans³ consist of states without clear borders. The efforts to secure borders around ethnically homogeneous territories through the techniques of population displacement and ‘ethnic cleansing’, have generated large numbers of refugees and displaced persons and laid the basis for long-term tensions in the region.

³ As defined by the EU, the Western Balkans include Albania, Bosnia-Herzegovina, Croatia, FR Yugoslavia and FYR Macedonia.

Conflicting territorial jurisdiction is compounded by the weak or non-existent rule of law, both domestically and between states. Externally, there are no accepted mechanisms for the peaceful resolution of border disputes. Domestically, law enforcement and the judicial system (i.e. police and law courts), do not function effectively, if at all. Indeed, with the collapse of local political structures, the legal vacuum that has emerged has led to a certain degree of lawlessness throughout the whole region.

These security problems cannot be disentangled from the undemocratic character of regimes in the region. The rule of law is not just a matter of formal arrangements. Paper constitutions and democratic rules are important. But they have to be based on and upheld by norms and values that are widely accepted in society. In the former Yugoslav states, many of the elements of formal democracy and the rule of law do exist. Elections are held with competing candidates and virtually universal suffrage; there are paper commitments to European standards of human rights, free media, freedom of association, and rules for a market economy. There are, of course, some serious shortcomings in the formal arrangements, most notably the ethnic basis of constitutions. But the fundamental problem is the existence of ruling groups who fail to respect the underlying norms and values and who espouse exclusivist, nationalist politics.

Most important in this respect is the Milosevic regime in the Federal Republic of Yugoslavia and Serbia. It is true, as many people in Belgrade insist, that it is not only the Milosevic regime that is responsible for all the tragedies of the last few years. The Tudjman government in Croatia, the nationalists in Bosnia-Herzegovina, the KLA in Kosovo have also contributed to the unfolding of these terrible events. It is also true that the removal of Milosevic will not instantly lead to democratisation and respect for the rule of law. Milosevic is at the apex of a system of violence and political extremism that has entrenched itself in the Western Balkans through the mechanism of war. Nevertheless, a change of regime would unblock the process of democratisation. It would make possible policies and measures designed to strengthen the lawful and democratic elements in society, and it would have a knock-on effect on the neighbouring countries.

Throughout the region, nationalist parties came to power and have stayed in power through elections that, at least on paper, were democratic. Nevertheless, these elections took place within the framework of societies that had experienced what has been described as 'soft totalitarianism'. Although the former Yugoslavia was much more liberal than the communist regimes in the rest of Eastern Europe, the ruling party exercised control over most key aspects of everyday life – sources of livelihood, security, and propaganda. As in other Eastern European countries, there was no clear distinction between politics and economics. Many of these forms of control were inherited and adapted by the present regimes. Milosevic rules through networks of loyal people in the security services, in key economic positions, or in the electronic media, who are also connected to various paramilitary and criminal groups. His control

is less absolute than the former communist regimes and, indeed, this may explain the need for violence and instability. But his position is strengthened by an authoritarian tradition that tends to support whoever is in power, by weak civil society especially outside major towns, by material and physical insecurity, and by a shared sense of being a victim rather than an accomplice in the disintegrative processes of the last few years. The system of rule is similar in other parts of former Yugoslavia, especially Croatia and Bosnia-Herzegovina and indeed undemocratic elements of this kind exist in all the post-communist Balkan societies.

There are, of course, alternative forces in society – individuals and groups who favour democratic reform. These are centred around independent media (mainly print and radio), NGOs and universities. These groups are greatly weakened and marginalised in conditions of war. Many educated people who form the backbone of these groups have left the region over the last few years. The Milosevic regime has introduced a number of measures to control NGOs and universities. Nevertheless, these groups may have more tacit support than is often assumed. The victory of opposition parties in Serbia in 1997 and the refusal of the regime to allow the newly elected parties to take power led to sustained demonstrations all over Serbia and the eventual capitulation of the government. Likewise, the election of a coalition of opposition parties, led by Djukanovic in Montenegro, has initiated a process of democratic reform in Montenegro. Similar positive developments in other parts of former Yugoslavia, include the sidelining of extreme Serbian nationalists in Republika Srpska and growing support for the Social Democrats in the Federation of Bosnia-Herzegovina, and the likelihood of a change of regime in Croatia after the next elections.

Elsewhere in the region, pro-democracy forces are much stronger. Bulgaria and Romania have managed to sustain the process of democratisation, despite great economic difficulties, and have also registered significant progress in the treatment of their own ethnic minorities, which may serve as an example for the other countries in the region. A fragile coalition of Slav Macedonian and Albanian nationalist parties in F.Y.R Macedonia has survived, for the time being, the after shock of the Kosovo crisis. On the other hand, in Albania the rule of law hardly exists and state power is extremely weak.

Macroeconomic Characteristics

The political characteristics of the region have profound implications for the management of economies. There are serious problems with public governance in all the Balkan countries. These have to do with the lack of responsibility, responsiveness, transparency and, going beyond internal politics, with the lack of regional and international co-ordination. These are all vital for a country or a group of countries that face major institutional and political reforms and changes and they are reflected in disequilibria of various types and in economic instability.

The region, whether South-East Europe is considered or just the Balkans, is economically quite diverse. If only post-communist countries are considered, Gross Domestic Product (GDP) per capita ranges from 500 euros in some areas of Kosovo, Albania and Bosnia-Herzegovina to over 4500 euros in Croatia. If other Balkan and South-East European countries are added, the diversity increases. Thus generalisations should be attempted with caution. This is worth saying at the very beginning, because what follows will treat the similarities in the macroeconomic characteristics of most of the transition countries in the Balkans.

The similarities have to do with the persistence of macroeconomic disequilibria and with the instability of the process of transition, growth and development. Three macroeconomic disequilibria are most important:

- 1) *External disequilibrium.* All transition countries in the Balkans run significant, large or very large trade and current account deficits which are basically unsustainable (see also Table 1, Annex D). It is important to treat the issue of sustainability in more detail. In the longer run, the initial trade and current account deficits can be sustained if they are eventually going to be financed from increases in exports of goods and services. Otherwise, either imports will fuel consumption or production for import-substitution and the deficits will accumulate beyond the levels of sustainability. So, the external deficits by themselves are not an indication of a problem, however if they are not instruments of growth and development they will breed instability and crisis. In the Balkans, the transition economies seem to be running these kinds of unsustainable external deficits and have already gone through one or more exchange rate or banking crises or both.

- 2) *Internal disequilibrium.* All transition economies in the Balkans have significant, high or very high unemployment rates (Table 1). These range from about 10% in Romania to about 40% in Bosnia-Herzegovina. Employment is decreasing and unemployment is increasing practically everywhere. This is a consequence of the process of de-industrialisation that has been going on in the entire region. Again, there are significant differences between countries like Albania, where industry is almost non-existent, and countries like Romania or Croatia where industrial production has been downsized, but is still present. More important is the fact that the process of the closing down of industrial firms and enterprises in the region leads to an increase in employment in the shadow economy and even in agriculture. The contribution of agriculture to the GDP of almost every country in the region has increased (because agricultural production has shrunk less than both GDP as a whole and industrial production) and in a number of cases so has employment. Thus, the region is, from an

economic point of view, a backward one that faces the task of embarking on the path of industrialisation.

- 3) *Fiscal disequilibrium*. Most of the transition economies in the Balkans run significant and often unsustainable fiscal deficits. In some cases, fiscal deficits do not appear to be an immediate problem, but this is often misleading. In fact, in most countries even those public obligations that are honoured would not be honoured if aid of some sort or were not forthcoming. The quality and the stability of public finances is an even more serious matter. Most social services are collapsing and significant public obligations towards certain segments of society are continuously being defaulted on. There are any number of problems with the efficiency and equity of public finances in the region, though the most fundamental is that the states in the region are practically bankrupt.

Macroeconomic disequilibria have contributed significantly to the lack of growth in the Balkans. All former communist countries in the region are still far behind GDP levels registered in 1989 (Table 1). Most of the countries in transition in the Balkans have gone through one or more episodes of instability or crisis. For instance, all of the successor states of former Yugoslavia have experienced an episode of hyper-inflation or of very high inflation. Most of the other countries in the region have also struggled with inflation and faced the spectre of hyper-inflation. However, even after prices stabilise, growth is either slow or often turns negative. At the moment, most of the region has a negative growth rate (exceptions are Albania and Bosnia-Herzegovina).

The reasons for this instability are to be found in the macroeconomic disequilibria described above, that have to be periodically corrected through crises, and external shocks that are hard to absorb. Obviously, macroeconomic stability, domestic and regional, would be helpful, but would not necessarily deliver sustainable growth and development. Reforms and changes would be necessary too. Here, there is a *circulus vitiosus*: the instability of growth influences negatively the sustainability of the political will to reform, while the lack of reforms undermines the economic growth. It is sometimes suggested that the circle can be broken after a major crisis, but this is not necessarily true in cases in which the economic prospects of a country depend significantly on regional stability; in which case a regional approach to stability and growth is required. This has proven difficult to forge in the Balkans, at least so far.

Microeconomic Characteristics

Growth is as much a microeconomic phenomenon as it is a macroeconomic one. Current microeconomic characteristics of the region have to do with structural changes, the financial system and the quality of institutions.

- 1) *De-industrialisation.* Throughout the region the share of industrial production of total GDP has decreased and there has been an increase in the contribution of agriculture and services. Even these two sectors have gone through significant structural changes and adjustments which have to do with what can be also seen as a version of de-industrialisation, i.e., those types of agricultural production and services that are not dependent on industry or do not contribute all that much to industrial production have grown faster. In addition, de-industrialisation in the Balkans does not seem to be a transitory phenomenon. In many cases in which a recovery has occurred, that of industrial production has been less convincing and often unsustainable. Indeed, it is to be expected that the process of de-industrialisation will continue for some time and may in fact accelerate.
- 2) *Financial situation.* The banking sector throughout the region is in bad shape. The reasons for this are not the same in all of the countries concerned. For instance, in some of the countries of former Yugoslavia, the credibility of banks is low because they are in default on foreign currency savings. In other countries, the more familiar problem of accumulated bad loans is greater. In other cases still, there is the problem of moral hazard connected with the history of the rehabilitation programmes of banks by which the budget takes on the losses of the banking system. What goes for the banking sector also goes for the other financial institutions. Thus, the entire financial system needs to be restructured.
- 3) *Privatisation.* In the region as a whole, either privatisation is lagging or the privatisation programmes chosen have been more than usually inefficient and unjust. As a consequence, enterprises lack clear ownership structure which has negative consequences for corporate governance. The central problem is how to restructure enterprises and depoliticise the management of enterprises so as to take economic positions out of the control of politicians.
- 4) *Institutional problems.* Throughout the region the key economic institutions do not function properly. Private property is not protected, the rule of law is not strong, corruption is rife, shadow economy is significant. However, generalisations here are more dangerous than in other instances. Obviously the situation in Bulgaria, for example, is not the same as that in Albania. Still, general characterisation is useful in order to point to the fact that the institutional circumstances are such that it is not surprising that private governance is not well organised and efficient throughout the region. This has significant consequences for the way entrepreneurial and managerial skills are allocated and used.

Given the microeconomic circumstances, as described above, it is not surprising that the allocation of resources in the Balkans is not optimal and that greater effort is being put into the redistribution of resources than in their production. As a consequence, growth is disappointing. In addition, the process

of restructuring incited by this microeconomic set-up may lock the region onto a path of development which may be difficult to reverse.

Private Governance

Like public governance, private governance is deficient in a number of ways. Unlike during communism, current problems do not originate from 'soft-budget' constraints. Rather, they are caused by a number of institutional failures, some commonly present in 'emerging markets', some developmental. They could be called 'soft-legal' constraints. Some of these will be mentioned here:

- 1) *Soft contracts*. Probably the key deficiency of private governance is connected with the importance of contractual relations. Essentially, contracts are considered to be unilaterally renegotiable. From the theoretical point of view, such contracts are optimal only if there are no missing markets, now or in the future. In which case, of course, contracts would be self-enforcing (which is probably a *contradictio in adjecto*). In normal, not to mention emerging, market economies, this is not the case. Thus, the wide-spread practice of unilateral re-negotiation of contracts represents, in effect, the culture of default.
- 2) *Inverted principles and agents*. Due to the prevailing models of privatisation implemented in the region, unclear or perverted relations between principles and agents have emerged. This is mostly visible in cases in which management buy-outs play a significant role. In these cases, the managerial functions are not substituted with the owner's function. In other words, rather than maximising the value of the firm, new owners tend to maximise managerial returns. The latter can be achieved, in the short-term, at the expense of the former.
- 3) *Distorted competition*. Markets in the region are distorted in more ways than one. Without going into details, it is fair to say that markets are segmented, monopolised, plagued with discriminatory rules and, in any case, do not conform to even an approximation of the 'free entry and exit' criterion. This is the consequence of the unconvincing liberalisation and of the less than fair methods of privatisation that have been introduced.
- 4) *Lack of insurance*. One characteristic of the emerging economy in the region is, paradoxically, the lack of moral hazard. As institutions are weak and public governance deficient, institutions geared towards making business activities more secure and predictable are absent. Thus, the problem opposite to the one that characterises moral hazard (also present especially when it comes to the way the banking system operates) is quite pervasive. Rather than operating as if the risks are too

low, the entrepreneurs have to operate as if the risks are too high. This lowers overall business activity.

Lessons of Transition

Any large scale aid programme has to take account of the lessons of transition over the last ten years, especially in Southeastern Europe. Transition was originally conceived in terms of a set of more or less standard recipes. In the political field, the emphasis was on the formal aspects of democracy, in particular, the introduction of elections. In the economic field, the emphasis was on liberalisation, stabilisation and privatisation.

What we have learned from the experience of post-Soviet and Balkan countries is that the political process of transition can be risky and turbulent. Elections that are held before the other prerequisites of democracy such as free media, active civil society and, above all a functioning rule of law are established, even if conducted relatively fairly, can contribute to instability, by providing a mechanism for legitimising extremist politicians. In Central Europe, many of these prerequisites do exist although the rule of law and civil society is weak in several countries. In those countries where a degree of pluralism preceded transition, for example Poland, Hungary or Slovenia, a democratic political culture is beginning to develop. Despite the decentralisation of the former Yugoslavia, a variety of factors including the authoritarian tradition in rural areas, the vacuum of political power at the federal level, the weakness of civil society and a widespread sense of insecurity arising both from unemployment and weak rule of law, led to the victory of extreme nationalists in the first democratic elections, who were able to hijack the political process.

In the economic field, transition has been successful in dismantling and, in some cases, depoliticising the inefficient state sector. And it has also provided the opportunity for the emergence of a more dynamic private sector. But inevitably, everywhere, the consequence of transition strategies has been a degree of de-industrialisation. In only a few countries, for example Poland and Slovenia, has the new private sector been able to generate sufficient productive opportunities to offset the decline of the state sector. In the vast majority of transition countries, national income is much lower than it was in 1989 and, nearly everywhere, unemployment is high.

The performance of the countries in the Balkans in the last ten years has been worse than in Central Europe and even the Baltic countries. The latter regions have superior macroeconomic and microeconomic characteristics and have grown faster, though the sustainability of their growth may still be an open question, at least for some of them. What have the more successful countries done well and what have the countries in the Balkans done wrong?

Some of the differences have to do with the lack of public consensus around the goals of transition in comparison with countries like Slovenia, Hungary, the Czech Republic and Poland. Also, there was greater reluctance in the Balkan countries to break with the redistributive policies of the past. But probably the most important difference is, of course, the one that is the consequence of the security problems in the Balkans. The wars and the disintegration of Yugoslavia resulted not just in physical costs but losses of trade, the diversion of transport and consequent increase in transport costs, the spread of criminality associated with for example sanctions-busting or gunrunning, and the burden of refugees. In addition, there are security problems that originate with the collapse of the internal political order, as in the case of Albania in 1997.

These key differences led to delays in the introduction of the necessary changes as well as to reversals in policy decisions. Thus, transition in countries like Croatia and FYR Macedonia was postponed till late 1993 or early 1994 when they introduced their programmes for stabilisation. Bosnia-Herzegovina started to change only much later and still faces major problems and dilemmas, while in FR Yugoslavia there was a deliberate attempt to avoid the process of transformation. Similarly, though for different reasons, the transition in Bulgaria and Romania was delayed and in some sense is only just starting in earnest. Finally, the process of transition in Albania collapsed in 1997 and is still to pick up speed. Indeed, if the process of transition in the Balkans were to be evaluated in terms of the key areas of reform, it could be seen that:

- stabilisation has been the most easy to attain, though its sustainability is another matter
- liberalisation has been incomplete or very deficient. Indeed, the Balkans is the one region where the overall level of barriers to trade has increased significantly for one reason or another
- privatisation has been lagging and has been marred with a larger than usual lack of transparency, efficiency, and justice
- restructuring has mainly been passive, while active restructuring is sporadic or non-existent.

As a consequence of the key fundamental differences and of the delayed transition just described, the social and political fabrics of these societies have suffered considerably. As is commonly observed, the social capital in the Balkans is lower than in the more successful transition economies. Also, the level of legality, legitimacy and credibility are lower. From this, another important lesson of transition can be learned: *corporate governance can hardly function properly without the proper functioning of public governance*. Put differently, market institutions can hardly deliver efficiency if the political and legal institutions are distorted and dysfunctional.

Thus, restructuring state capacity needs to be central in the effort to transform the economic system of ex-socialist countries. The phenomenon of ‘weak states’ was among the principal causes of the collapse of these economies. Transition, with its emphasis on downsizing the government, has actually weakened the state – a ‘minimal’ state was sometimes confused with a ‘weak’ state. Socio-economic progress along market lines is only possible if there is an effective state capable of fulfilling its basic functions (The World Bank, 1997).

The Example of Bosnia-Herzegovina

Some of the lessons of transition discussed above were taken into account in the reconstruction effort that began in Bosnia-Herzegovina after the Dayton agreement. The World Bank, as the lead agency, did put an emphasis on institutional reform and institution building, although with some delay, and despite the very great difficulties of operating in the contested territory. Rebuilding economic management structures in line with the new constitutional arrangement for Bosnia-Herzegovina was one of the main tasks of the Priority Reconstruction Programme. Fiscal restructuring, aimed at restoring revenue raising capacity at all levels of government - central state, entities, cantons and municipalities - has been the centrepiece of the reform in Bosnia-Herzegovina. The World Bank has sponsored a fundamental tax reform and the reform of the customs system. However, the implementation of the reform has been very slow due to the obstructions by the local partners as well as the lack of administrative capacity in the relevant bodies. At the same time, the reforms, which would restructure and reduce public spending as well as improve expenditure management, have hardly begun.

Public spending is dominated by donor-funded reconstruction of physical assets, while locally raised revenues cover social sector recurrent expenditure and defence spending. Thus, the issue of fiscal sustainability, once donor assistance subsides, remains high on the agenda. There is a danger that a significant imbalance between revenue and expenditure might emerge, especially in the Federation where the progress in unifying the two still distinct economic systems inherited from the war leaves much to be desired. The public sector in the post-war economy is almost by definition bound to be large, given various claims for the restoration of basic services, while revenue collection capacity tends to lag behind. Furthermore, the new constitutional set-up of Bosnia-Herzegovina has installed multiple layers of government, which has resulted in the bloated, inefficient and often corrupt state apparatus, which poses too heavy a burden on the country’s weak economy.

The Central Bank, which opened in August 1997, under the chairmanship of a foreign official, has strictly adhered to the rules of the currency board, which has brought inflation down. But contrary to expectations, currency stability, and hence increased confidence, have not translated into lower interest rates (they are prohibitively high as finance is scarce, and financial institutions remain fragile, in spite of

improved banking supervision and technical assistance provided under the various donor funded schemes). High interest rates pose a strong constraint to the cash starved enterprise sector and economic revival remains subdued.

The internationally financed reconstruction programme has resulted in a strong surge in imports, which against the country's modest export capacity, has created the large trade deficit (import to export ratio was around 1:10 in mid 1999). It is estimated that some 90% of items for daily household consumption are imported. Exports are concentrated in few sectors, while three markets, i.e. Croatia, Slovenia and FR Yugoslavia account for around 50% of exports from Bosnia-Herzegovina. Fragile economic recovery and slow progress in economic reform suggest that the trade deficit is likely to remain large, and will continue to cause a large current account deficit. Weak external position could eventually undermine the currency board arrangement, which has so far been the mainstay of macroeconomic stability, and sap economic growth.

Bosnia-Herzegovina has inherited significant foreign debt from the former Yugoslavia. Although financial assistance in the framework of the post-war reconstruction has allowed the debt burden to increase only modestly, there is genuine concern over the country's debt-servicing capacity in the medium-term. Bosnia-Herzegovina has been given a substantial debt write-off – 85.5% by the London Club and 65% by the Paris Club of creditors. Even so, debt-servicing obligations were an issue in the formulation of the state budget in 1997 and 1998. This was so partly because of inability of the entities to come up with the funds needed, but also due to the constitutional arrangement whereby the central state is responsible for servicing the foreign debt incurred by the entities, which are in turn required to transfer their respective shares towards servicing the debt to the central budget. Servicing foreign debt is likely to remain problematic in the absence of a more substantial inflow of foreign direct investment.

Some other specific elements have been included in Bosnia-Herzegovina's reconstruction programme. The World Bank has initiated the creation of an investment guarantee scheme, which offers prospective investors the protection against the political risk of investment in Bosnia-Herzegovina, and a similar scheme exists under the auspices of the European Union. In spite of this incentive, foreign investment has been minimal, as Bosnia-Herzegovina continues to be perceived as high risk country with cumbersome and costly administrative, legal and fiscal constraints, which act as further deterrent to potential foreign investors. Bosnia-Herzegovina's market is too small to be particularly attractive to foreign investors anyway, and instability in the wider region has aggravated prospects of substantial foreign investment. An export promotion scheme is also being considered, aimed at reinvigorating foreign sales; but exportable items in the war ravaged economy are very few, and trade opportunities are restricted in the absence of a wider co-operation between the two entities.

Much of the initial strong post-war recovery has been reconstruction-led, while a widespread recovery of production, particularly in industry, which was the backbone of the pre-war economy both in terms of employment and output, has failed to materialise. Donor aid accounts for some 30% of official GDP; the capacity utilisation is estimated at 40% of the pre-war level and industrial output at around 25%. Unemployment in the country as a whole is around 40%, and in some areas exceeds 70%. One of the main reasons for the lack of widespread recovery has to do with the fact that restructuring of the existing production capacity has been much downplayed in the context of reconstruction in Bosnia-Herzegovina.

Transitional theory suggests that short-term growth effects should come from the improved allocation of resources and better use of under-utilised capacities. In the context of an economy whose productive capacity is to a great extent physically destroyed or technically obsolete, with broken supply networks, lost markets and inadequate skills, and where the institutional framework is inadequate, it is difficult to see how this process can be triggered without a systematic approach. Politics continues to take primacy over economic considerations, which additionally complicates the potential for restarting some viable production capacity. These enterprises are in the meantime subjected to further deterioration and erosion of skills with serious implications on employment levels and balance of payment.

The experience of transition in other ex-communist countries confirms the leading role of the new private enterprise sector in economic recovery. But in the post-war Bosnia-Herzegovina, where early and strong economic recovery, and job creation in particular, are of paramount importance in securing stable peace, the emerging private sector, typically small and micro-service enterprises, cannot accomplish this task. The internationally sponsored reconstruction programme has been built around a vision of Bosnia-Herzegovina as a service based economy. Compared with the inherited economic base, this implies a wholesale structural change, requiring huge financial and human resources and a fairly long time horizon. Given that one of the main reasons of prolonged economic decline prior to the war was precisely the inability of the economy to adjust to changes related to the emergence of new technologies, a developmental task on the scale that such a structural change would require is simply not possible in the specific context of post-war Bosnia-Herzegovina.

Transition in this context requires a much more creative approach to these issues, especially since the experience of other countries in Central and Eastern Europe suggests that the pace and sustainability of the economic recovery continues to be largely dependent on the recovery of manufacturing (Boone, Gomulka and Layard, 1998). The experience of Bosnia-Herzegovina suggests that the issue of transition towards sustainable market based economy is not simply a question of recovering and improving the utilisation of the existing production capacity, but of rebuilding the production base of the economy. This is a process that takes time, substantial resources and an appropriate set of policies.

As in other transition countries, privatisation is taken to be the key for restructuring the economic base of Bosnia-Herzegovina. Most donors have made it clear from the start that only the private sector could benefit from the reconstruction assistance. But at the same time, privatisation has become primarily a political issue, taken out of the context of reconstruction and transition as such. The passage of relevant legislation was delayed and privatisation in both entities only started in 1999. However, there are still many problems in the functioning of the relevant institutions, prospective buyers are few and far between, which combined with the politicisation of the entire process, is likely to prolong the sale of state assets. The dominant focus of the reconstruction programme on supporting private, almost exclusively small and medium enterprises, has been particularly harmful to large industrial enterprises, which were once the main source of employment and output.

Unemployment remains one of Bosnia-Herzegovina's main problems, which threatens to undermine whatever progress has been achieved in stabilising the country after the war. Unemployment is particularly high among refugees and displaced persons. The reconstruction programme, besides its general effect on restarting economic activity and employment, has also included targeted programmes which were supposed to generate both temporary and permanent employment. Targeted programmes, such as public works, micro-credit lines to industry and agriculture, have generally resulted in modest and largely short-term employment. In the absence of a widespread recovery, the overall job generation effect of the reconstruction programme has fallen short of needs.

Most of the new jobs are linked to reconstruction and public administration. Very few jobs have been created through manufacturing, since most of the schemes have bypassed this sector dominated by the large state owned enterprises. Public administration is the only sector where the number of employees exceeds the pre-war figure, which puts additional strain on already precarious public finances. Restricted opportunities for productive employment of a large number of demobilised soldiers, which is likely to increase with further cuts in defence expenditures, is of particular concern for its potential security implications. Given the complexity of the economic situation in Bosnia-Herzegovina, and the fact that economic reforms needed to sustain growth take time, much greater attention should have been given to the issue of job generation in the context of economic reconstruction and transition.

In spite of the novelties of the reconstruction programme, which build on some of the experiences of transition in other ex-socialist countries, and an amount of aid judged to be the highest per capita in recent history, Bosnia-Herzegovina is far from being a sustainable economy and society. Its economy is donor dependent, and the presence of international military and police force is still indispensable for keeping peace and order in the country. Institutions are weak or non-functioning. There is a lack of political consensus at the local level on the key issues of economic reform as well as the implementation of other aspects of the peace agreement, which are the key blocks in rebuilding Bosnia-Herzegovina as

a unified state. Constitutional arrangements set out in the Dayton peace agreement have proved to be an impediment to reconstruction and development. The reconstruction programme itself has been based on a traditional perception that development is essentially a financial and technical matter, which combined with the transition policy prescriptions, has failed to deal with the key obstacles to economic and societal normalisation. As a consequence of all this, continuous and concerted pressure of the international community remains essential for sustaining the reconstruction momentum as well as safeguarding peace.

III. Policy Issues

Reconstruction in the Balkans has to be conceived not as a post-conflict strategy, as was the case after World War II, but as a conflict prevention strategy. The key to conflict prevention in this part of the world is, as has already been stressed, restoration of the rule of law both as it applies externally to relations between states and as it applies internally to everyday life. The pervasive tendencies for clientelism and criminalisation which dominate societies in the region, have to be countered by a system based on respect for law and democratic participation and which can provide a framework for the rejuvenation of the formal economy.

Indeed, restoration of the rule of law is paradoxically both the precondition and goal of any reconstruction effort. There will be no material improvement in the region without a clear legal framework for a market economy and without the eventual elimination of the dominance of the shadow economy. But it is difficult to conceive of the restoration of the rule of law without democratisation, that is to say, without the existence of political regimes that accept the rules within which democracy operates, in particular the notion that conflicts have to be managed in a non-violent way. However, the process of democratisation in turn depends on security both physical and material; it is the atmosphere of fear and insecurity that sustain extremist rulers and generates conflict.

In our view, this vicious circle can only be broken through simultaneous efforts in the fields of security, democratisation and the economy. There are 'islands of hope' in the Balkans – regions or localities or groups of people who are struggling to create a sense of political or economic normality. The challenge is how to build up democratic alternatives to the criminal systems generated by war and nationalism. In this paper, we place particular emphasis on a change of regime in Serbia. Although a change of regime in Serbia does not amount to democratisation, it could help to unblock the situation and allow the beginnings of a process in which improvements in security contribute to political loosening, which in turn would allow for positive developments in the economy. In what follows, we consider each of the main fields in turn; and then discuss what this means for EU strategy.

III.1 Political Settlement and Security

Perhaps the most salient feature of the current situation in the Balkans is the gap in the provision of security, both external and internal. For the time being, that gap can only be filled by the international community.

Up to now, it is possible to distinguish broadly two approaches that have been adopted by the international community. One is the so-called realist approach that focuses on the issues of borders and external security. The realist approach aims at solving problems from above and focuses on borders and external security. The policies adopted place the emphasis on pressure on states or warring parties. They include top-down diplomacy, backed by threats of bombing or sanctions and/or conditionality attached to aid. One variant of the realist approach envisages a solution based on the creation of ethnically homogeneous states and various forms of partition and/or power sharing. Another variant, which is favoured by the United States and is therefore dominant, treats Serbia as a 'rogue state' to be excluded from the international community. Neither variant is able to provide a basis for long-term stability. Both variants leave important sections of society excluded and dissatisfied – refugees in the first case and Serbs in the second – and neither copes directly with the underlying social conditions.

An alternative approach could be described as the humanitarian approach where the problem is perceived primarily as a problem of human rights and of legitimacy. Efforts to protect people, through for example safe havens or humanitarian corridors, to assist the return of refugees, or to support civil society are typical of a humanitarian approach. A humanitarian approach combines 'top-down' policies with 'bottom-up' measures. The emphasis is on the establishment of a transnational rule of law which could provide the basis for agreements about borders and status, and which would combine external and internal security. What does such an approach entail in the current situation?

- 1) The international community has to make it clear that it is willing to stay in the region as long as it takes to reach a permanent political agreement. This applies both to Kosovo and to Bosnia-Herzegovina and, if necessary, also elsewhere. Moreover, it also has to make it clear that it is ready to deploy troops to underwrite a future agreement.
- 2) The international community has to assist with internal as well as external security tasks. This could mean that troops have to undertake policing jobs, or that additional international police are sent, or that reform of local police and judiciaries are undertaken with the assistance of the international community.

- 3) The international presence in FYR Macedonia and also Montenegro may need to be strengthened, as long as there is an explicit request by the governments concerned. This could also be an international civil presence or an OSCE security presence.
- 4) As part of the Stability Pact, the international community needs to develop proposals for common security arrangements for the region as a whole which would encompass overall reductions in military spending, co-operation among armed forces, civilian control of public security services, elimination of paramilitary groups and other private security forces, control of the arms trade, particularly small arms, and common institutions for conflict resolution.
- 5) Such security arrangements could be envisaged within an international co-operative framework that includes both NATO and Russia. One possibility is to build on the Partnership for Peace agreements that have been signed between NATO and several countries of the region and to supplement these agreements with a multilateral approach that includes Russia. Another possibility is to establish a Balkan Helsinki process within the framework of OSCE.

There are currently some 80,000 NATO troops in the region, including 30,000 SFOR troops in Bosnia-Herzegovina, between 32,000 and 35,000 KFOR troops in Kosovo, and a further 10,000 troops in FYR Macedonia and 5,000 in Albania in support of the Kosovo operation. There are also Russian troops as well as troops from neutral countries in Bosnia and Kosovo. These troops, especially in Bosnia-Herzegovina and Kosovo, do reduce the risk of another war as long as they remain in the region. However, they see their role primarily as one of providing external security. Thus the main task in Bosnia-Herzegovina is to separate opposing forces and to control heavy weapons. Although they arrest war criminals, they do not undertake what are traditionally internal security roles; they do not protect returning refugees or help to provide conditions conducive to refugees returns – this is considered to be the job of the police. In Kosovo, the troops are supposed to demilitarise the KLA and protect minorities but they have not been effective in this role so far. They are likely to be most effective in preventing the return of Serbian forces. Thus the presence of outside troops tends to freeze the conflicts that are the immediate reason for war but, as yet, they have failed to cope with the underlying social conditions that lead to violence.

The temporary arrangements that characterise the security situation in the Balkans are, of course, expensive and uncertain. Within this framework, which includes ‘hard’ and ‘soft’ protectorates, the prospects for reconstruction and sustainable development are inevitably weak. The issues of status and territory do have to be resolved. But they have to be resolved by the local actors. The international community cannot impose a solution from above, but it can help provide a long-term framework within which these issues can be resolved. One of the main errors of the international community up to now has

been to focus on possible solutions or outcomes rather than on process and method. The question of where borders are situated can only be settled within a framework in which human rights are respected and conflicts are resolved through non-violent methods. What matters is not so much a specific solution, but what constitutes a legal and legitimate method of resolving these issues.

Many in the international community are currently arguing that a strong position needs to be taken from now concerning respect for borders and that the independence of Montenegro and Kosovo should be opposed because this will encourage further disintegration and Balkanisation as well as conflict between Albania and Serbia. There is much justification for this argument. On the other hand, the Yugoslav federal constitution does include a right for republics to secede. There is surely a political case for arguing that since other former Yugoslav republics have been recognised, it would be wrong to deny Montenegro the same opportunity, especially in view of its current situation as hostage to the Milosevic regime in Belgrade. Moreover, while the legal status of former provinces may be different from former republics which have the right to secede, is it not politically wrong to deny this right to Kosovo on the basis of a legal technicality?

We argue that neither position should be adopted. Any number of solutions are possible. What is important is that any solution is legalised and legitimised and that a politically acceptable framework for making a decision be established. For this to be the case, any permanent political solution has to satisfy the following three conditions:

- it has to be acceptable to the parties involved in the conflict
- it has to be acceptable to other affected countries in the region
- it has to be internationally acceptable

At present, however, the prospects for permanent solutions of this kind in any of the conflicts mentioned above seem remote. A precondition for this kind of agreement is acceptance of the rule of law both between states and within states - the notion that conflicts cannot be resolved through the use of force. It is impossible to envisage respect for the rule of law so long as extremist politicians remain in power, especially but not only in Serbia. And this in turn depends on how far the social conditions underlying violence can be changed. The most the international community can do is to try to create an environment conducive to the establishment of the rule of law through helping to provide security and to reduce the atmosphere of fear that nurtures extremist politicians.

III.2 Democratisation

What is happening throughout the Balkans could be described as an increasing polarisation between pro- and anti-democratic forces, between those seeking to mend the broken relationships in society and those who thrive on the negative dynamics of political extremism and criminality. The latter are strengthened by war and violence. The former have an opportunity to develop in conditions of relative stability, as was the case to some extent after the Dayton agreement and before the recent Kosovo crisis. They benefit from co-operation across borders and from international assistance.

The reconstruction effort has to find ways to strengthen the pro-democratic forces in society. In particular, in the aftermath of the Kosovo crisis, much of the European policy towards the Balkans and the Balkan policy towards Europe will depend on political developments in Yugoslavia, and that mainly means Serbia. At the moment, there are a number of unresolved issues as far as Serbia is concerned and those illustrate quite well the security, political and economic problems discussed above. It is worth noting, however, that it is equally important to strengthen the process of democratisation among Serbia's neighbours. A change of regime in Croatia, which is possible after the next elections, the success of the democratisation process in Montenegro, or further moves towards integration of Bosnia-Herzegovina, will also have knock-on effects on Serbia.

In what follows, we start by outlining the problems of Serbia and Kosovo and then put forward some more general proposals for the region as a whole.

Regime change in Belgrade

For both security and economic reasons, a regional approach is virtually impossible to conceive without political change in Serbia. From the point of view of security, Serbia is an example of a state without clear borders and this poses serious risks for the region as a whole. On one hand, the borders with Bosnia-Herzegovina are fuzzy, to say the least. On the other hand, the internal borders with Kosovo and Montenegro are in the process of becoming international borders.

From the economic point of view, non-inclusion of Serbia into the regional plans for the Balkans would present serious problems not only for Serbia but also for the wider region. Though it would be an overstatement to say that Serbia holds the power of veto on Balkan integration and on the integration of the Balkans into the European Union, there is no doubt that both would be easier if Serbia were involved. There is no need to stress the obvious fact that regional and European integration would also be beneficial to Serbia.

From the political point of view, it is evident that none of the regional and international interests can be satisfied without a political change in Serbia which would lead to the democratisation of the country. None of the Serbian interests can be secured with the current regime. This being the case, the key question is how can the forces for change in Serbia co-operate with the international community and be helped by it?

Some Western leaders have suggested that Yugoslavia should be excluded from the reconstruction process until the Serbian people dispose of the Milosevic regime. The problem with this approach is that it increases the sense of isolation and victimisation that may actually help to underwrite support for the current regime. Some lessons should be learned from the experience with sanctions against Iraq. What is needed instead is an approach that isolates the regime while ending the isolation of Serbian society. The goal is to provide assistance in a way that sidelines the regime.

There are two ways in which this might be done. First, the EU and the international factors involved in the region should give legitimacy to the opposition by including their representatives in the ongoing international political activities. Opposition should include not only party leaders but also representatives of civil society – independent intellectuals and NGOs. Where possible they should also find ways to encourage communication and exchange – through town twinnings, student exchanges, media training and other forms of civil society networking. Secondly, given that Kosovo, although still nominally part of FR Yugoslavia, is under the control of UN and NATO forces, and also given that the Montenegrin government is co-operative, the international agencies should use these channels to help opposition forces and private businesses within Serbia financially and economically. This would require that the current system of sanctions be replaced by a system of selective sanctions aimed at isolating the current government, but not the Serbian economy and polity. In particular, humanitarian assistance should be provided through non-governmental channels directly to those in need.

At present, sanctions only apply to finance, travel for 300 identified members of the regime and to oil, although some countries, notably Russia, the Ukraine and Bulgaria have not imposed oil sanctions. If heating oil is in short supply, this is either because of financial constraints and/or because the regime is only willing to supply oil to the security forces and is using the sanctions as a scapegoat. The mayor of Nis, for example, has suggested that, if the international community were prepared to pay for heating oil, he would go personally to the Bulgarian border together with a group of citizens to escort the oil to his city and to make sure the oil is only used for humanitarian purposes.

An international civil administration in Kosovo

The United Nations has been slow to establish an international civil administration, especially policing. Moreover, as in Bosnia, there is a plethora of international governmental and non-governmental organisations all competing for power with locally organised structures. Already disillusion and frustration is developing within ethnic Albanian society; while the desperation of the non-Albanian minorities represents a serious cause of future problems. There is a risk that the province could develop into a haven for various criminal gangs and that authoritarian tendencies among the Kosovar Albanians may gather pace.

It is important that the UN Administration develop some coherence in the international approach towards Kosovo; there is a real risk that the international community will find itself protecting a closed-in exclusivist authoritarian society. It must find ways to support the development of legitimate self-organised structures and create an environment conducive to democracy. The focus has to be on 'bottom-up' functions; the provision of security; minority rights, the organisation of elections, and support for civil society. There is a tendency, drawing on the experience of Bosnia, to establish various power-sharing arrangements with the Serbian community. This could turn out to be counter-productive given that the Albanian population represents the overwhelming majority. In the end, Serbs will only return if a democratic safe society can be built. In particular, it is important to avoid the creation of divided cities and ethnic enclaves as these could become the source of long-term tension and instability.

Assistance to civil society throughout the region

This is crucial both as a way of strengthening pro-democracy groups and as a way of integrating the region at the level of society. Negative nationalist and criminal networks are much stronger in this part of the world than civic-minded networks. There should be a formal citizens' dimension to the Stability Pact, through which citizens groups could have direct access to decision-makers. This would also provide a mechanism for including Serbian society while continuing to isolate the regime. Assistance to civil society could include:

- *Education.* It is vital to invest in the human resources that are needed to build a democratic political culture. The European Union's programmes on higher education should be extended to the whole region. They need to encourage student and faculty exchanges within the region as well as with the rest of Europe. There is an urgent need to provide assistance aimed at the reform of curriculums and to provide appropriate teaching material including electronic sources and new textbooks especially in the social sciences and humanities. It is also important to encourage the teaching of the different cultures and languages of the region and to organise

Summer Schools and other events which bring together students, young people and teachers from all over the region.

- *Independent media.* Countering state propaganda is an essential element in any programme of democratisation. At present, television tends to be dominated by governments, although those with satellite dishes have access to international networks. This includes both the well-known networks like CNN, Sky or BBC World Service and programmes put out by Diaspora groups, such as the Albanian service broadcast from Geneva. The international administration in Bosnia-Herzegovina did take the lead in initiating a countrywide independent television network and although this does not yet have very wide access, it has had some influence. In the main, independent media tend to be newspapers and magazines or local radio. Independent local radio has had a significant influence especially in Serbia. It is very important to provide material assistance to these independent sources of information and commentary as well as other kinds of assistance such as training and participation in workshops and conferences where key political issues are discussed. It is also important to break the monopoly of state television in several countries, but especially Serbia. One proposal is to establish an independent station in Pristine.
- *Municipalities.* It is important to encourage participation at local levels and to build up municipalities as a check on centralised power. Town twinning within the region and between the region and the rest of Europe is a way engaging a wider array of people in transnational exchanges, fostering discussion about democracy at local levels and even providing various forms of concrete assistance. The experience of Tuzla in Bosnia-Herzegovina, which twinned with the town of Bologna at the height of the war there and has received assistance from a number of cities in Western Europe, offers a concrete example of the advantages of this strategy.
- *Entrepreneurs and Trade Unions.* The business community has an interest in the construction of a rule of law and the elimination of illegal trading and various forms of 'protection'. The establishment of a Balkan Business Forum could provide an opportunity for businessmen from the whole region to meet each other and discuss common interests and problems and even to act as a civil society lobby. The same could apply to trade union organisations.
- *NGOs.* Assistance needs to be provided to a variety of NGOs ranging from those who provide local social services to those who act as advocacy groups on human rights and poverty issues. NGOs can provide a mechanism for individual participation in civic life, they can help to spread the values and norms which underpin democracy and the rule of law, and they can put pressure on governments to check abuse and violations of the law. It is especially important to encourage

women's groups, youth groups and independent trades unions and to provide funding to help establish Balkan-wide networks.

- *Religious institutions.* In this part of the world, churches and mosques have often been the site of nationalist propaganda. However, there have always been religious voices putting forward a message of peace and reconciliation. In recent months, constructive statements from the Serbian Orthodox Church have been heard. Links with Churches in the rest of Europe as well as ecumenical dialogue could help to stimulate and empower the more positive elements in the religious institutions.

III.3 Economic Recovery

Economic recovery in the post-communist Balkans and the progressive integration of all the countries of the region into the European system present some major challenges. The fundamental problems faced by these countries are the dramatic decline and even disappearance of productive capacity, the smallness of the regional market and the high level of investment risks. We argue that while the standard recipes for recovery/liberalisation and monetary stabilisation – need to be applied, they will not be effective unless accompanied by fiscal reform, public investment and micro-economic restructuring.

As the experience of transition clearly illustrates, the key issue is precisely the one of rebuilding the economic base of the Balkan countries. The experience of Bosnia-Herzegovina moreover underlines that the dominant approach, while focusing primarily on the issues of physical rebuilding and macroeconomic stabilisation, has neglected the importance of the process of micro-restructuring, which is necessary if the initial gains from the reconstruction effort are to be sustained. Macroeconomic stability by itself or the trade openness for that matter cannot accomplish the process of restructuring and modernisation that these economies must undergo in order to become internationally competitive. In fact, in some cases, good short term macroeconomic indicators, e.g. price and exchange rate stability, tend to disguise serious mismanagement of these countries. Effective enterprise restructuring is the key to strong growth and exports, and a set of policies supportive of these processes must be included in any programme of reconstruction.

Macroeconomic Measures

Trade policy is the first and key area to look into. The relevant considerations in devising the trade regime and policy are the following: (i) the Balkans are effectively (despite the existing barriers) integrated into the EU, because the EU is and will continue to be their dominant trading partner, (ii) regional trade is, in most cases, small and not expanding fast, (iii) barriers to trade both regional and

those with the EU are significant, and (iv) contractual trade relations with the EU have an important element of asymmetry against the Balkan countries, because of the high level of protection of agricultural markets in the EU (Gligorov, 1999; see also Tables 2 and 3 in Annex I). Liberalisation of trade within the region is vital both to restore the regional market and for political and security reasons. Proposals for liberalising trade with the EU are discussed below.

Monetary policy is the other obvious area to consider. The following considerations are of major importance: (i) the EU is a monetary union, (ii) the German mark is the preferred currency in the region, (iii) monetary authorities have little or no credibility throughout the region, and (iv) the bulk of investments will have to come from abroad.

Taking into account the existing situation, the choice of monetary policy should be determined by the considerations of price stability and of the growth of output. The relationship between stability and growth may not be a straightforward one in many cases, but in the case of the Balkans it could be argued that, for reasons of history and geography, the choices have either already been made or are quite limited. The economies have already made the choice in terms of stability: reliance on foreign currency. Also, their growth will depend significantly on foreign investments. That leads to the use of foreign currency as an anchor for monetary policy. However, this still does not determine completely the actual choice of the exchange rate regime.

Experience with the fixed exchange rate regimes is not altogether encouraging. Experience with the currency boards seems to indicate that this arrangement is preferable to the other types of fixed exchange rate regimes in cases in which significant inflows of foreign money is to be expected. Obviously, if it is to be expected that there will be a significant and sustained flow of foreign investment and finance into the Balkans, the currency board would be preferable for a small and open economy which has had bad history with monetary policy (this description fits most of the Balkan countries). However, if, for various reasons, the inflow of foreign finance disappoints, the currency board arrangement can prove to be a liability, because it will deliver stability, but would sap growth.

What goes for currency boards goes for euroisation too (see also Calvo, 1999). The advantage of euroisation over currency boards is in the elimination of the residual exchange rate risk. This should, *ceteris paribus*, deliver lower interest rates in the euro zone than in the zone with a currency board. Still, the exchange rate risk is only one of the country-specific risks. Other elements of the overall country risk would remain even if the country were to adopt the euro. Albania would not stop being Albania because it adopted euro. It may be the case that the country risk would be lower for the lack of the devaluation risk, but even that may not be the case. Of course, if the banking system were to be run by foreign banks, euroisation would be the right policy choice. However, the rehabilitation and the privatisation of

the banking systems in the Balkans may take a while. And, in addition, the key issue is what can the choice of the monetary regime contribute to restructuring, not what is the best monetary regime in a country where the banking system is mostly owned by foreigners.

Therefore, the choice of monetary policy in the region depends on the overall economic expectations, which depend on all those regimes and policies that support investments and growth. In the end, if integration progresses, the region will join EU monetary union. However, the way to approach this need not be uniform. Monetary policies differ in the Central European countries (mainly as a consequence of the difference in the degree of the effective openness of the respective economy and due to different levels of exposure to foreign debt, accumulated and current) though they all aim at joining the euro zone. The same could be the case in the Balkans.

With this, it is natural to turn to issues of *fiscal policy*. Throughout the Balkans, the states are either bankrupt, run high budget deficits or have a hard time maintaining some kind of fiscal stability. The fiscal problems are essentially the consequence of (i) the collapse of economic activity, and (ii) inefficient fiscal systems.

What the whole debate about the virtues of supply-side economics has come to is the obvious point that growth is good for public finances. The key issue, however, is what system of public finance is good for growth? The current situation in the Balkans is a combination of high taxes, and other sources of revenue, that are a consequence of the collapsing tax base and of tax evasion, rent-seeking and corruption that are, at least partly, a consequence of the high tax rates. Thus, the obvious advice for fiscal reform is to lower the tax rates and to widen the tax base.

This type of fiscal reform would solve only one set of problems. The other would have to do with the fiscal deficit and with the level of public expenditure. For instance, the obligations embedded in social funds can hardly be honoured in full. Thus, a reform of the system of social security is unavoidable. In addition, the set of social services provided by the state has to be re-examined. Finally, much of what passes as the state's function as a redistributor of resources has to be reformed.

What emerges as a system of public finance in the Balkans may very well be a lean state that supports the allocation of resources, but not so much social solidarity and social justice. Whether this would be supportive of long-term growth is another matter. It could be argued that the role of the state in the reconstruction and development of the Balkans should be quite significant. However, the state in the Balkans has proved not to be altogether modernising. Therefore, a small, but efficient state, could be the most one can hope for.

Microeconomic Measures

In a classic article written in 1943, Rosenstein-Rodan argued that in a backward area like South East Europe, the problems of reconstruction were essentially microeconomic in nature. This is still true today, although the priorities may be different.

The first priority, emphasised by Rosenstein-Rodan, concerns the *upgrading of the infrastructure*. The costs of transportation must be brought down, otherwise trade will not prove to be the engine of growth. In addition nowadays, telecommunications are vitally important. The focus should not be merely on physical repair and upgrade but important policy issues related to finance and the quality of services ought to be addressed simultaneously. Every effort should be made to reintegrate infrastructure at the regional level so as to benefit from the economies of scale and ensure that the level of services is sustained. Under the donors' pressure to see the projects implemented quickly, there is a tendency to go for partial solutions which are not technically optimal and are more expensive.

The second priority is the *development of the private sector*. It can be argued that private investment will not be forthcoming, at least not as much as would be desirable, if the local risks are not somehow insured against. This means that as long as private business and especially the local banking sector is not developed enough, investments would have to be insured by the more developed governments. The key issue here is not so much to have price stability, but to have a sound and efficient banking system.

In addition, there is a need for specific schemes, which will facilitate the start up of new enterprises, particularly as the process of privatisation advances. This is necessary because most of these countries do not have substantial experience in micro-business enterprise, particularly outside sectors such as trade, catering, crafts and construction. This, among other things, involves more sophisticated forms of micro-credit finance.

A third priority is *industrial restructuring*. It can be argued that the foreign trade sector must become the engine of growth. Nowadays there is a need for a strategic vision of the kind of viable economic profile to which regions or localities can aspire. Most of these economies are burdened with a large proportion of economically non-viable capital stock, and its replacement is costly and time consuming. The manufacturing sector is usually dominated by mid-tech industries whose product quality is typically low; the proportion of heavy industry is generally significant.

What is needed is a sectoral approach to industrial restructuring along the lines the EU is trying to implement in Bosnia-Herzegovina. This would involve a strategic review of all sectors, particularly in industries with a significant domestic resource content, support to viable companies including the

preparation of privatisation plans, training, encouraging industrial co-operation and the development of industrial associations. In this context the issue of large state enterprises that are too big to be left to the market to restructure should also be addressed. Some form of support for their restructuring is necessary. They have been left in a conceptual and policy vacuum during the process of transition, which has devastated some of these economies' most technically advanced productive capacity. There is also a need to carefully design the donor programmes of financial assistance to enterprises, particularly various credit lines. All too often, donors are reluctant to provide finance for the purchase of equipment and instead focus on small scale credit towards working capital, which in the absence of domestic credit, prevents many enterprises from restarting their activity. Very often, what some of these firms need is a major injection of technology, capital and managerial know-how to turn themselves into a viable business enterprise.

In many cases, this involves a redefinition of a business portfolio, organisational redesign, technological restructuring and the redefinition of the target markets. *Corporate governance* has not been given adequate attention in the process of transition. Existing companies need technical assistance to help them create a new business structure, which would have a potential to survive in the changed environment. This in turn points to the need to formulate some sort of overall development strategy in the process of reconstruction.

Given the scale of change these countries are undergoing, there is a widespread lack of vision at the enterprise level as to what their competitive advantage will be in the long term. Instead, an overwhelming sense of uncertainty and lack of strategic thinking prevail, which reflect the lack of interest in engaging in production, and an attitude of going for quick gains, often in activities of speculative character. Assistance which would improve the level of information exchange and the co-operation between business people in the region would be helpful in breaking up the short-term and locally oriented mentality that are characteristic of the region's business community.

Special attention has to be given to the regional dimension in the process of economic recovery. Municipalities and other bodies dealing with regional development issues should be supported through a range of activities involving the local business community. It is possible to organise training programmes, support business advice centres etc. More flexible schemes that quickly respond to requests at the local level could be developed.

On the basis of the description of the current economic situation in the Balkans and in view of the tasks that reconstruction and recovery should accomplish, our recommendations with respect to economic policy measures are as follows:

Monetary policy: Given the current debate on euroisation, the initial dilemma in the Balkan countries might be whether to pursue any monetary policy at all. However, given that monetary policy is pursued, the real issue becomes the choice of policy. Based on the experience of other countries in transition and emerging markets in general, it can be argued that an independent central bank (instrument independent and not necessarily goal independent) should be the aim. In addition, monetary policy should aim at an interest rate that would be convergent, over a reasonable period of time, to that in the EU. The other powers within the jurisdiction of a central bank (e.g., licensing of commercial banks, supervision of the banking system, restructuring of commercial banks) should be geared towards delivering a low interest rate, i.e., a low cost of financial intermediation.

Exchange rate policy: Assuming that most of the countries in the Balkans will choose to rely on monetary policy, the choice of exchange rate policy will depend on the time distribution of the goals of monetary policy. In a number of cases, fixed exchange rate regimes may have to be used in the period when stability is the dominant worry of the monetary policy. Once policy can focus on growth, one or another type of less irrevocably fixed exchange rate regime should be chosen. The exchange rate policy and monetary policy should, in any case, aim at an optimal mix between exchange rate and interest rate volatility as answers to external and internal shocks. Support of the export sector as a prime motor of development and integration with the EU should be a major consideration.

Fiscal policy: Budgets have to be financed from revenues and public expenditures have to be at a sustainable level. These fiscal goals imply that budget deficits should be kept at reasonably low levels and that the share of public expenditure of the GDP should not be too high (e.g., not higher than one third). As for the system of taxation, it should be simple, business- and employment-friendly as well as convergent with that of the EU (e.g., it should make use of VAT). The tax structure must be targeted in order to support corporate development and thus the growth of employment. Long-term sustainability of social security arrangements (involving substantial reforms) should be high on the agenda.

Trade policy: Regional trade liberalisation is almost mandated by the Stability Pact. The appropriate arrangement would be some kind of a regional free trade area. A number of countries in the region are already members of CEFTA, which means that the two free trade areas could eventually merge into one. However, the key issue is that of trade liberalisation and integration with the EU. Irrespective of the ways in which the process of integration will actually proceed, it should in principle follow the logic of the Europe Agreements extending to cover the so-called sensitive areas too (e.g., agriculture). This means that liberalisation of trade between the countries in the Balkans and the EU should be asymmetric in favour of the former; in other words, EU markets should be opened up more quickly to imports from the Balkan countries. The added protection of the economies in the Balkans should as a rule not extend over more than the medium term and should be designed in such a way as to minimise special protection and

rent-seeking in general. Given these goals and instruments of trade policy, it is to be understood that the main aims of trade policy are allocational and developmental, not fiscal.

Labour market policies: Given the high level of unemployment in the region, labour markets and labour market policies are essential. Three issues are of major importance: first, bringing down existing barriers to employment; second, legalising black market employment, when and where possible; and third, increasing and upgrading training and re-training activities. Strong emphasis should also be placed on reducing long-term and youth unemployment.

Investment policies: The economic policy measures discussed above should lead to an increase in investment opportunities and in the level of investment. Nevertheless, given the general backwardness of the region and given the significant level of microeconomic risk, additional measures should be taken both domestically and internationally to spur investment. This means that the specific risks should be identified and financial institutions devised that would insure investors against these risks. This should be done either via the existing international financial institutions, through the European institutions or through a regional development bank that would be institutionally connected with the development and investment banks in Washington and in Europe. Given that foreign direct investment has proven to be an essential agent of modernisation and development, capital account transactions should be liberalised gradually with the view of securing sustainable and longer term financial inflows rather than short-term capital movements.

Financial sector development: Experience has shown how extremely vulnerable and of key importance is the financial system in transition is. Lessons can be learned concerning the methods and timing of bank restructuring and the sound development of other institutions of financial intermediation. Attention must be given to the close monitoring and the setting-up of regulatory agencies and the building-up of the required expertise. Distortions in the lending operations of financial institutions in the transition are well known and could be partially corrected through the setting up of specific institutions (such as those targeting SMEs or those supporting exports). However, the root causes of such distortions should be dealt with (entry barriers for new entrants, information problems, inherited and evolving stock of bad loans, macroeconomic conditions).

Reconstruction policies: The reconstruction policies designed within the Stability Pact or in other regional initiatives should aim at those reconstruction efforts that would support higher and sustainable investments, specifically of indigenous corporate development (see some of the recent failures of international efforts in Bosnia-Herzegovina in this respect). This means that reconstruction should be aimed at the removal of those fixed costs that are making individual investment projects less than profitable. For instance, the reconstruction and development of infrastructure should have the required

beneficial effect on the overall business activity. Also, in the longer term, reconstruction should aim at supporting industrial production and the spread of modern technology, though in the short and medium term most of the employment will have to come from small and medium sized enterprises specialising in services. To support these activities, the reconstruction should aim at creating financial facilities that would support credits for these kinds of activities.

Human and social capabilities: The process of reconstruction and development requires investment in human and social capabilities. There is a general presumption that human capabilities are abundant in the region, though concrete studies are lacking. On the other hand, social capabilities are generally believed to be underdeveloped. In any case, the reconstruction and development process should take investment into human and social capabilities seriously and should rely on significant resources devoted to technical assistance and to institution building. Such programmes already exist and should be expanded and made more targeted and efficient. External assistance will also be vital in supporting and reforming social security systems, which are in near collapse in most countries in the Balkans.

IV. European and Regional Integration

‘Joining Europe’ in this part of the world has a powerful symbolic significance. On the one hand, the goal of ‘joining Europe’ has been assimilated into the discourse of nationalism as some ethnic groups claim to be more ‘European’ than others. Indeed, it can be argued that competition to join the European Union was a factor in the disintegrative process as better-off regions tried to separate themselves from more backward regions. On the other hand, the term ‘European values’ is widely used by those who favour democracy to contrast themselves from the exclusive and illegitimate stance of the nationalists.

There has been until now a patchwork of institutional and other relations between individual countries of the Balkans and the EU. Diversity and bilateralism have been the name of the game, despite various periodic attempts to add some coherence to the policy pursued by the Union towards the region as a whole.

With one member country in the region, since Greece joined in 1981, the EU now has extensive bilateral relations with two other Balkan countries, namely Bulgaria and Romania, which are included in the list of 11 (to date) candidate countries (10 Central and Eastern European countries plus Cyprus). These relations include trade liberalisation measures in the context of the Europe Agreements; the provision of financial aid, mostly in the form of technical assistance, under the PHARE programme; regulatory alignment as part of the preparation for full integration in the European internal market; and

institutionalised dialogue. These are all now being complemented by Accession Partnerships, which will allow the flow of pre-accession aid to the candidate countries.

However, both Bulgaria and Romania have been until now on the slow track leading to accession, because of the relatively limited progress they have registered in meeting the criteria for membership set out by the European Council in Copenhagen in 1993. On the basis of the progress reports published by the European Commission in October this year (European Commission, 1999), it now appears very likely that the two countries will begin accession negotiations sometime in the year 2000, even though the date of entry may still look rather distant.

Turkey has a customs union agreement as well as a long and turbulent history of institutional relations with the EEC (and later the EU). Its status, concerning eligibility for membership, is still not clearly defined, although there is now a serious possibility that it will be granted the status of candidate country at the European Council in Helsinki next December. It will, however, have a long distance to cover in meeting the political and economic criteria for membership.

The successor republics of former Yugoslavia and Albania are trailing far behind in the race to Brussels: FYR Macedonia and Albania have co-operation agreements, and the others much less, while relations with FR Yugoslavia have been completely frozen for several years, marked by a whole range of official restrictions and embargoes. On the other hand, Slovenia, also a constituent republic of former Yugoslavia, has been promoted out of the Balkan league. Accession negotiations with the EU were opened in March 1998.

The emphasis had been until recently on bilateralism and differential treatment of individual countries. The Royaumont process initiated in 1995 and the so-called Regional Approach towards the Western Balkans adopted in 1997 were the exceptions, which did not substantially change the rule. In recent years, initiatives aiming at regional co-operation in the Balkans have come from both inside and outside the region, with relatively few, albeit not insignificant, results until now.

During the painful transition from communism in the Balkans, marked by the bloody disintegration of former Yugoslavia, the dramatic decline in living standards and the criminalisation of large parts of the economy and society in the region as a whole, the EU has evidently had little success in trying to export stability, democracy and economic development. As it befits a civilian power, the influence which the EU can exert on third countries is generally a function of trade, aid and, most importantly when it comes to European countries, the prospect of membership. The further the prospect of membership, the smaller the influence. Trade and aid are in turn partly dependent on it. This general rule fits very well in the case of the Balkan countries. Furthermore, given the underdeveloped nature of the Common Foreign and

Security Policy (CFSP) until now, when the guns began to sound in the region, the EU had little or nothing to say.

A New Policy for the Balkans

The EU will have to play a central role in any reconstruction effort in the Balkans. It is, of course, a question of moral responsibility; but it is also a matter of wise investment for a region which is close to home. Instability tends to spill over national frontiers; and so do economic and political refugees. Indeed, it can be argued that the future legitimacy of the Union, as has historically been the case for other political entities, depends on the extent to which it is seen to provide both external and internal security. The founders of the European Union envisaged economic integration largely as a means to an end; the goal was to prevent another war in Europe. The prevention of further wars in Southeastern Europe can be viewed as an essential component of any future European identity.

There are already concrete signs, such as the initiative which has led to the adoption of the Stability Pact and the proposals on the Stabilisation and Association Process for the countries of the Western Balkans, which indicate that the EU may be ready to move in this direction. The new Commission should be expected to act as a driving force. Yet, there is still a big gap between general declarations of intent and hard commitments, both in terms of financial resources and institutional perspectives. As the sight of wretched refugees and bombed sites fades away from our television screens, there is indeed a danger that politicians in the prosperous countries of Europe will shift their attention to other domestic priorities, thus leaving the Balkans trapped once again in the vicious circle of economic misery, crippled democracy and insecurity, which has been repeatedly made worse in the past by destabilising foreign interventions.

For the EU to play an effective stabilisation and modernisation role in the region, it will require:

- political will
- financial resources
- innovative ideas.

It will have to offer a clear prospect for the progressive integration of all countries concerned into the European system, even though it will have to make clear that full membership of the EU is not likely to happen before long. The Union needs to enlarge its membership in stages, eventually incorporating all European countries which may wish to join, without sacrificing the goal of ever deepening integration. Generosity and flexibility will need to be combined with conditionality and continuous monitoring. This in turn means that a regional approach is not incompatible with differential treatment of individual countries

as a means of rewarding success, as long as it is based on some generally applicable rules. Thus, an EU regional approach to the post-communist Balkans should in no way be interpreted as a means of delaying the accession to the EU of countries such as Bulgaria and Romania, which are in this respect far ahead of any other country in the region, although still quite a long distance from becoming full members.

In the process, the EU will need to rethink its European policy; to define new categories of associate (or virtual membership); to draw some hard lessons from the experience of Bosnia-Herzegovina; to assess critically the efficiency of established programmes of dispensing aid to third countries; to invent flexible management structures; and last but not least, to decide whether the treaty articles on the Common Foreign and Security Policy (CFSP) are meant seriously or not. If the EU fails to pursue an active policy in the Balkans, it is difficult to imagine where else it would successfully do so (see also Bildt et al, 1997).

Another general question which will need to be dealt with concerns the relationship between increasing participation of the Balkan countries in European integration on the one hand and co-operation/integration at the regional level on the other. There is certainly no incompatibility between the two processes. On the contrary, they should be viewed as closely linked to each other and mutually reinforcing; and the EU should ensure that they remain so.

Regional co-operation/integration is desirable for economic, political and security reasons. But given the history of the region, it may have to proceed at a modest pace, at least initially, and even more so, as long as final political settlements accepted by all parties concerned are pending, especially as regards parts of former Yugoslavia. Past experience seems to suggest that the emphasis, at least in the early stages, should be on low politics, thus offering large scope for the old Monnet method. One thing should, however, be made clear: regional co-operation/integration can never be a substitute for integration in the wider European system. The region is too small in economic terms⁴ and peripheral in geopolitical terms, and none of the countries concerned would accept such an alternative.

Trade liberalisation should be a key component of the new EU policy towards the Balkans. Improved access to trade can be more important than economic aid. Some immediate steps should include:

- As a minimum, the EU should offer tariff-free access for industrial exports from all countries in the region. This is in fact very close to what already applies. This measure could therefore be decided very soon (applicable from 1/1/2000?).

⁴ Although there is undoubtedly considerable scope for growth in intra-regional trade, the latter would start from a very low basis indeed (see Table 3).

- Free access for agricultural exports from the countries of the region will be more difficult to obtain, given the highly protectionist character of the CAP. Liberalisation of agricultural trade is very important, since farming represents a large share of total production in many countries of the region. Liberalisation will, of course, depend on the pace of internal reform of the CAP. As a first step, there should be a generous increase in agricultural export quotas offered to the countries in the Balkans.
- There is now a big asymmetry in trade relations between the EU and individual countries in the Balkans, as expressed by the large deficits incurred by the latter. There is also, arguably, an asymmetry in terms of trade liberalisation between the two sides, working again at the expense of the Balkan countries, because of the restrictions imposed by the CAP in agricultural trade. If anything, this asymmetry needs to be reversed, in order to take into account the different levels of economic development of the two sides. Thus, the timetable for trade liberalisation should allow some breathing space for restructuring on the side of the partners of the EU. Admittedly, transition periods for adjustment are not usually profitably used. Instead, they often provide a convenient excuse for delaying painful decisions. However, immediate liberalisation of external trade in the Balkan countries would further exacerbate the already huge problem of unemployment, while also leading to the permanent closure of many inefficient firms, some of which could survive with proper and timely restructuring. A clear timetable of tariff liberalisation extending to five (?) years should be adopted.
- Liberalisation of intra-regional trade should be applied more easily, thus leading to the creation of a free trade area in the Balkans, which should become part of the wider European free trade area. This could start from the year 2000. However, given the structure and size of individual countries in the Balkans, the immediate prospects for growth in intra-regional trade should be relatively modest (see Table 3). In the context of intra-regional trade, improved relations among the successor republics of former Yugoslavia should allow for at least some part of the old intra-Yugoslav economic exchange to start again. On the other hand, the growth of intra-regional trade, as well as trade with the rest of Europe, very much depends on the improvement of transport networks.

In the world of mixed economies, and especially in the context of the EU and the preparation for accession, trade liberalisation should be intimately linked with regulatory alignment (see also Majone, 1996; Tsoukalis, 1997). A great deal of the effort in preparing the 11 candidate countries for full membership has been spent on the progressive alignment of national rules to the internal market *acquis* on the basis of the White Paper of 1995. Thus, the candidate countries have been required to undertake most of the regulatory adjustment prior to their accession; and sometimes, at a not insignificant cost for them (e.g., environmental rules). The wisdom of this policy is under some doubt.

Although the harmonisation of rules is an essential part of the preparation for EU membership – and this should be clearly the long-term goal for all the countries of the Balkans – too much emphasis on it at an early stage would be counter-productive, given the much lower level of economic and institutional development of the Balkan countries. There is much basic institution building that will need to be done first.

Euroisation could have great symbolic significance as a way of linking the Balkans with EMU and the euro. The replacement of national currencies by the euro should, however, be a gradual process extending over a period of ten years and allowing for different speeds to cater for the special characteristics of individual countries. The progressive euroisation of the Balkan economies needs to be accompanied by technical assistance, financial aid and a whole range of internal reforms, especially as regards the financial sector.

Economic aid should be an integral part of the overall package to be offered by the EU to all the countries of the region. The launching of the Stability Pact needs to be followed by sizeable financial commitments on behalf of the EU and the other potential donors. The amounts committed until now are almost exclusively directed at physical reconstruction in Kosovo. *The European Agency for Reconstruction* (EAfR) should therefore take responsibility for the Balkan region as a whole, while also adopting a wide definition of the term reconstruction.

The political decision to proceed with a comprehensive plan for reconstruction and regional co-operation in the Balkans will need to involve substantial sums of money over a period of years. The EU will have to operate within the budgetary ceiling of 1.27% of GNP until the year 2006. On the basis of present projections of expenditure, this ceiling does, however, leave considerable margin for manoeuvre. Given the small economic size of the region, even modest sums of money by EU standards would represent very substantial transfers for the recipient countries; and there is, of course, a limit to their absorptive capacity. At current market prices and exchange rates, the combined GDP of Albania, Bulgaria, Romania and the successor republics of Yugoslavia (excepting Slovenia and Croatia) is smaller than the GDP of Greece. In other words, it represents approximately 1% of the GDP of EU-15. Thus, annual transfers of the order of 3-5 billion euros to the whole area of post-communist Balkans should be within the limits of the budgetary ceiling of 1.27% for the period 2000-2006; and wisely used, this sum could make a great deal of difference in the region. On the other hand, there is considerable scope for additional funds to be made available in the form of grants from individual donors and loans through the EIB and international financial institutions.

The efficient use of funds will require strict conditionality and continuous monitoring. This in turn implies flexible management structures and a kind of operation which is human resource intensive on behalf of

the donors. Thus, money will not be the only constraint. Lessons will have to be learned from the experience of aid to Bosnia-Herzegovina: the large sums of money spent until now, when they have not gone down the corruption drain, may have produced new bridges and schools. But they have hardly succeeded in creating the conditions for sustainable economic development. The Commission will also need to learn from its own experience in providing structural aid. The experience with aid giving through the PHARE and TACIS programmes for the countries of Central and Eastern Europe and the former Soviet Union leaves something to be desired.

What follows below is an indicative list of priorities for EU economic aid:

Top priority should be given to the improvement of *public infrastructure*, and especially transport and telecommunications networks. Trade liberalisation both within the region and with the EU depends on it. The plans for the pan-European corridors, as an extension of trans-European networks (TENs), are already there. All the countries of the region now need to be involved in the process. The financing should combine official grants, loans as well as other schemes relying more heavily on the private sector. Today in the Balkans, infrastructural investment should be a powerful integrating factor, arguably the equivalent of coal and steel in Western Europe in the 1950s.

Balance of payments aid should be primarily the responsibility of international financial institutions. On the other hand, transfers through the EU budget should be directly linked to progressive euroisation and the *restructuring of the financial sector*, which will be absolutely crucial for economic development. Consideration could also be given to the EU undertaking part of the *social security* burden, especially if this is linked to further restructuring and the laying off of workers. Furthermore, special attention should be given to *private investment and the generation of new employment*, with particular emphasis on new technologies and SMEs. EU grants in this area should be primarily aimed at reducing the high-risk premium of new investment in the Balkans.

A major priority of EU aid should be the whole area of *institution building*. We have now learned from bitter experience that weak institutions and non-transparent rules explain much of the painful and largely unsuccessful transition of post-communist countries in the Balkans. Institution building should involve a great deal of technical assistance from other European countries. Basic groundwork should be followed by progressive harmonisation of rules in anticipation of EU membership.

Given the special characteristics of the Balkans, a good deal of EU aid should bypass central governments aiming at the strengthening of the private economy as well as *civil society and NGOs*. We need to strengthen pro-democracy forces in Balkan societies, which may act as counterbalance to the

centralising and authoritarian tendencies of the state, and also forces which may help to build bridges across frontiers.

High consideration should be given to projects which extend beyond the frontiers of a single country, thus helping to lay the foundations of *Balkan co-operation* and starting mainly in areas of low politics. Transport, energy, telecommunications, water resources as well as visas, frontier control, drugs and organised crime are some examples of the kind of areas in which there is rich scope for Balkan co-operation, with the EU acting, when necessary, as a catalyst. Cross-regional training efforts and corporate support programmes should also be given priority. Regional co-operation should go hand-in-hand with closer integration of the Balkan countries in the EU.

Justice and home affairs already represent a significant part of EU legislation. The gradual lifting of restrictions on the free movement of people between the EU and the countries of the Balkans will have to be directly linked to an ever closer co-operation between the two sides, which should also include the fight against organised crime and drug trafficking.

This finally brings us to *institutional relations*, which should aim at reconciling the new regional approach of the EU with the traditional hub-and-spoke relation between the Union and individual associate members. The new agreements to be signed with those countries of the Balkans, which do not have as yet the status of associate and/or candidate member, should bring with them the institutional and other benefits of association with the EU, including institutionalised dialogue at different levels and gradual access/participation in different EU policies. The speed of integration of each associate member will, of course, vary depending on the ability to meet clearly defined economic and political criteria. At the same time, the new associate members, together with the old ones, will be invited to participate actively in different manifestations of regional co-operation, in which the EU as such will also play a part. The regional dimension of institutional relations should not be limited purely to low politics. It should also include periodic meetings at the ministerial level as well as annual meetings of the heads of state or government.

V. Conclusions

The Stability Pact is an immensely ambitious project. Most of the post-communist societies of the Balkans are deeply disabled. Borders are disputed; the rule of law is weak or non-existent; hundreds of thousands of people have been displaced from their homes and constitute a long-term source of frustration and insecurity; several regimes are characterised by political extremism and disregard for international norms, especially that in Serbia. The economies of the region are on the verge of collapse

with high and unsustainable external deficits, high and increasing unemployment, and, in several cases, with public finance close to bankruptcy. Productive capacity has been destroyed as a result of political disintegration and above all war, and the financial sector hardly functions. In this context, the war in Kosovo and the NATO bombing has left a trail of disasters with political tension mounting in Montenegro, FYR Macedonia and inside Serbia, and further interruptions to trade and production. Both Serbia and Kosovo are likely to face a humanitarian crisis this winter with inadequate power and heating supplies.

In this paper, we have emphasised that the task of reconstruction is not only physical and economic, but also social and institutional. In particular, we argue that a 'bottom-up' approach is required. It should be aimed, first and foremost, at building and enforcing the norms and institutions required to guarantee the rule of law and civil society. The goal is to provide a framework for normalisation of everyday life in which seemingly intractable problems can be managed. Public security, respect for human rights, employment opportunities, functioning health and education systems are all essential components of such normalisation. We also stress the need for an integrative approach to the region as a whole and in relation to the rest of Europe. Without a serious commitment in all fields simultaneously – security, democracy and economy – the Stability Pact has little chance of success.

In the field of security, we argue that the international community has to fill the security vacuum until permanent political settlements can be reached according to international law. This means a continued presence in Kosovo and Bosnia and an enhanced presence in FYR Macedonia, Montenegro and Albania, which may well be in the form of an international civil presence or an OSCE security presence. Moreover, the international community has to develop the capacity for internal as well as external security either through international policing or reform of local police and judiciaries. In the longer term, proposals need to be developed for a regional security system which would reduce military spending and control arms trade, integrate armed forces, eliminate paramilitary groups and criminal gangs, and institutionalise mechanisms for conflict resolution.

We also argue that the key to the establishment of a rule of law is the strengthening of democratic groups and individuals in society. The most important obstacle to the establishment of the rule of law is the existence of undemocratic regimes led by extremist politicians linked in to networks involving security services, criminal networks and paramilitary groups. These regimes should be sidelined; this is especially important in Serbia where a distinction must be drawn between the regime and Serbian society. At the same time, assistance should be provided to democratic opposition groups. It is also important to support democratic developments in neighbouring regions, particularly Montenegro and Kosovo. Throughout the region, the international community should promote civil society and the construction of citizens' networks, through municipalities, schools and universities, independent media, businessmen's

associations, NGOs, and religious institutions. In particular, we propose that there should be a formal citizens' dimension to the Stability Pact.

Economic recovery and, in particular, increased employment opportunities and improved social security can also help to provide the conditions for the rule of law and democratisation. We agree that trade liberalisation both within the region and with Europe, stable currencies, as well as fiscal reform are important for macroeconomic stability. But these measures will not work unless accompanied by an injection of foreign funds and by microeconomic restructuring. The latter must be conceived as part of an overall industrial strategy which includes the upgrading of infrastructure, especially telecommunications, the development of the private sector including schemes for micro-credit and for investment insurance, the restructuring of existing public enterprises, the reform of corporate governance, and local economic development.

Finally, we believe that the European Union has a special responsibility for ensuring the success of the Stability Pact because of its size, proximity, wealth and political importance. The EU model of integration starting with economics and low politics can be fruitfully applied to the Balkan region. In particular, it is very important that the EU improve the trade access of Balkan countries, including tariff-free access for industrial goods and increased agricultural quotas. Trade liberalisation should be complemented with substantial financial transfers on the basis of conditionality and subject to continuous monitoring. We propose that the target for EU aid to the region as a whole should be of the order of 3-5 billion euros annually, extending for a period of at least 5 years. The priorities for aid are public infrastructure, financial restructuring, employment generating projects, especially new technologies and local development, and institution building including public governance and civil society. As regards euroisation, we believe that the conditions are not yet ripe. However, this should constitute a key long-term target for all the countries of the region. The European and more specifically the EU vocation of the Balkans should be clearly recognised and also translated in the appropriate economic, political and institutional terms. Furthermore, European integration and regional integration should be seen as integral parts of the same process.

A serious commitment to the region is important not just for the Balkans but for the whole of Europe. The disintegrative processes that the Balkans have experienced are, unfortunately infectious. A genuine effort to reverse those processes could provide the opportunity for the European Union to redefine its basic mission. Indeed, it could be argued that the future of the European project depends on whether the Union is able to rise to the risks and challenges posed by the situation in South East Europe.

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ANNEX I

Table 1: Basic macroeconomic indicators (1998)

Table 2: Exports to and imports from some major trading partners (% of total, 1998)

Table 3: Intra-regional trade: Exports and imports as % of total (1998)

Table 1

Basic macroeconomic indicators (1998)

	GDP	Industrial production	Consumer Price Index	Unemployment	Current account
Czech Republic	95	79	11	8	-2
Hungary	95	103	14	10	-5
Poland	117	119	12	10	-4
Slovak Republic	100	79	7	16	-10
Slovenia	104	76	8	15	0
Bulgaria	66	48	22	12	-2
Romania	76	46	59	10	-8
Croatia	78	57	6	19	-7
Bosnia and Herzegovina	40	9	16	40	-50
FYR Macedonia	71	47	1	35	-8
FR Yugoslavia	52	46	30	27	-8
Albania	89	28	20	18	-12

Notes: GDP and industrial production are presented as indices where 1989=100. In some cases, retail prices are used instead of CPI. Current account is presented as % of GDP.

Source: National statistics and WIIW Database.

Table 2

Exports to and imports from some major trading partners (% of total, 1998)

	E U		G e r m a n y		I t a l y		R u s s i a	
	X	M	X	M	X	M	X	M
Albania	89.7	75.4	8.3	8.5	59.5	41.8	0	0.3
Bosnia and Herzegovina	51.6	41.8	19.0	14.9	22.7	11.9	0	0.5
Bulgaria	49.7	45.0	10.4	13.7	12.7	7.7	5.5	20.1
Croatia	47.6	59.4	16.9	19.3	17.7	17.9	3.6	4.8
Greece	52.6	63.0	15.4	14.1	10.1	17.4	1.0	1.3
Hungary	73.0	64.1	36.6	26.2	5.8	7.6	2.8	6.5
FYR Macedonia	47.6	55.5	20.5	15.1	10.4	9.4	2.2	0.1
Romania	64.5	57.7	19.6	17.4	22.0	17.4	1.0	9.0
Slovenia	65.5	69.4	28.4	20.7	13.9	16.8	2.6	1.8
Turkey	49.9	47.4	20.5	16.9	5.7	8.8	1.7	4.2
FR Yugoslavia	35.0	40.0	11.7	13.5	12.8	12.1	5.7	11.3

Source: IMF, *Direction of Trade Statistics*; WIW Database

Table 3

Intra-regional trade: Exports and imports as % of total (1998)

	Albania		B & H		Bulgaria		Croatia		Greece		Hungary		FYR Macedonia		Romania		Slovenia		Turkey		FR Yugoslavia	
	X	M	X	M	X	M	X	M	X	M	X	M	X	M	X	M	X	M	X	M	X	M
Albania	..	..	0	0	0	3.4	0	0.8	1.3	23.5	0	0.9	1.8	1.6	0	0.6	0	0.8	0	0	0	0
Bosnia and Herzegovina	0	0	..	..	0	0.4	29.0	29.5	0	0	0	5.5	0	0	0	0.6	8.6	14.0	0	1.6	..	..
Bulgaria	0.6	0	0.3	0	..	..	0.2	0.1	8.8	5.9	0.8	0.7	2.3	0.8	1.2	1.2	0.7	0.4	7.9	2.6	2.2	0.8
Croatia	0	0	14.4	1.9	0	0.1	..	..	0.2	0.2	1.1	2.5	1.4	0.7	0.2	0.2	9.5	8.6	0.2	0.3	0	0
Greece	1.6	0	0	0	2.4	1.4	1.7	0	..	..	0.5	0.3	0	0.4	1.7	0.7	0.2	0.1	4.1	1.2	0.8	0.1
Hungary	0.1	0	0.6	0	0.2	0.1	0.9	0.2	0.3	0.2	..	..	0.1	0	2.5	0.7	1.1	0.6	0.4	0.3	0.6	0.2
FYR Macedonia	1.0	0.3	0	0	2.6	5.4	3.6	4.2	1.6	2.1	0.3	1.3	..	..	0.3	0.3	3.3	9.0	2.4	4.9	9.6	12.0
Romania	0.1	0	0	0	0.9	0.4	0.2	0	2.4	1.7	2.6	4.6	0.1	0	..	..	0.4	0.4	3.9	2.3	0	0
Slovenia	0	0	3.5	0.5	0.2	0.5	9	4.3	0.3	0.2	1.6	2.4	1.8	0.5	0.5	0.2	..	..	0.6	0.4	1.1	0.7
Turkey	0.2	0	0.1	0	0.4	0.7	0.1	0	0.1	0.1	0.5	0	0.3	0	0.9	6.9	0	0	..	..	0	0
FR Yugoslavia	0	0	18.9	5.9	1.4	1.8	2.5	0.5	4.3	4.2	..	..	9.3	6	1.7	1.7	1.6	1.6	0	1.5	..	..

Source: IMF, *Direction of Trade Statistics*; WIW Database

ANNEX II

List of Participants at the Meeting held in Vouliagmeni, Greece, 8-10 July 1999

LIST OF PARTICIPANTS

Meeting held in Vouliagmeni, Greece on 8-10 July 1999

- Anastasakis, O.**, Research Officer, The Hellenic Observatory, LSE
- Avgouleas, S.**, Secretary-General, Ministry of National Economy, Athens
- Bicanic, I.**, Professor, Institute of Economics, Zagreb/ C.E.U., Budapest
- Bishev, G.**, Vice-Governor, National Bank of Macedonia, Skopje
- Bojicic, V.**, Research Fellow, Centre for the Study of Global Governance, LSE
- Daianu, D.**, Former Minister of Economics, Bucharest
- De Largentaye, B.**, Policy Planners, Ministère des Affaires Etrangères, Paris
- De Menil, G.**, Professor, Ecole des Hautes Etudes en Sciences Sociales, Paris/CRPE, Bucharest
- Dimitrov, V.**, Lecturer, Department of Government, LSE
- Dinkic, M.**, Professor of Economics, University of Belgrade
- Djunic, D.**, President, Economic Institute, Belgrade
- Artugrul, O.**, Embassy of the Republic of Turkey, Athens
- Faber, M.**, Secretary General, Interchurch Peace Council, The Hague
- Gehart, F.**, Consultant & Former Envoy, Ministry of Foreign Affairs, Vienna
- Gligorov, V.**, Senior Economist, The Vienna Institute for International Economic Studies
- Hughes, K.**, Director, The European Institute Policy Unit, LSE
- Ivanic, M.**, Professor, University of Banja Luka, Former Presidential Candidate
- Ioakimides, P.**, Advisor, Ministry of Foreign Affairs/University of Athens
- Kaldor, M.**, Director, Global Civil Society programme, LSE
- Kekic, L.**, Director of Transition Economies, Economist Intelligence Unit, London
- Krastev, I.**, Director, Centre for Liberal Strategies, Sofia

Kusljugic, M., Dean, Faculty of Electrical and Mechanical Engineering, University of Tuzla

Lampsa, P., Special Advisor to the State Secretary, Office of the Prime Minister of Greece

Landesmann, M., Scientific Director, The Vienna Institute for International Economic Studies

Novak, T., Professor, Institute of World Economics of the Hungarian Academy of Sciences, Budapest

Padoan, P.C., Professor, University of Rome & Advisor to the Prime Minister, Rome

Pashko, G., Professor, University of Tirana & Economic Advisor to the Prime Minister, Tirana

Pavlova-Sylvanskaya, M., Editor, Foreign Policy Journal, Moscow

Poeschl, J., Senior Economist, The Vienna Institute for International Economic Studies

Simic, P., Professor, Institute of International Politics and Economics, Belgrade

Stacher, U., Director General, Austrian Federal Chancellery, Vienna

Swoboda, H., Member of European Parliament

Theodoropoulos, V., Former Secretary General, Ministry of Foreign Affairs, Athens

Tsoukalis, L., Professor/Director, The Hellenic Observatory, LSE

Vejvoda, I., Executive Director, Fund for an Open Society, Belgrade

Veremis, T., President, Hellenic Foundation for European and Foreign Policy/University of Athens

Vukotic, V., Professor of Economics, University of Podgorica

Wallden, S. A., DG1A, European Commission, Brussels

Woodward, S., Senior Research Fellow, King's College, London/Brookings Institution, Washington DC