The Transition Twelve Years After - Specific Problems of Southeast Europe

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1. The Transition Twelve Years After – Changing Perceptions

Over the last twelve years there has been a growing differentiation among transition economies.[1] Economic systems and economic performance in Central and South Eastern Europe today are much more heterogeneous than in 1989, or even five years ago. Some countries have progressed faster and gone further towards a market economy than others. Twelve years on, some countries are approaching the finishing line and are about to join the EU; a few are barely off the starting point; others are somewhere in between, at various points along the track. Whereas in 1989, socialist countries from Eastern Europe had many features in common, today we can distinguish at least four distinct groups, primarily on the basis of their status vis-à-vis the EU:

- the eight countries in Central Eastern Europe (the three Baltic states, the Czech Republic, Hungary, Poland, the Slovak Republic, and Slovenia) which – together with Cyprus and Malta – are envisaged to join the EU on 1 May 2004;
- the two associated countries lagging behind – Bulgaria and Romania – scheduled to join in 2007;
- the five non-candidate countries in South East Europe (SEE) – Albania, Bosnia and Herzegovina, Croatia, Macedonia and Serbia and Montenegro – which today are all included in the EU's 1999 Stabilisation and Association Process introducing prospects of EU membership at a future date; Croatia is the only one that has applied for candidate status;
- the countries from the former Soviet Union which are not, and are probably unlikely to be in the near future, anywhere near the prospect of EU membership.

1 This section is mainly based on the paper by Uvalic and Nuti (2003).

After the fall of the Berlin Wall in November 1989, which marked the beginning of the transition to a market economy of countries in Central and South East Europe, the perceptions of the transition process were very different from those of today. In particular:

- a number of issues were overemphasised, such as the importance of speedy privatisation;
- a number of problems were underestimated, such as the overall costs of transition, since the expectations were generally far too optimistic;
- a number of problems were neglected or simply ignored, such as the importance of private and public governance; and finally,
- a number of new problems have emerged as a by-product of the transition which initially were not anticipated, such as financial pyramid schemes, or diffused corruption.

The transition strategy initially suggested and actually implemented by the majority of countries in transition included the following main elements:

(1) liberalisation of prices and of foreign trade and macroeconomic stabilisation;
(2) privatisation, capacity restructuring, and the creation of a viable financial sector, the latter two elements both treated as a simple by-product of privatisation; and
(3) legal and institutional reforms.

It was hoped that liberalisation and macroeconomic stabilisation could be undertaken fairly quickly, as well as privatisation of small-scale enterprises. The privatisation of large-scale enterprises and legal and institutional reforms were expected to take longer and be implemented more gradually, hence the rush to mass privatisation in order to speed up the process. What has been the actual outcome?

(1) In most cases liberalisation and macroeconomic stabilisation have been implemented successfully. However, some of the consequences have not been perceived or anticipated correctly. The transition and the overshooting of stabilisation led to a dramatic fall in output and

labour productivity. The incidence of absolute poverty, unemployment and inequality (as measured, for instance, by the Gini coefficient) have seriously increased. There were also other negative social and demographic trends, such as an increase in morbidity and mortality, as well as worse access to education, pensions and welfare. In South East Europe, some of these problems are particularly striking, as will be seen in the following sections.

(2) Initial debates on privatisation and restructuring mainly concentrated on the choice of privatisation methods, giving particular importance to speed. Advocates of mass privatisation, through the free or subsidised distribution of vouchers to the population, did not anticipate that this method would not resolve other equally important issues, such as enterprise restructuring or more efficient corporate governance mechanisms, access to better management and technical know how or additional investment funds. Actual experience has clearly demonstrated some of the negative features of voucher privatisation, especially if other ingredients are lacking, such as a proper legal framework (as in the case of the Czech Republic). More gradualist approaches to privatisation based on a combination of various methods, such as those pursued in Hungary, Poland or Slovenia, proved to be more effective and more conducive to enterprise restructuring and good governance.

Though privatisation was undoubtedly an important part of initial reforms, other important complementary conditions also need to be met in order to increase enterprise efficiency, including the introduction of hard budget constraints, competition and anti-monopoly legislation, more effective mechanisms of corporate governance, a legal structure to protect property rights, and so forth. Indeed it turns out that these conditions on their own can deliver many of the advantages expected of privatisation.

(3) The last group of transition issues includes legal and institutional reforms. These reforms have generally been somewhat neglected and slow to implement, irrespective of the country considered, since institution-building takes time. In the late 1980s, only a few countries possessed some form of market-type institutions (Hungary, Poland, and the former Yugoslavia), while in most countries they had to be built from scratch. Particularly in the area of financial reforms and the development of capital markets, change has been extremely slow. Measures aimed at introducing efficient institutional change did not, in many cases, bring the expected results quickly.

Therefore, from today's perspective, the results of twelve years of economic reforms in transition countries have in many ways diverged from initial expectations, in part because of excessive optimism. Considering that in 1989 there were no blueprints on how to implement such a systemic reform, involving the radical change from a socialist to a capitalist market-based economy, this is not surprising. In the meantime, in academic and policy-oriented debates, the emphasis has shifted to related but somewhat different issues. Without being able to cover all the relevant topics, we will mention only some of the issues that have become central in current discussions.

- *Longer-term issues*, including the determinants of economic growth, catching up and convergence prospects, and conditions and constraints for sustainable development – as opposed to the earlier emphasis on short-term measures of liberalisation and stabilisation.

  As suggested by various studies, the possibilities for CEE and SEE countries to catch up or even narrow their income gap with respect to existing EU members are not particularly bright. It has been proposed that the criteria by which countries are being evaluated today are inappropriate. According to Mencinger (2003), macroeconomic performance ought to be judged on the basis of the sustainability of growth in relation to the situation on the current and capital accounts, or the 'intrinsic or inherent economic growth' which an economy can attain without reliance on foreign assistance, foreign loans or sale of assets to foreigners.

- The role of *active government policies* in certain areas – contrary to the initial widespread belief that free markets would take care of everything. In agriculture, trade liberalisation has been implemented to such an extent that farmers in EU countries are today far more protected than those in most transition countries. Not surprisingly, protectionist measures have indeed gained strength in CEFTA countries in recent years. Moreover, several Central and East European countries joining the EU in 2004 will have to re-introduce tariffs vis-à-vis third countries for a wide range of products, in order to align them with EU tariff levels. The need to implement some type of industrial policy has also emerged, especially in the economically less developed countries.

- Some neglected *microeconomic issues*, such as de-monopolisation and ensuring fair competition; measures to improve entry conditions through greater deregulation, and exit conditions through more adequate bankruptcy laws and procedures; increasing transparency in company law regulations – as opposed to the earlier almost exclusive emphasis on a stable macroeconomic environment as the main precondition for attracting foreign investors;

- The importance of *good governance* at both the microeconomic and macroeconomic level – namely, the issue not only of improving corporate governance in enterprises, but also of public governance, and the related need for speedy and efficient reforms of the public administration.

What are the lessons for the laggards, countries where the transition is proceeding at a slower pace, including the countries in SEE? The most common view, particularly within the major international financial organisations – the International Monetary Fund, the World Bank, the European Bank for Reconstruction and Development – has been that countries lagging behind ought to follow a similar path as the forerunners, in line with the so-called 'Washington consensus'. However, there are areas where radical reforms are more urgent than in others.

There is no doubt that any economy that relies on market mechanisms of resource allocation, regardless of the scope of state ownership or the importance of other political or economic priorities, needs to use at once market-clearing, single prices; to abolish state foreign trade monopoly and quantitative restrictions and to open trade and investment to all; to mobilise entrepreneurial energies through legalisation and encouragement of private enterprise; and to seek a stable macroeconomic environment.

Other aspects of economic policy are open to a much wider choice than is, or was ever, contemplated by the 'Washington consensus' of the early 1990s (see Stiglitz, 2002). The speed of dis-inflation does not have to be fast at all costs; indeed it is no accident that one of the most successful transition economies, Poland, in spite of its shock therapy reputation, should have dis-inflated over twelve years at an excruciatingly slow pace. Trade opening does not have to be instantaneous, unilateral and total; some priority sectors may need to be protected for a certain period in order to avoid the immediate negative impact of foreign competition. This is precisely what lies behind the ‘asymmetric’ trade concessions given by the EU to Central East European countries in the Association Agreements –the possibility for these countries to delay trade opening in selected sectors. Central bank independence can be granted without following and exceeding the Bundesbank model (as has happened in several cases). Hard budget constraints in the public sector should apply to public debt, not necessarily to budget deficits regardless of expenditure composition, unless they impinge on the sustainability of debt.

In addition, other crucial areas of reform must not be neglected, as has often been the case. These include labour redeployment, finding ways to create jobs for the unemployed; restructuring the capacity and finances of major loss-making enterprises; reforms and re-capitalisation of the banking sector; substantial downsizing of the state sector through the redeployment of assets; radical legal and fiscal reforms; and anti-corruption measures and the strict implementation of the rule of law.

Within such general trends and reflections on twelve years of transition, where do South East European countries stand today? How far are these countries on their transition path? In which way is the general economic situation today better or worse than in other transition countries? In what follows, we will first point to some specific features of the transition in South East Europe, and then consider, in greater detail, three groups of issues:

- Macroeconomic performance of SEE countries since the early 1990s;
- Progress with institutional reforms required by the transition;
- Role of international finance.

The wider definition of the SEE region will be adopted which comprises all seven transition countries in SEE – Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Former Yugoslav Republic of Macedonia (FYROM), Romania, and Serbia and Montenegro (or the SEE-7). Occasionally however, only the five countries of the so-called Western Balkans will be considered (or the SEE-5, which comprises the same group of countries but without Bulgaria and Romania).

2. Specific Features of the Transition in SEE

Due to extreme political instability during the 1990s, the transition to multiparty democracies and market economies has clearly proceeded at a slower pace in South Eastern Europe (SEE) than in many other areas of the former communist world. Although the SEE region today is rather heterogeneous, these countries also face a number of similar political and economic problems. This applies primarily to the five countries of the so-called Western Balkans – Albania, Bosnia and Herzegovina, Croatia, Macedonia, and Serbia and Montenegro (until February 4, 2003 the FR of Yugoslavia which formally also includes Kosovo) – though some common problems are also shared by the other two SEE transition countries, Bulgaria and Romania.

Starting from the early 1990s when the Socialist Federal Republic of Yugoslavia disintegrated, the region has experienced military conflicts in practically all the five of its successor states, nationalistic policies which imposed priority of political over economic objectives, and ethnic strife and policies of ethnic cleansing, accompanied by massive migrations of the population both within the region and abroad. FR Yugoslavia has remained isolated from the rest of the world throughout most of the decade, under political and economic sanctions of the international community and the NATO bombardments in 1999, which have had additional destabilising effects on the whole SEE region. Although the political situation has greatly improved in the meantime following the radical political changes in Croatia (early 2000) after Tudjman's death, and in Serbia after the end of the Milosevic regime (October 2000), the continued presence of protectorates/semi-protectorates, and the recent assassination of Prime Minister Djindjic, are clear signs that permanent stabilisation in SEE has not yet been fully achieved.

These highly unfavourable political circumstances in SEE throughout the 1990s have left very deep traces on the political, economic, social, cultural and other characteristics of the single SEE countries, which unfortunately are felt still today. The political events of the 1990s have substantially delayed not only more radical political reforms towards democratisation and establishment of functional states, but also economic and institutional reforms, both of which have direct implications for the process of integration with the European Union (EU).

The economic implications of these events have been particularly devastating for those countries directly affected by them, namely most countries of former Yugoslavia, as they have negatively influenced the course and speed of transition. Many important economic reforms have been substantially delayed, while those that have been implemented have been carried forward in a distorted way. Not surprisingly, the economic characteristics of the SEE countries are today somewhat different than those of transition economies in Central and Eastern Europe (CEE); but they are also different from those in the Commonwealth of Independent States (CIS).

At the heart of the most pressing economic problems in SEE are a number of internal constraints on growth and development, which in some countries are aggravated by externally-imposed reform agendas, aid-dependency and inappropriate international assistance policies. Despite a large amount of international, particularly European Union (EU), multilateral and bilateral assistance extended to SEE countries throughout the 1990s, this region has remained one of major political and economic instability, characterised by recurrent economic crises, reform backsliding, reversals in macroeconomic stabilisation and in economic recovery (see Hoey and Kekic, 1997). Although the first decade of transition in Central and Eastern Europe has produced important lessons on the sequencing of reform measures, mistakes from the early years of transition have been forgotten only too easily in those SEE countries which have embarked on radical reforms later (see Uvalic and Nuti, 2003).

Most SEE countries have also greatly delayed establishing closer relations with the European Union (EU). It was only in 1999, after the end of the NATO bombardments of FR Yugoslavia, that the EU launched the Stabilisation and Association Process for the five countries of the Western Balkans, which introduced a series of important measures to support transition in the SEE-5, including generous trade preferences, contractual relations through the signing of Stabilisation and Association Agreements, ongoing political dialogue, the CARDS programme of financial assistance (€ 4.65 billion over the 2000-2006 period and an additional € 210 million proposed in Thessaloniki in June 2003), and even prospects of future EU membership (see Uvalic, 2003a).

In the meantime, joining the EU has become a top political priority for all countries in the region, though only two have so far signed a Stabilisation and Association Agreement – Macedonia and Croatia. In December 2002, the Copenhagen Council underlined the European perspective of the countries of the Western Balkans. More recently, at the June 2003 Thessaloniki Summit, the EU again confirmed its determination 'to fully and effectively support the European perspective of the Western Balkan countries, which will become an integral part of the EU once they meet the established criteria' (Presidency Conclusions, Thessaloniki European Council, 2003). Despite the announced intentions, for most SEE countries the prospects of EU membership are likely to be fulfilled only in the medium to long-term. A key challenge for SEE countries today is to carry forward the transition to a market economy and create sound conditions for self-sustainable economic growth, at the same time integrating with neighbouring countries through regional cooperation, as part of the preparations for future EU membership.

3. Macroeconomic Performance

All SEE countries started the transition to a market economy in 1989-90, but continued with economic reforms at variable speed as a consequence of a number of country-specific factors. As elsewhere in Central and Eastern Europe, initial measures of transition have had a number of negative economic and social consequences, including high inflation, a substantial fall in output, and a rise of unemployment, social differentiation, inequality and poverty; but in SEE these problems have been of much greater scope than in CEE, as will now be illustrated in detail.

Regarding macroeconomic stabilisation, all countries in the region have gone through episodes of very high inflation, even hyperinflation, especially the countries of former Yugoslavia following the disintegration of the country in 1991-92. Several SEE countries have also had unsuccessful attempts to stabilise the economy during the past decade. Nevertheless, by now, *inflation* has been substantially reduced in practically all SEE countries (Table 1). The only exceptions are Romania and Serbia and Montenegro: in spite of clear signs of improvement in recent years, average inflation in 2002 still remained in double-digit figures. The relatively high inflation in Serbia and Montenegro is primarily due to the short-term effects of measures of substantial price liberalisation following the political changes in October 2000, and it is expected to fall further, below 10 per cent, in 2003.

However, the situation is much less satisfactory regarding fiscal accounts. In most SEE countries, the structure and level of public expenditure has not changed much in recent years. Public expenditure remains particularly high in Bosnia and Herzegovina, at 61 per cent of its GDP, which clearly is not sustainable (Table 2).

In addition, government tax-collection capacity has not improved much. Little has been done to suppress the informal economy, while general government revenues have been unstable under the impact of ongoing fiscal reforms. The public deficit remains relatively high in most countries, ranging from four per cent to eight per cent of GDP (Table 3). These problems on the fiscal side could prove to be a serious impediment for maintaining macroeconomic stability in the future, as has proved to be the case in the past.

Growth prospects in SEE countries for the next five years are fairly good (see EBRD, 2002), but economic recovery after the deep recession of the early 1990s has not been sufficient to compensate for the earlier very substantial fall in output. In part, this is due to the fact that in all countries except Bosnia and Herzegovina there has been a reversal in the trend after recovery, with negative growth rates registered in the second half of the 1990s (Table 4).

Table 1. Inflation in SEE Countries, 1989-2002 (change in annual average retail/consumer price level, in per cent)

	1989	1990	1991	1992	1993	1994	1995
Albania	0.0	0.0	35.5	226.0	85.0	22.6	7.8
Bulgaria	6.4	26.3	333.5	82.5	73.0	96.3	62.0
Bosnia & Herzegovina (Total)	1,268.0	588	144	--	--	--	--
--Federation	--	--	--	73.1	44.069	780	-4.4
--Republika Srpska	--	--	--	74.461	2.233	1,061.0	12.9
Croatia	na	609.5	123.0	665.5	1,517.5	97.6	2.0
Macedonia	1,246.0	608.4	114.9	1,664.4	338.4	126.5	16.4
Romania	1.1	5.1	170.2	210.4	256.1	136.7	32.3
Yugoslavia	1,269.0	593.0	121.0	9,237.0	116.5×10^{12}	3.3	78.6
Mean in 27 Transition Countries	316.4	219.2	120.7	1,080.3	1,074,5	1,262.2	176.3

	1996	1997	1998	1999	2000	2001
Albania	12.7	33.2	20.6	0.4	0.1	3.1
Bulgaria	123.0	1,082.0	22.2	0.7	9.9	7.4
Bosnia & Herzegovina (Total)	--	--	--	--	--	--
--Federation	-24.5	14.0	5.1	-0.3	1.9	3.3
--Republika Srpska	16.9	-7.3	2.0	14.0	14.7	11.0
Croatia	3.5	3.6	5.7	4.2	6.2	4.9
Macedonia	2.5	1.5	0.6	-1.3	6.5	5.3
Romania	38.8	154.8	59.1	45.8	45.7	34.5
Yugoslavia	94.3	21.3	29.5	37.1	60.4	91.3
Mean in 27 Transition Countries	85.6	68.7	16.7	27.2	20.6	15.3

Source: EBRD (2001): 61, 125 and EBRD (2002): 60, 129

Table 2. General Government Revenues and Expenditure in SEE Countries (as per cent of GDP), 1995-2001

	1995		1996		1997		1998		1999		2000		2001	
	Rev	Exp	Rev	Exp	Rev	Exp	Rev	Exp	Rev	Exp	Rev	Exp	Rev	Exp
Albania	23.4	33.4	18.3	30.3	16.9	29.4	20.3	30.7	21.3	32.7	22.4	31.4	23.0	31.5
Bosnia & H.	39.0	39.3	0.5	52.7	39.2	39.7	57.3	65.3	60.4	69.5	56.3	66.4	55.0	61.3
Bulgaria	35.7	41.3	31.7	42.0	30.7	32.7	35.4	34.5	40.7	41.6	41.4	42.4	36.6	37.4
Croatia	43.5	44.9	44.3	45.3	42.5	44.4	45.6	46.7	43.2	49.7	41.7	48.8	40.2	46.0
Macedonia	37.9	39.0	35.7	37.1	34.8	35.1	33.3	35.0	35.4	35.4	36.7	34.2	34.3	40.6
Romania	31.4	34.7	28.9	33.8	27.1	34.0	28.1	34.9	31.1	35.6	31.5	35.1	31.2	34.6
FR Yugoslavia	na	na	na	na	na	na	na	na	na	na	39.2	40.1	41.5	42.8

Source: EBRD (2002): 62-63.

Table 3. General Government Balances in SEE Countries (as per cent of GDP), 1994-2002

	1994	1995	1996	1997	1998	1999	2000	2001 (estim.)	2002 (proj.)
Albania	-12.6	-10.1	-12.1	-12.6	-10.4	-11.4	-9.1	-8.5	-8.0
Bosnia & H.	na	-0.3	-4.4	-0.5	-8.0	-9.1	-10.1	-6.3	-5.5
Bulgaria	-3.9	-5.7	-10.3	-2.0	0.9	-0.9	-1.0	-0.9	-0.8
Croatia	1.2	-1.4	-1.0	-1.9	-1.0	-6.5	-7.1	-5.8	-4.6
Macedonia	-2.7	-1.0	-1.4	-0.4	-1.7	0.0	2.5	-6.3	-4.4
Romania	-2.2	-2.5	-3.9	-4.6	-5.0	-3.5	-3.7	-3.5	-3.0
FR Yugoslavia	na	-4.3	-3.8	-7.6	-5.4	na	-0.8	-1.9	-5.6
Averages for: - 9 CEE countries (with Croatia)	-2.2	-2.5	-2.3	-2.0	-2.8	-4.1	-3.3	-3.4	-4.1
-6 SEE countries	-5.3	-4.0	-6.0	-4.6	-4.9	-5.0	-3.7	-4.6	-4.6

Source: EBRD (2002): 61.

Table 4. Growth in Real GDP in SEE Countries, 1989-2002

	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	GDP in 2001 (1989=100)
Albania	9.8	-10.0	-28.0	-7.2	9.6	8.3	13.3	9.1	-7.0	8.0	7.3	7.8	6.5	6.0	116
Bosnia & H.	n.d.	-23.2	-12.1	-30.0	-40.0	-40.0	20.8	86.0	37.0	9.9	10.6	4.5	2.3	3.0	na
Bulgaria	0.5	-9.1	-11.7	-7.3	-1.5	1.8	2.9	-9.4	-5.6	4.0	2.3	5.4	4.0	4.0	80
Croatia	-1.6	-7.1	-21.1	-11.7	-8.0	5.9	6.8	6.0	6.5	2.5	-0.9	2.9	3.8	3.5	85
Macedonia	0.9	-9.9	-7.0	-8.0	-9.1	-1.8	-1.2	1.2	1.4	3.4	4.3	4.6	-4.1	2.0	77
Romania	-5.8	-5.6	-12.9	-8.8	1.5	3.9	7.1	3.9	-6.1	-5.4	-3.2	1.8	5.3	3.5	84
Yugoslavia	1.3	-7.9	-11.6	-27.9	-30.8	2.5	6.1	7.8	10.1	1.9	-18.0	5.0	5.5	3.0	50
Aver. in 27 Transition Countries	0.3	-3.3	-8.1	-11.0	-6.9	-6.1	-0.2	0.1	2.3	-1.0	3.0	5.5	4.2	3.4	76

Source: EBRD (2002): 58.

Table 5. Level of Development of SEE Countries

	Population 2002 (mln)	Real GDP Index 2002 1989=100	GDP per capita 2002 US$ (current prices)	GDP per capita 2002 US$ (at PPP)	GDP per capita 2000, as % of EU average
Albania	3.2	112.4	1,470	4,200	10.7
Bosnia & H.	4.2	69.7	1,350	5,750	12.9
Bulgaria	7.8	83.3	1,990	7,060	21.8
Croatia	4.4	86.9	5,050	9,950	29.4
Macedonia	2.0	78.5	1,820	6,500	13.8
Romania	22.4	88.2	2,040	6,510	18.5
Serbia & Mont.	10.7	50.5	1,890	4,920	12.4

Source: Economist Intelligence Unit (2003a): 4; Grabbe (2001). Data on Serbia and Montenegro do not include Kosovo.

Thus still today, none of the SEE economies except Albania, which has had exceptionally high growth rates throughout most of the 1990s due to a very low start, have reached the level of Gross Domestic Product (GDP) achieved in 1989. SEE countries remain underdeveloped, and will clearly have serious problems catching up with the other more advanced transition economies.

There are presently wide differences in SEE in the achieved level of *economic development*, wider than among CEE countries (Table 5). In 2002, the richest country was Croatia, with a GDP per capita at current prices of over US$5,000 (or almost US$10,000 at Purchasing Power Parity – PPP), while the poorest was Bosnia and Herzegovina with a GDP per capita at current prices of US$ 1,350 (or US$ 5,750 at PPP), which in 2000 corresponded to only around 10-30 per cent of the EU average.

The present low level of development in SEE countries is also reflected in the structure of their economies, though with enormous differences across countries. Agriculture contributes a dominant proportion of output only in Albania (over 50 per cent of GDP), while all the other countries have reached a much higher level of industrialisation. In some cases, as in Bosnia and Herzegovina, Croatia and Macedonia, the contribution of services to GDP is close to or over 60 per cent (Table 6).

Table 6. Sectoral Structure of GDP in SEE Countries, 1999

	Agriculture	Industry	Services
Albania	52.6	25.4	22.0
Bosnia & H.	10.0	29.4	60.6
Bulgaria	17.3	26.8	55.9
Croatia	9.2	31.6	59.2
Macedonia	11.0	31.1	57.8
Romania	15.5	36.2	48.3
Yugoslavia	18.1	38.9	43.0

Sources: UNECE (2001): 106 and 134.

The social costs of the transition in SEE have been high. Most countries have not successfully undertaken measures to create new jobs for workers being laid off. Except for Romania, the official unemployment rates today are extremely high (Table 7).

Table 7. Unemployment Rates in SEE (per cent of labour force)

	1998	1999	2000	2001	2002*
Albania	17.8	18.0	17.1	14.5	14.2
Bosnia & H.	37.4	38.9	39.7	40.1	41.0
Bulgaria	12.2	16.0	17.9	17.9	16.3
Croatia	11.4	13.6	16.1	15.8	14.5
Macedonia	34.5	32.4	32.2	30.5	30.5
Romania	10.3	11.5	10.5	8.8	8.1
Serbia & Mont.	na	27.0	27.0	28.0	29.0

*Projections. All data for Bosnia and Herzegovina are official estimates.
Source: For the SEE-5: Commission of the European Communities (2002); for Bulgaria and Romania: UNECE (2003): 227.

At the end of 2002, the registered unemployment rates were much higher than elsewhere in transition countries – especially in Bosnia and Herzegovina (41 per cent), Macedonia (over 30 per cent) and Serbia and Montenegro (29 per cent). What is particularly alarming is that in several countries – namely Bosnia and Herzegovina, and Serbia and Montenegro – unemployment rates have been increasing in recent years, and are bound to grow more with the further implementation of enterprise restructuring and privatisation.

These high unemployment figures, however, do not take into account that a large portion of activities in all SEE countries is in the unofficial (informal) economy. According to some recent estimates of the size of the informal economy in transition economies, it is generally larger in the SEE than in the CEE countries, in 2000-2001 on average ranging from 32 per cent in Croatia to 45 per cent in Macedonia, though smaller than in many CIS countries (see Schneider, 2003, p. 27; however, not all SEE countries are included).

In addition to very high unemployment rates, poverty in SEE has also increased, both because of the sharp fall in output and greater inequality in the distribution of income. As evidenced by a number of recent studies, inequality has been increasing during the past decade, together with remarkable social stratification. Thus the Gini coefficient for per capita income has generally increased in SEE countries over the past decade (World Bank, 2002; Bicanic, 2003).

The *external sector* of SEE countries is also characterised by high fragility. In most SEE countries foreign trade is highly unbalanced, the value of imports being two, three, or even four times the value of exports (Table 8). In 2002, the highest coverage of imports by exports was achieved by Romania (82 per cent), Bulgaria (76 per cent) and Macedonia (71 per cent), while all the other countries were in a far worse situation, especially Albania (24 per cent), Yugoslavia (40 per cent), Bosnia and Herzegovina (42 per cent), even Croatia (51 per cent). Rigid exchange rate policies required for macroeconomic stabilisation purposes have frequently led to the appreciation of national currencies, which is seriously undermining the competitiveness of SEE countries on international markets.

Table 8. External Balances of SEE Countries, 1999-2001

Country	Merchandise trade in 2002			Current Account Balance (% of GDP)			
	Exports (mln US$)	Imports	Coverage of imports by exports (%)	1999	2000	2001	2002
Albania	342	1,414	24	-7.2	-6.9	-6.3	-6.0
Bosnia & H.	1,165	2,764	42	-20.7	-21.4	-23.1	-20.3
Bulgaria	5,350	7,050	76	-5.3	-5.6	-6.5	-5.9
Croatia	4,657	9,202	51	-7.0	-2.3	-3.3	-3.5
Macedonia	1,187	1,674	71	-3.4	-3.1	-9.8	-10.2
Romania	12,068	14,641	82	-3.7	-3.7	-6.1	-5.0
Yugoslavia	2,250	5,567	40	-7.5	-7.4	-10.7	-12.9

Source: EBRD (2002) Country assessments tables and p. 64; and the present author's calculations.

In addition to large trade deficits, some SEE countries also have very high current account deficits. In 2002, the current account deficit was still over the dangerous threshold of seven per cent of GDP in several countries – in Bosnia and Herzegovina, Macedonia, FR Yugoslavia (Table 8). The large imbalances on the external account have to be covered by capital inflows from abroad, primarily foreign aid and debt financing, since Foreign Direct Investment (FDI) so far has been fairly low (as will be seen later). Several SEE countries have had to rely primarily on large inflows of foreign aid to cover their deficits. In Bosnia and Herzegovina, capital inflows in 1999 amounted to as much as 31 per cent of GDP, though sharply decreasing afterwards, and the same problem is repeating itself today in Serbia and Montenegro (UNECE, 2001 and 2002). These problems are further aggravated by high external debt, particularly in FR Yugoslavia (Table 9).

Table 9. Foreign Debt and Official Reserves of SEE Countries

	Gross Debt (in US$ mln)		Gross Debt (in % of exports)		Gross Debt (in % of GDP)		Official Reserves (mln $)
	2000	2002*	2000	2002*	2000	2002*	2002
Albania	1,130	1,090	138	98	30	23	411
Bosnia & H.	2,870	2,500	168	159	64	49	1,165
Bulgaria	11,202	10,553	153	126	89	67	4,204
Croatia	11,002	13,675	122	125	60	62	5,852
Macedonia	1,488	1,527	88	114	41	41	793
Romania	10,658	14,705	86	94	29	33	7,049
Yugoslavia	11,418	11,472	439	376	164	85	1,916

* End of September.

Source: UNECE (2002), 1: 152; UNECE (2003), 1: 191. For Yugoslavia, debt prior to Paris Club write-off.

Under such circumstances, several SEE countries have become *aid-dependent* economies, as they continue to depend on uninterrupted inflows of international assistance. Until fairly recently, the prevalent part of foreign aid has not been used for productive investment, but rather for other purposes (emergency programmes, humanitarian assistance and food aid), so foreign assistance programmes have not helped much in creating conditions for attaining self-sustaining growth. Because of high dependence on foreign aid, there is a risk of these economies virtually collapsing in case of withdrawal of aid. The phenomenon of ‘aid addiction’ – transfers of large amounts of international resources without the creation of sound conditions for more permanent economic recovery and self-sustaining growth – is today an acute problem primarily in Bosnia and Herzegovina and recently also in Kosovo, though it could easily become a serious problem in Montenegro, Macedonia, and Serbia as well (on the problem of aid-addiction, see the excellent article by Kekic, 2001). One of the most urgent tasks is therefore to stop, prevent, or reverse such trends, by changing the focus and nature of foreign assistance programmes.

Table 10. Savings-Investment Balances in Selected SEE Countries, 1994-99 (as per cent of GDP)

Country	1994	1995	1996	1997	1998	1999
Bulgaria						
Gross domestic investment	9.4	15.7	8.4	11.4	16.9	19.0
Gross domestic savings	9.1	14.6	7.8	15.0	16.4	13.7
Foreign savings	0.3	1.1	0.6	-3.6	0.5	5.4
Croatia						
Gross domestic investment	17.4	17.6	21.9	28.2	23.2	23.2
Gross domestic savings	23.0	9.9	16.2	16.6	16.0	15.9
Foreign savings	-5.7	7.7	5.8	11.5	7.1	7.3
Macedonia						
Gross domestic investment	15.5	20.8	20.1	22.4	23.0	21.0
Gross domestic savings	10.8	15.8	13.6	14.9	14.2	17.0
Foreign savings	4.7	5.0	6.5	7.5	8.8	4.0
Romania						
Gross domestic investment	24.8	24.3	25.9	20.6	21.4	19.9
Gross domestic savings	23.4	19.3	18.6	14.6	14.3	16.1
Foreign savings	1.4	5.0	7.3	6.1	7.2	3.8

Source: Based on UNECE (2001): 173.

Another major characteristic and constraint on economic development in SEE are very low *savings and investment rates*, generally lower than in leading CEE countries (Table 10). Low savings rates are the outcome of several interrelated factors, including low levels of income, falling living standards, underdeveloped capital and financial markets, various pyramid schemes (in Albania, Bulgaria, Macedonia, and Serbia), delays in banking reforms, lack of confidence in official financial institutions, continued practices of savings held under mattresses, and high levels of corruption and criminality. In the four SEE countries for which data are available, savings rates in 1999 ranged from 14-17 per cent of GDP. Given that most SEE countries have attracted limited foreign savings for investment purposes, investment rates in SEE countries have also been rather low, in recent years usually not surpassing 20 per cent of GDP, thus substantially lower than in leading transition economies such as the Czech Republic, Hungary or Poland. These CEE countries have in recent years experienced an investment boom (in 1999, they had an investment rate of over 28 per cent), often led by FDI (UNECE, 2001: 171).

4. Progress with Institutional Reforms

More rapid economic growth in SEE is also hampered by delays in implementing some major economic reforms required by the transition to a market economy. The indicators on progress in transition of the European Bank for Reconstruction and Development (EBRD) suggest that there are no large differences between results achieved in CEE and SEE regarding some reform measures that were generally easier to implement, including small-scale privatisation, price liberalisation, or reforms of the trade and foreign exchange systems (Table 11).

However, there are other fields such as competition policies, enterprise governance and restructuring, or development of securities markets and non-bank institutions, where far-reaching reforms in most SEE countries have indeed been substantially delayed. Even though in most countries the private sector share in GDP by now exceeds 60 per cent – the exceptions are Bosnia and Herzegovina (45 per cent) and Serbia and Montenegro (40 per cent) – privatisation has left many problems unresolved and poor corporate governance has substantially delayed microeconomic restructuring. It should also be borne in mind that the EBRD indicators cover the major reform areas, but do not reveal other economic problems a country may be facing which potentially could represent a serious threat to economic performance, especially in the medium term (e.g. various structural problems).

Table 11. Progress in Transition in SEE, mid-2002

		Enterprises			Markets and trade			Financial institutions		Infras-tructure
Country	*Private sector share of GDP (in %) mid-2002*	*Large-scale privatisation*	*Small-scale privatisation*	*Governance and Enterprise restructuring*	*Price Liberalis-ation*	*Trade and foreign exchange system*	*Competition policy*	*Banking reform and interest rate liberalisation*	*Securities markets and non-bank financial institutions*	*Infrastruct-ure reforms*
Albania	75	2+	4	2	3	4+	2-	2+	2-	2
Bosnia & H.	45	2+	3	2-	3	3	1	2+	2-	2+
Bulgaria	70	4-	4-	2+	3	4+	2+	3+	2+	3-
Croatia	60	3	4+	3-	3	4+	2+	4-	3-	3-
Macedonia	60	3	4	2+	3	4	2	3	2-	2
Romania	65	3+	4-	2	3+	4	2+	3-	2	3
Yugoslavia	40	2	3	2	3	3+	1	2+	2-	2

Source: EBRD (2002): 20-21.

There are substantial differences in progress achieved in various fields of economic reform within the SEE region. Croatia has apparently achieved the best results so far, and in several areas has surpassed Bulgaria and Romania. Other SEE countries are lagging behind, particularly FR Yugoslavia, which has embarked on radical economic and institutional reforms only after the October 2000 political changes, and Bosnia and Herzegovina, still facing serious post-war difficulties linked to the fragility of its institutions and malfunctioning of the state administration. However, in Serbia and Montenegro, many reforms have been moving forward at accelerated speed over the last three years, which is not fully reflected in the presented EBRD table.

Most of the problems discussed represent serious constraints on growth and development in SEE. These problems cannot quickly be overcome, but will have to be gradually removed through further institutional and other economic reforms, in line with the main objectives of the transition to a market economy. The short-term measures undertaken so far – macroeconomic stabilisation, and price and foreign trade liberalisation – are certainly fundamental, but are not sufficient to pull the SEE region out of underdevelopment. The highly unsatisfactory situation in Bosnia and Herzegovina, where the currency board arrangement has provided nothing else but monetary stability, clearly warns us against too simplistic solutions (on some lessons learned from the experience in Bosnia and Herzegovina, see Papic et al., 2001). For the SEE region to receive the necessary ‘big push’, which could eventually lead to achieving self-sustained economic growth, foreign resources will continue to be of fundamental importance, at least in the medium run.

5. International Finance

Because of specific constraints on growth and development of SEE countries which have been discussed so far, the inflow of financial resources from abroad will have a fundamental role to play in facilitating their development efforts. Until only a few years ago, most SEE countries were able to count on a very limited amount of private and public funds from abroad, and this was an additional constraint for achieving quicker development. On the one hand, the inflow of FDI into SEE during the 1990s has been extremely low; on the other hand, international donors have limited their assistance – until 2000 – to only certain types of aid and to only some SEE countries.

So far, the inflow of *FDI* to the SEE region has been extremely low in comparison with CEE countries in transition, even if we include Bulgaria and Romania (Table 12).

Due to high political risk, the major interest of foreign partners in other transition economies, smallness of markets (Romania probably being the only exception), the SEE region has attracted very limited FDI, especially in the early 1990s. Indeed, over the 1989-96 period, the cumulative net inflows of FDI into six SEE countries (without Bosnia and Herzegovina, for which data are not available), have amounted to only 2.8 billion dollars – corresponding to 6.6 per cent of total inflows into all 27 transition economies over the same period.

The situation regarding FDI has generally improved over the last five years, at least in absolute terms. Since 1997, the *annual* FDI inflow into SEE has been at the level of three to four billion dollars (therefore equal or even more than during the entire period 1989-1996). Nevertheless, the SEE-7 share in total FDI in 27 transition economies has actually been declining, from around 18 per cent in 1997 to 15 per cent in 2001. It has also concentrated on mainly a few SEE countries – namely Bulgaria and Romania, responsible for around half of overall FDI in the SEE-7, and Croatia. The cumulative total invested into the seven SEE countries over the whole period 1989-2001 has amounted to around 21 billion dollars, which is a bit more than 14 per cent of total FDI net inflows into 27 transition economies.

The overall picture is, however, even less favourable if we exclude Bulgaria and Romania, as these are among the SEE countries which have attracted most FDI so far. Particularly during the initial period, the SEE-5 countries have attracted extremely low amounts of private capital. The cumulative FDI inflows into the SEE-4 (without Bosnia for which data are not available), from

Table 12. Net Inflows of Foreign Direct Investment in SEE - 1989-2001 (mln US$)

Country	*Cumulative FDI net inflows 1989-96*	*FDI net inflows (annual)*					*Cumulative FDI inflows 1989-2001*	*Cumulative FDI inflows per capita 1989-2001*
		1997	*1998*	*1999*	*2000*	*2001 Estimate*		
Albania	295	42	45	51	141	204	799	259
Bosnia & H.	Na	0	100	90	150	130	470	109
Bulgaria	450	507	535	789	1,003	641	3,961	491
Croatia	564	347	835	1,445	1,086	1,325	5,858	1,315
Macedonia	38	18	175	27	175	445	888	444
Romania	1,434	1,267	2,079	1,051	1,154	900	7,928	356
FR Yugoslavia	0	740	113	112	25	165	1,155	135
Total FDI in SEE-5	897	1,147	1,268	1,725	1,577	2,269	9,170	na
in SEE-7	2,781	2,921	3,882	3,565	3,734	3,810	21,059	na
FDI in 27 tran-sition Countries (mln. US $)	42,002	16,153	21,871	24,367	23,254	24,407	145,565	603
-SEE-5 share in total (%)	2.1	7.1	5.8	7.1	6.8	9.3	6.3	na
-SEE-7 share in total (%)	6.6	18.1	17.7	14.6	16.1	15.6	14.5	na

Sources: Calculated from data of the EBRD (2002): 68, and earlier data reported in Uvalic (2001b).

1989 to 1996, have amounted to less than 900 million dollars, which is only 2.1 per cent of the total invested into the 27 transition countries. The situation has substantially improved only during the more recent period, but the SEE-5 share over the whole 1989-2001 period still remains at the very low level of six per cent of total investment into all 27 transition economies.

The launching of the Stability Pact for Southeast Europe in mid-1999 was supposed to improve the general climate for attracting FDI into SEE, but the expectations were probably far too optimistic. Over the 2000-2002 period, FDI in the SEE-5 have amounted to some six billion dollars (or six per cent of the total invested in the same period in 27 transition economies), while FDI in the SEE-7, to around 11.5 billion dollars (or 12 per cent of the total) (see Economist Intelligence Unit, 2003b). Thus although in the last three years the absolute amount of FDI in SEE has increased, the overall proportions do not seem to have changed much.

According to an Economist Intelligence Unit report, the foreign investment boom in transition economies will withstand the global slowdown, including FDI in SEE countries (see Kekic, 2001b). In the forthcoming period, one country which is likely to attract major FDI is Serbia and Montenegro, as it will substantially improve its business environment score, jumping from the 27th post in 1996-2000 to the 16th post in 2001-2005 (Kekic, 2001b).

In addition to the fundamental importance of continued inflows of private capital from abroad, donors assistance is also going to be an important factor facilitating future development efforts of SEE countries. The European Union has been the most important donor to the SEE region and therefore its assistance policies in the forthcoming period are also going to be crucial. The new EU approach towards the SEE region launched for the five countries of the so-called Western Balkans in mid-1999 is certainly a major turnaround with respect to the *ad hoc* policies implemented throughout the 1990s. In addition, the CARDS programme of financial assistance ought to secure 4.65 billion Euro over the period 2000-2006 (and an additional 210 million proposed in June 2003) to help transition and reconstruction efforts of these five

SEE countries. However, all these measures in favour of the SEE may not be sufficient to sustain quicker economic development. The EU ought to find ways to increase its financial aid to the SEE countries and to improve the effectiveness of its assistance programmes.

Given their present low level of development, most SEE countries are likely to face serious difficulties in catching up with the more developed countries, and present and incoming members of the EU. In order to prevent the further broadening of the development gap between present EU members and future newcomers, new mechanisms will probably need to be devised to help SEE development efforts, as well as increased financial assistance. Whereas the problem has been explicitly addressed by the EU for countries like Bulgaria and Romania through the programme of measures adopted in the 1997 Agenda 2000, and by structural funds and loans provided by the European Investment Bank, this has been much less the case with the other SEE countries. After 2004, not only the incoming members but also Bulgaria and Romania will be receiving much more financial assistance than the SEE-5, which will increase the development gap even further. A way must be found to prevent the decrease of EU financial support after 2004, as presently seems will be the case (see more in Uvalic, 2003b). The allocation of no more than 500 million Euro in total annual assistance to the countries of the Western Balkans in 2005 and 2006 would hardly be sufficient to cover their enormous needs.

Increasing EU financial assistance to the Western Balkans is, of course, no guarantee that it will substantially contribute to faster economic growth and development. There is ample empirical evidence from the EU and many other countries which suggests that international aid can be a problematic instrument of policy. Although it can fill resource gaps and stimulate growth, it may also perversely remove the urgency for domestic policy makers to introduce fundamental economic reforms and may also lead, as already indicated, to ‘aid addiction’, thus contributing little to achieving conditions for self-sustaining growth. Moreover, international assistance programmes have frequently had a limited impact due to the low aid absorption capacity of the beneficiary country.

Although the empirical literature has yielded inconclusive results on the positive impact of foreign aid on growth, the urgent and priority objective of accelerating economic growth and development in SEE will undoubtedly be easier to achieve with more, rather than with less, EU money, given the extreme scarceness of domestic capital at present in most SEE countries.

It is also of crucial importance to improve the effectiveness of EU assistance programmes. Over the last decade, a relatively large amount of EU resources has already been directed towards SEE countries, even the narrower group. If we consider the total amount of funds that has been directed towards the SEE-5 from 1991 until 1999 (including EU, bilateral assistance, EIB and EBRD funds), we see that the amount has been around 8.2 billion Euro, therefore more than FDI over the same period. However, the largest part of the EC-EU resources has been in the form of humanitarian aid provided under the ECHO programme (almost 50 per cent of total EU funds), which stands in contrast with the minimal amount provided by the European Investment Bank (EIB), in the 1991-1998 period extended to only one country – Albania. Since most SEE countries are today poorer than they were in 1989, it is clear that these funds have gone primarily into consumption, and not into investment. Western assistance so far has helped these countries merely to survive, rather than develop and prosper. In order to transform SEE into an economically prosperous region, it is therefore extremely important that the financial resources within the CARDS programme are utilised in such a way as to contribute much more to sustainable growth and development of SEE countries. There ought to be a more balanced distribution of funds between humanitarian, reconstruction, and development aid, the last form especially having received far too little attention so far. In this regard it would be extremely important to adopt cohesion policies for the Western Balkan countries, as recently proposed by the Greek Presidency.

6. Concluding Remarks

SEE countries today still face a number of complex problems – economic, political, social – that have not yet been resolved in a satisfactory way, nor can be resolved in the short run. The primary responsibility for finding appropriate solutions for resolving these problems in a more permanent way lies with the SEE countries themselves; but a part of the responsibility also lies with the wider international community, considering that many of these problems – especially the political ones – have in recent years become increasingly internationalized. Unless the EU puts major efforts to help resolve some of the remaining very complex political issues in the SEE region, which presently clearly cannot be handled by the countries themselves – such as the final status of Kosovo and therefore also of Serbia and Montenegro – the unsettled question of state borders will continue to be an element of instability, and as such also an impediment for the inflow of FDI, faster economic development, and progress towards integration with the EU. Perhaps the time *is* ripe to address these issues for the sake of finally achieving more permanent stability in the SEE region.

The challenges in front of the SEE countries are numerous and the tasks multifold. Still, the overall prospects for the future of the SEE region are today much brighter than only three years ago. With the further implementation of the transition to a market economy and democratisation, regional integration and measures facilitating SEE access to EU markets, major international assistance from the EU and other international donors, announced prospects of future EU membership and possibly increasing inflow of FDI, the overall conditions for achieving more permanent stabilisation and sustainable growth are likely to improve. This should in turn facilitate the future integration of SEE countries into a wider Europe, despite all uncertainties and difficulties regarding future EU integration processes. What is probably most important, is that these processes are now irreversible even in a country like Serbia and Montenegro, where possible political changes may influence the speed of transition, but not its general course.

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