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CAN FURTHER ECONOMIC DECLINE BE STOPPED IN SOUTH EAST EUROPE?*

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Introduction

The signals we get at the start of the new millennium are pretty confusing. On one hand, there are bouts of optimism, which rely on the advent of new information technologies and the longest period of economic growth of the US economy since the Second World War. Some claim that the "information revolution" will usher in another long-term economic upswing in the world[1]. In this context there is talk about a "new economic paradigm" which would combine rapid and sustained economic growth with low inflation. On the other hand, there is no scarcity of bad news. Arms proliferation is apace, there are numerous inter-ethnic conflicts, financial and economic crises have been a constant and alarming feature of the last decade, rising income inequality both inside and among countries puts pressure on governments and strains trade relations, domestic and international terrorism are on the rise, there is growing resentment to globalisation in both rich and poor countries, and so on. Likewise, the record of post-communist transition is much below expectations. The current mood is a strange combination of hope and disquiets, a big change from the overriding optimism reigning at the start of the last decade.[2]

"The end of history" injunction expressed the *Zeitgeist* of the early 90s.[3] In a fundamental sense the author was right: 1989 marked a watershed in history, signalling the decisive demise of communism. In another sense, his analysis was simplifying and obscuring resilient forces at work in history, those which maintain ideological, religious and ethnic differences; forces which, when unconstrained by democracy (checks and balances) and mutual tolerance, and in the absence of economic progress, can lead to huge human suffering, such as inter-ethnic conflicts and wars.[4] The early 90s were also gripped by euphoria and a sort of

1 A new Kondratieff cycle with intense Schumpeterian creative destruction.
2 For an upbeat interpretation see Th. Friedman's "The Lexus and the Olive Tree", New York, Farrar, Strauss and Giroux, 1999, whereas for a downbeat view see J. Gray's "False dawn", New York, The New Press, 1998 amd E. Luttwak's "Turbo-capitalism. Winners and Losers in the World Economy", New York, Harper Collins, 1999
3 F. Fukuyama, "The End of History", New York, Free Press, 1990
4 R. Kaplan's "The Coming Anarchy" (New York, Random, 2000) is also a highly pessimistic response to the

naivety as to the ease with which each prosperity could be created, almost overnight, on the ashes of communism. One easily forgot that that development (modernisation) is very much a historical product, that *natura facit saltus* only under exceptional circumstances.

The Balkans is salient proof that the past is still very much with us. Carl Bildt, the former Swedish Prime Minister and the special UN envoy for the region, perceptively remarked that "For Europe, the last century began and ended with strife and conflict in the Balkans… This abominable practice is still taking place today …" What went wrong with societies and economies in South East Europe? This has been an obsessive question for many Europeans.

This paper tries to scrutinise the situation in South East Europe by focusing on two major sources of economic plight in the region and on prospects for economic regeneration. One source of difficulties involves the dissolution of the former Yugoslavia.[5] The wars in the region caused enormous pain and suffering, and involved the deaths of a large number of people; there has also been enormous material destruction, with the last war causing extensive damage to the civilian infrastructure of Kosovo and Serbia. In the aftermath of the last major conflict the state of affairs in the Balkans is no less unclear; major uncertainties about future dynamics persist, the political map of the region is still fuzzy and reform policies continue to face major hindrances.

Another origin of economic failures is tied to the difficulties of transforming command systems. Economic dynamics in most post-communist countries have disproved the high hopes of the early 90`s. Post-communist transformation[6] has proved to be a much more complex and complicated process of institutional change than some had thought it would be. At the same time, the magnitude of the required resource reallocation (*strain*) and the friction caused by regime change (*disorganisation)*[7] made restructuring a very painful and protracted process; the scope of the latter can be linked with the legacy of communism and, here, one can point out the importance of history, geography and culture. Clearly, much of South East Europe was badly placed in this respect and bad *path dependencies* were put into motion, or reinforced, during the last decade. *Strain* and *disorganisation,* as well as very weak institutions explain much about reform failures during transition, and frequently have pushed into irrelevance allegedly correct choices of policy; these factors have significantly reduced the room for manoeuvre of policy-makers.

1. Deciphering transformation

The map of transition is quite diverse; there are clusters, groups of countries that differentiate among themselves as to economic performance and the way

euphoria of the early nineties.

5 For an historical account see M. Glenny, "The Balkans, 1804-1999. Nationalism, War, and the Great Powers", London, Granta, 1999. S. Woodward, "Balkan Tragedy provides an earlier analysis. Chaos and Dissolution after the Cold War", Brookings Institution, Washington DC, 1995

6 J. Kornai first suggested the distinction between transition and transformation.

7 O. Blanchard, "The Economics of Post-communist Transition", Oxford University Press, Clarendon Lectures, 1997

institutions function. It is noteworthy that the best performers are in the neighbourhood of the EU and, not accidentally, have the highest income per head.[8] Bulgaria and Romania, which also have Association Agreements with the EU, have had a much more difficult trajectory and their prospects to join the Union are considerably less favourable. For most of the Balkan area the term *distress economies* seems quite appropriate.

A major lesson of transformation is the need to consider various hypotheses and viewpoints, not to be a prisoner of clichés and taboos, to understand that there can be no perfect blueprints as there can never be a perfect world and that policies should be judged on their own merits.[9] Some years ago, those who emphasised the *structural nature* of the problems facing post-communist countries made up a minority in the chorus of upbeat voices; they warned about the lack of realism of the theses and conceptions which smelled of the possibility of compressing time at will, and developments seem to vindicate their views.

There has been an great temptation to lump countries together, in various groups, by assuming a pretty much deterministic (mechanical) relationship between preordained results and policies implied by a conventional wisdom. As in the old Latin saying 'post hoc, ergo propter hoc' close performances were ascribed more to presumed similar policies than to commonalties in initial circumstances, structural factors and policy peculiarities.[10]

1.1. Major underplayed issues

The burden of the past

Transition countries show common (structural) traits, but also major discrepancies; the latter can be linked to different pre-communist legacies (the former Czechoslovakia, as a leading industrial country during the inter-war period, is the most obvious example) and different brands of central planning, in terms of relaxation of direct controls and choices of economic policy. Different histories explain widely different incomes per capita, why market institutions vary

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8 S. Fischer and R. Sahay remark that "the extent of reform has been strongly correlated with the initial conditions – that the reformers are those closer to Western Europe, with a shorter period under communism, and more advanced economically when they fell under Soviet control or when transition started. That is a large part of the story, but not the whole because there are both fast and slow reformers in CEE" (The Transition Economies after Ten Years, paper for the conference "Ten Years after: Transition and Growth in Post-communist Countries, CASE, 15-16 October 1999, Warsaw

9 D. Rodrik underscores that although neo-classical analysis has much to offer to development policy there has been "an excessive focus on relative prices…The encounter between neo-classical economics and developing societies served to reveal the institutional underpinnings of market economics"("Institutions for High-Quality growth: What They Are and How to Acquire Them", paper prepared for the IMF Conference on Second Generation Reforms, 14 October, 1999, manuscript, p.1) According to J. Stiglitz 'Imperfect and costly information, imperfect capital markets, imperfect competition: these are the realities of market economies – aspects that must be taken into account by those countries embarking on the choice of an economic system'("Whither Socialism", Cambridge, MIT Press, 1995, p.267).

10 Poland became the 'classical example' of shock therapy regarding price liberalization, but not privatization. At the same time Hungary, in spite of a remarkable policy consistency, can be viewed as an example of clever gradualism, and its economic performances are due also to reforms initiated before 1989. As to the Czech Republic, it applied a big-bang to privatization and a sort of heterodox stabilization policy, while Slovenia applied a gradualist policy.

qualitatively among the national environments[11] and why macro- and micro-imbalances differed among them on the eve of 1989; partial reforms before that year explain also the scope of *disorganisation* during a change of regime. Undoubtedly, Slovenia, Hungary, the former Czechoslovakia and Poland had a substantial competitive edge in starting the process of managing transition. Unsurprisingly, all these countries have fared better than the rest in their stabilisation programs, although their recipes were not similar, as some would argue.

The magnitude of required resource reallocation: the emergence of strain

In transition countries the structure of the economy and the legacy of resource misallocation put the system under exceptional *strain* once the combination of the internal shocks, engineered by reforms or, simply, triggered by the uncontrolled processes of system dissolution, and external shocks occurred. A glaring illustration of *strain* are arrears (inter-enterprise debt) which, aside from the primitive state of financial markets and *moral hazard*, mirror the inefficiency (inability to pay) of a large number of companies at the new market clearing prices.[12] . An implication of intense *strain* is that policymakers face extremely painful trade-offs and, in most cases, unless policy is consistent and sufficient external support is available[13], the room for manoeuvre is in practice, quite limited. Macroeconomic stabilisation in certain countries hides deeply-seated tensions which, sooner or later, come into the open unless deep restructuring takes place.

Strain can be seriously magnified by fragmentation (dissolution) when *switching costs* are very high. This was the case with firms or regions (republics) in the FSU and the former Yugoslavia. The impact of the collapse of CMEA markets can be judged in the same vein.[14]

Poor microfoundations of macroeconomic policy during transition

Years ago a debate erupted among professionals on the “poor micro-foundations” of Keynesian macroeconomics;[15] that debate is analogous to the critique made by some leading economists on the divorce between macroeconomic policy and microeconomy in transition economies. Where property rights are poorly defined, where the legal framework is fuzzy and institutions for contract enforcement are missing, a firm's behaviour becomes “perverse”; this behaviour is enhanced when the magnitude of required resource reallocation is overwhelming. Consequently, the issue of corporate governance

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11 As P. Rutland points out ‘in a travesty of Hayekian logic, it was assumed that market institutions would be self-generating’ (“Has Democracy failed Russia?”, The National Interest, winter, 1994-1995, p.11)

12 A recent study of the World Bank, done by Brian Pinto, confirms this causality (“Russia’s unique economy may have led to the 1998 crisis”, Financial Times, 22 February 2000). See also D. Daianu: “Inter-enterprise arrears in a post-command economy”, IMF Working Paper, 54/94 and “Resource Misallocation and S*train*” in “Transformation of Economy as a Real Process”, Aldershot, Ashgate, pp.183-184)

13 J. Sachs constantly stressed the importance of aid for strengthening policy effectiveness.

14 Examining “stagflationary effects of stabilization policies” in transition economies G. Calvo and F. Coricelli remarked, years ago, the similarities between the “enterprise-side” and the neo-structuralist approaches ("Stagflationary Effects of Stabilization Programs in Reforming Socialist Countries: Enterprise-side and Household-Side factors”, World Bank Review, vol.6(1), 1992, pp.71-90). They anticipated Blanchard’s work on *disorganization*.

15 R. Clower and A. Leijonhufvud initiated the debate in the late sixties. This debate preceded the arrival of the New Classical Macroeconomics.

has attracted increasing attention.[16]

Ownership of programs (reforms)

Lately, the IFIs, in particular the World Bank, have stressed the importance of empowering transition governments in policy formulation by developing social and political prerequisites for a domestically-grounded reform policy.[17] There is a feeling that it is not sufficient to blame governments for failing to apply the strictures of IMF and WB sponsored programs, particularly when those programs may contain flaws. Governments should have more say in the formulation of their programs, and conditionally, too, should take that into account.[18]

1.2. Inferences about transformation

Institutions are at the roots of economic performance[19]; but institutional build-up takes time and needs to have domestic roots.

Macroeconomic stabilisation is necessary, but far from providing the benchmark between success and failure. Structural reforms are key to achieving macroeconomic stability, stability in general, but these reforms hinge on the ability of a system to undergo fast change. Whereas the marginal costs of delayed reforms increase over time, there seem to be limits as to how much one can speed up reforms. Intense *strain* enhances a culture of *rent-seeking.* And generally, of defensive behaviour. One can talk, in this respect, of a *natural rate of adjustment of society*.

Macroeconomic numbers are deceptive in transition economies when they are not supported by the strength of a real economy and solid institutions. High vulnerability is a strong argument for gradualism especially, but not only, in developing financial markets. Foreign capital can play a significant role in triggering a virtuous circle in view of the extreme complexity and complicated nature (the very high cost) of deep restructuring of economy, but it itself requires an institutionally friendly environment. [20]

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16 For a wider connotation of corporate governance (than strictly through the interests of share-holders/Anglo-Saxon approach) see E. Berglof and E. L. von Thadden, "The Changing Corporate Governance Paradigm: Implications for Transition and Developing Countries", paper presented at the ABCDE conference, Washington DC, April 1999, manuscript; they argue that reforms cannot take place against the will of the main actors in the process. See also J. Stiglitz, "Quis Custodiet Ipsos Custodes? Corporate Governance Failures in the Transition", ABCDE-Europe conference, Paris, 21-23 June, manuscript.

17 The Comprehensive Development Framework (CDF) is a step in this direction.

18 "The key issue is whether it is feasible or desirable to force or induce the adoption of policies and strategies by a government that does not believe in them or a populace that will not support them. The evidence suggests that such attempts are not sustainable, and that the efforts by different donors to impose their own different conditionalities have proved detrimental to the development process"(R. Kanbur, T. Sandler and K.M. Morrison, "A Radical Approach to Development Assistance", Development Outreach, The World Bank Institute, vol.1, no.2, fall 1999, pp.17)

19 M. Olson, "Big Bills Left on the Sidewalk: Why Some Nations are Rich and Others are Poor?", Journal of Economic Perspectives, vol.10, no.2.

20 One can argue that some of the fast growing economies of Asia relied less on foreign capital and that, in their case, the essential factor was the very high savings ratios (35-40%). Such ratios are essential for economic growth and economic policy should strive to stimulate them. Nonetheless, geographic and historical circumstances make foreign capital play a special role in transition countries.

Policy credibility depends on how much structural adjustment the system can undergo in a period covered by the respective policy; thence derives the importance of aid for mitigating *strain*.

Persistent and high structural unemployment can become very burdensome for reform policies – a *hysteresis* phenomenon can develop quite disturbingly. The weakness of safety nets is a major problem, particularly in the poorer transition countries, where the consequences of a 'new type' of poverty could be extremely serious.[21]

Social arrangements are considerably influenced by the actual results of privatisation as a process. If privatisation results in the development of a strong middle class as the social backbone of the new economic system, stability and vigour will be secured and democratic institutions will develop. Otherwise, the new system in the making will be inherently unstable.

State weakness is reflected by the ubiquity of lawlessness – the 'blossoming' of organised crime and corruption[22]

2. Transition in South East Europe[23]: the roots of failures

Why have some transition countries witnessed better institutional change and, implicitly, better economic performance ? An answer, which finds increasing appeal nowadays, is that history, geography and culture have much explanatory power, which further leads to the issue of initial conditions.[24] Certainly domestic policy does matter but, most of the time, it seems to have been quite insufficient in managing a stark reality, in the absence of favourable circumstances.[25]

2.1. Late Stalinism in action

Late Stalinism was practised in Albania, Romania and Bulgaria until the very end of the communist rule. In Bulgaria, there was a slightly milder form of Stalinism than in Romania, but in the end the command system was essentially unaltered. Both Bulgaria and Romania relied extremely heavily on Comecon

21 Including the potential for the appearance of aggressive extremist groups, liable to engage in domestic and international terrorism.
22 See Francois Bourguignon, "Crime, Violence, and Inequitable Development", paper presented at the World Bank ABCDE conference, Washington DC, April 1999, manuscript.
23 It should be said that Southeast Europe reveals commonalties, but also substantial diversity: in terms of income per head, from below \$800 in Albania to over \$4,600 in Croatia, in respect of the precariousness of institutional set-ups, in respect of contractual arrangements with the EU, etc.
24 The 1999 EBRD Transition Report states that "The development of institutions and of behavior depends strongly on history and culture"(p.6)
25 Some are tempted to assert that Poland and Romania had similar conditions at the start of transition (Transition Report 1999, EBRD, p.27). Thus, they seem to ignore that under communism, Poland had always been more open than Romania, that it did undertake partial reforms, that there was a significant private sector (not only in the farming sector), that the Catholic Church and Solidarnosc formed powerful structures of resistance, which bargained with the communist government, etc.

markets, which amplified the shock of the collapse of external markets after 1989 and gave more salience to resource misallocation.[26] This should be contrasted with the steady reorientation of Hungary and Poland towards Western markets during the eighties. Albania had for a long time been a pinnacle of ideological rigidity and isolationism. The links with China were much reduced after Beijing embarked on market reforms after 1978. Albania was poverty-stricken (actually, the poorest country in Europe) and superautarkic even according to communist standards.

Albania, Romania and Bulgaria, and some parts of the former Yugoslavia (Macedonia, Kosovo, Montenegro and Bosnia-Herzegovina,), were traditionally the poorest areas of Europe. Therefore, the failures of reforms are in these areas more painful for the majority of citizens when they involve widespread impoverishment and high unemployment. Thence one can get a plausible explanation for the rapid expansion of the underground economy and criminal activities during transition.

It appears that the main explanation of economic reform failures in both Romania and Bulgaria has been the inability of governments to deal effectively with the legacy of huge resource misallocation[27] and its consequences for the financial sector, against the background of very weak institutions, of *disorganisation*.[28] This policy paralysis led to a major economic and financial crisis in Bulgaria, in 1997, and the introduction of a currency board. In Romania, too, the inefficacy of several attempts to stabilise the economy, and the crisis in the banking system, tell essentially the same story. Could the political process have changed the dynamic of policy choices so that actual reforms would have been substantially more effective? The answer is yes. But arguably, the probability for having been able to avoid big troubles (such as banking crises) was quite low in the absence of sustained assistance from abroad.

Transition in Albania has been considerably more complicated than in both Romania and Bulgaria and the political process mirrors it. We are used to talking about extremely *weak states* in this region of Europe, but the state – as an organisation supposed to provide public goods - almost vanished in Albania, where a civil war (in the wake of the financial crisis) illustrates the very early and fragile stage of a pluralistic society, the scarcity of social and institutional capital

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26 Bulgaria relied on the markets of the FSU for more then 70% of its foreign trade. Romania, in the eighties, redirected its trade towards the FSU in order to pay back its external debt. At the same time, Hungary and Poland were increasing their trade links with the West, which was also a result of their partial economic reforms and opening. Research undertaken by the Vienna Institute for Comparative Economic Studies (M. Landesmann and R. Dobrinsky, ed.: “”Transforming Economies and European Integration”, Edward Elgar, Aldershot, 1996, pp.15-31) s) shows that Bulgaria and Romania witnessed a downgrading of the structure of their exports, after 1989 – whereas the opposite had occurred in Poland, Hungary and the Czech republic. One can establish a certain similarity between the impact of the collapse of Eastern markets on Bulgaria and Romania and the dissolution of trade links among the republics of the former Yugoslavia. It should be said, nonetheless, that this impact was less severe for Croatia and Slovenia.

27 “When one looks at differences in terms of progress of restructuring it seems that likely that these can best be explained by preconditions than current progress in reforms”(S. Estrin, M. Dimitrov, X. Richet: ”State Enterprise Restructuring in Bulgaria, Albania and Romania”, Economic Analysis, vol.1, no.3, 1998, pp.233)

28 According to O. Blanchard “the evidence from those transition countries which are doing less well suggests a larger role for disorganization. In Bulgaria and Romania, two of the countries with the largest drop in output, supply shortages still played an important role more than two years after the start of transition”(1997, pp.45)

and the clannish pattern of social interaction. Thereby one can question the nature of democracy in such an environment.

2.2. The dissolution of former Yugoslavia

In the very early 90s, not a few experts would have indicated most of the republics of the former Yugoslavia as having the best prospects for more rapid transformation; they benefited on human, capital and market-required skills, a relatively decentralised economic system based on “labour management”,[29] substantial cultural and economic intercourse with the West, the exposure to Western labour markets of hundreds of thousands (if not millions) of former *gastarbeiter*, and so on. In addition, Croatia and Slovenia benefited on a relatively high income per capita figure. Yugoslavia had been a member of the IFOs, an associated member of the OECD and had had privileged relations with the EU. It is true that there were considerable economic gaps inside the Federation but those divides could not modify the general economic outline and prospects of the republics.

President Tito’s strong grip on power and his international stature helped to keep the Federation together during the Cold War period. To this one can add the substantial amount of credits which Yugoslavia got from Western countries[30]. But Tito’s death released political dynamics inside the Federation, much beyond the succession issue and ensuing constitutional implications, and unleashed national grievances. These events together with the growing economic crisis of the eighties, the increasing dispute between the rich republics (Slovenia and Croatia) and the rest of the Federation as to the redistribution policies of the federal government in Belgrade, and rising nationalism created prerequisites for major conflicts.[31] Separation and fragmentation became almost unavoidable against the background of intensifying economic difficulties.[32] And it occurred violently, through military conflicts and ethnic cleansing. This evolution impacted strongly on economic and political reforms in most of the republics.

Why was the dissolution violent? One explanation can be linked with the quest for self-identity. It should be said, however, that the quest for one’s own identity is a phenomenon which encompasses most of the post-communist world, for totalitarianism also shackled the communities’ longing for self identity – whether national, religious, or ethnic. Likewise, it would be a mistake not to acknowledge that inter-ethnic and religious conflicts precede the advent of communism and, consequently, that their termination is not a purely ideological

29 For a comparative and analytical presentation of the Yugoslav system of self-management (the behavior of collectively-owned firms) see John Michael Montias’s “The Structure of Economic Systems”, New Haven Yale University Press, 1976, especially part five.
30 Yugoslavia’s external debt reached around $20 billion during the eighties. Increased indebtedness was enhanced by the plethora of petrodollars following the oil price shocks of the 1970s.
31 For a thorough analysis of the Yugoslav economic crisis of the 1980s see H. Lydall: “Yugoslavia in Crisis”, Oxford, Oxford University Press, 1989
32 At a conference organized by the economic think-tank CASE in Warsaw (15-16 October, 1999) J. Sachs mentioned the shortsightedness of Western countries in dealing with the Ante Marcovic government by not granting him the required aid. One can speculate if velvet dissolution could have taken place or, indeed, the Federation could have stayed together, although in a much looser form.

affair. In the Balkans one finds a mixture of cultural and historical circumstances which favoured fragmentation[33], more than in other parts.[34] Ironically, this has happened at the same time with the desire of many post-communist to join the European Union. The question remains: why has separation happened in such a violent way? It can be argued that its origins are to be found in intensifying economic antagonisms among Yugoslav republics, leading to the economic crisis of the eighties and malign rising nationalism. Ethnic cleansing became a means for “pursuing” self-identity. The violent separation could not but reinforce mutual animosities and increase the propensity for reciprocal recrimination and shunning one’s neighbour's behaviour.

Aside from its political and security dimensions, the process of fragmentation has led to some very serious economic implications. The latter refer to trade links (with significant trade diversion), to the availability of infrastructure that supports a national economic system and to economic viability in general. For instance, can Kosovo cease completely relying on the infrastructure of Yugoslavia?[35] Or, formulated in a different way, how costly would this endeavour[36] be, and who would bear the costs[37]? Dissolution has also brought about the formation of protectorates as political and security-related solutions.

2.3. Protectorates vs. independent states. (hard vs. soft protectorates)

One motive for the emergence of protectorates stems from “pronounced

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33 More than eighty-five years ago a Commission set up by the Carnegie Endowment for International Peace published its findings on the atrocities committed by the belligerents of the two Balkan Wars. In 1993, prompted by the new conflicts in the former Yugoslavia, the original text was reprinted with an introduction by the famous Mr. X, the historian G. F. Kennan. In that text the latter says: “Eighty years have now passed since the Carnegie commissioners paid their visit to that region. And this writer knows of no evidence that the ability of the Balkan people to interact peaceably with one another is any greater now than it was those eighty years ago” (Quoted by T. Veremis in “Greece’s Balkan Entanglement”, Athens, ELIAMEP, 1995, p.1). Veremis questions this implied “congenital barbarism “ in the region and says that “while the region has suffered more than its fair share of violence, much of it was engineered by competing alliances hatched in the West, rather than local animosities”(ibid.p.2)

34 Veremis compares the former Yugoslavia to “a Russian doll – within each Republic are sub-groups and in each sub-group there are others”(Ibid.p.63). Veremis quotes also Lawrence Freedman who remarked that “there has never been a close fit between state boundaries and the distribution of ethnic groups. But the principle of a state for every nationality leads to a ludicrous and anarchic patchwork of micro-states, few of which are truly viable without close cooperation, yet all of which define themselves by their differences from each other”(“Now force is the only way”, The Independent, 17 May, 1992)

35 For example, there is practically no autonomous banking network in Kosovo and all transactions of the Albanian Kosovars are made in cash. Only last January a bank was set up with the help of the EBRD. Or think about Montenegro’s desire to have its own airlines company, which is a clear sign of independence quest, and not necessarily of economic necessity.

36 See “Post war order for South East Europe”, a document worked out by Riinvest, a Pristina based consultancy company. For the gigantic task of reconstructing Kosovo see also the study undertaken by the British consultancy company GHK International Ltd “Ideas on Kosovo: Organization and Resources”, manuscript. Herein it is argued that “a development perspective should replace an aid perspective”(p.4)

37 The $150 million assigned by the EU for 1999, and about $500-600 million for each of the next five years, are meant to cover both immediate humanitarian needs and reconstruction aid. The size of aid was assessed by relying on the experience of work done in Bosnia-Herzegovina (which has a population of 3.5 million, as compared to the circa 2 million in Kosovo - by assuming that most of the Kosovar Albanians returned from the neighbouring countries (where they fled to or were driven by Serbian authorities), and not counting the Serbs who left the region after the end of the military conflict.

minority links" which complicate the search to find viable solutions to political problems and crises in the various countries.[38] Many people in the Balkans think along such lines: "why should I be a minority in your country when I can be a majority in my country?"[39]. This is the sort of *collective psychology* [40] - with roots in deep history[41] - which almost invites conflict and fragmentation, unless there is an exogenous, constraining (and hopefully pacifying) force at work. Political leaderships can easily exploit this ubiquitous collective psychology for their own purposes including the distraction from economic hardships.

Thus, in Bosnia-Herzegovina which, de facto, is not a multi-ethnic federation, many refugees did not return to their homes and national (religious) separation continues. Likewise, the leaders of the three communities refuse to implement most of the provisions of the Dayton Agreement, which indicates non-adherence to its spirit and practical meaning.[42] Actually, this state of affairs seems to magnify the sense of artificiality of the Federation, which survives owing to the presence of a foreign authority, the presence of tens of thousands of foreign soldiers and a huge infusion of financial assistance (with little effect, apart from the repair of infrastructure). Whereas, initially, it was announced that the foreign troops would stay for a year and, later on, for eighteen months, they may be required there for an indefinite future.

There are several protectorates in the Balkans. Bosnia-Herzegovina and Kosovo are, what one could call, *hard protectorates*; foreigners under the aegis of the international community (UN) perform the administration of the entity. Macedonia and Albania can be viewed as *soft protectorates*, where governance is undertaken by local authorities, but with the support of economic and military assistance from abroad. Undoubtedly, the dynamics in the region asked for intervention from outside and the presence of peace-maintaining devices; in certain cases the creation of protectorates might have been unavoidable. There is even a line of reasoning which claims that this political and governance instrument is the most effective in keeping things under control (order maintenance) and fostering economic and political progress[43]. There are obvious merits with this

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38 S. Borisitz, The Southeast European Nonassociated Countries- Economic developments, the impact of the Kosovo Conflict and relations with the EU", Oesterreichescher Nationalbank, Focus on Transition, 1/99, p.87
39 V. Gligorov, who is a leading economic expert on the region, concocted this suggestive proposition
40 A. M. Carazzo-Bild, "Let's stop demonizing the Serbs", May 1999, manuscript. Here she says: "My experience is that the fear of being oppressed by the other ethnic group was genuine, a fear deeply rooted in centuries of Ottoman and other foreign domination …In the West we have a tendency to assume that the people of this region would or should think and behave the way we do. They do not."
41 For an historical account of pre-World War II developments in the Balkans see I. Berend's 'Decades of Crises", University of California Press, 1998. See also R. Kaplan's "Balkan Ghosts", New York, 1995, and M. Glenny (1999)
42 S. Pecanin, the chief editor of the weekly DANI, from Sarajevo, remarks that "The experience of the four-year implementation of the Dayton Peace Accord suggests that all credit for the apparent advance in the stabilization of Bosnia and Herzegovina should go to the High representative and other representatives of the international organizations and Western countries. It is a sad fact, but unfortunately the reality, that the present tripartite governance has not succeeded in reaching consensus even on such questions as the design of the cover page of the passport, the flag or the national anthem. Even these simplest of issues have had to be resolved by decision of the High representative…"("Bosnia and Herzegovina and the Stabilization pact for South East Europe", paper presented at the Halki conference on the Balkans, June 1999, p.7)
43 J. Sharp, "Prospects for peace in Bosnia: The role of Britain" in S. Clement (ed.): "The Issues raised by Bosnia and the Transatlantic Debate", Chaillot Cahiers, 32, May 1998

solution, but it presents important pitfalls as well. One is that it may only “freeze” a complicated situation, which sooner or later bursts out. Secondly, it does not *empower* people to run their own affairs, and it may develop their inclination to form “parallel” governance structures, or only pretend compliance with the strictures of the formal acts of the official authorities.[44] The issue of empowerment is important in itself - as a reflex of democratic structures and transparent market economies - , and as an essential feature of the local communities’ sense of their own identity.[45] And here lies, probably, the biggest threat for and difficulty in implementing the rules of a protectorate, and hence to their capacity for laying the foundations for sustained economic development.

3. Economic transition in South East Europe

3.1 How relevant are economic indicators?

It is useful to first make a few remarks as to the relevance of some economic indicators, which have considerable bearing on describing the situation in the Balkans.

Inflation

Subduing inflation is a major goal of economic policy. It is part of the widely shared conventional wisdom that bringing inflation down is a must for achieving sustainable (sound) economic growth. The experience of Turkey in the 70s and the 80s, or Brazil a couple of decades ago, are taken more as exceptions which reinforce a rule. It goes without saying that the dynamics of bringing inflation down also matters. In the case of transition economies, single digit inflation was seen as a very ambitious target, hard to achieve by the frontrunners included. But low inflation, however commendable in itself, cannot be of much help in addressing, for instance, the issue of very high unemployment. When low inflation coexists with huge unemployment there is a clear sign that something is wrong. Certainly, one has to introduce another variable into the discussion: the informal sector, as a means for mitigating the pains of unemployment. Nonetheless, there are limits as to what the informal sector can do in this respect and, besides, another issue is brought through the backdoor, namely, the transparency of the economy and rules of behaviour.

The parallel (informal) sector

It is not surprising to meet large informal sectors in poor countries, where many citizens find a way to survive or make ends meet better, financially. In addition, in transition economies, where there is much non-transparency and the

44 Pecanin makes a piercing analysis of the functioning of Bosnia-Herzegovina by saying that the same political parties and leaders are in power who “based their programs and ideologies on the ethno-religious representation of their respective peoples, and who acquired this exclusionist legitimacy with the greatest of ease. Nationalism as a means, nationalist movements as the framework, and nationalist leaders as the focus of identity came to be an effective instrument for the creation of three comparable, parallel systems of one-party governance"(Ibid. p.2)

45 In several instances, at conferences attended by this author, E. Busek, the SECI Coordinator, emphasized that it would be a grave mistake for the external actors to adopt a “colonial attitude” in dealing with the local authorities.

legal framework is unclear, the informal sector can be enhanced by the weak institutional context; it may not necessarily reflect a high propensity to break formal rules. It should be said that important parallel sectors exist in rich countries as well (Italy, Greece, and Spain), where they reflect widely disseminated habits as well as a quest for beating the system in an unlawful way. The big threat for society is when the informal sector expands to the detriment of the formal sector; when trying to beat the system - assuming that the latter has noble purposes - becomes a lifestyle, and criminality is ubiquitous.

GDP and export dynamics

Economic growth is another major goal of economic policy. Particularly during transition, where the "transformational recession" was the equivalent of a big slump - with important social costs - growth resumption acquired particular significance; in terms of responding to the normal demand by citizens for better life (after the end of communism), but also as a sign that transformation is well under way and making substantial progress. One should distinguish however between *growth* and *recovery*. The latter is much easier to register, especially when it happens after a considerable plunge in the economy, or when there is much under-utilisation of resources. It is true that transition economies are quite fuzzy as to the scope for non-inflationary recovery - since many factors of production are not easy to mobilise - but the distinction is meaningful. Unless there is investment in capital goods and technological transfer occurs, one can hardly talk about growth. Moreover, in an open economy growth hinges to a large extent on a steady upgrading of exports.

A surge in exports may be quite meaningless when it is tied to a recovery of output or a positive exogenous shock. For exports to both induce and follow sound growth they need to demonstrate constant upgrading (rising value-added). This requires high saving and investment ratios, the build-up of human capital. Where the latter does not exist, stagnation or regression is the most likely scenario.

3.2 Judging economic performance and reforms in South East Europe

Prima facie South East Europe may seem to have been pursuing reforms strenuously, in spite of enormous difficulties. Markets have largely been liberalised as well as trade and foreign exchange systems. With the exception of Bosnia-Herzegovina the private sector currently generates most of the GDP in all countries of the region[46]. Aggregate numbers on GDP dynamics between 1989-1998 also compare the region not unfavourable, for example, with the Baltic countries. If one takes 1989 as the base the 1998 GDP level for the Balkans was just below 70% whereas for the Baltics it was just above 66%. But many of the challenges remain those of the early transition, including the privatisation of key industries and imposition of financial discipline. The region has made little progress in establishing the legal and social institutions that underpin effective markets and provide the predictability, fairness and transparency required for private investment.[47]

46 "Transition Report" 1999, EBRD, London, pp.82
47 "Transition Report", London, EBRD, pp.82

There are two layers of perceptions that condition the relative neglect of the deeper causes of economic failures in the region. One layer is formed by the consequences of the dissolution of the former Yugoslavia, by the wars which produced *distress economies*. Thus, the effects of reform policies are less visible, particularly where the dissolution of the former Yugoslavia is intertwined with military conflicts. This layer ensconces that even the new sovereign entities need to undertake thorough reforms, to overhaul the economic regime which relied on self-management. Another layer of perceptions is due to a simplistic view of transition,[48] and of reform policies.

The simplistic vision has underestimated, inter alia:
- the relative backwardness of most of the region[49], which goes back deeply into history[50];
- the institutional dissolution, or chaos, in the countries which practised late Stalinism until the very end of the system;
- the initial conditions from which transition began, seen in terms of the magnitude of the required resource reallocation cumulated with the inability to undertake restructuring (impose hard budget constraints);
- rapid destruction of manufacturing capabilities without compensating growth of services, and a big surge in unemployment;
- the proliferation of the unofficial economy and the pervasive activities of organized crime;
- *social exclusion* on a very large scale;
- the congenital fragility of the banking systems;
- the low level of foreign direct investment[51].

Together with *strain,* institutional fragility helps to explain stop-go policies (*boom and bust cycles*), as well as many of the setbacks and inconsistencies in the transition process.[52]

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48 How deceptive, for example, stabilization can be is the experience of Albania. A few years ago, that country was branded as a model of democratic and markets reforms, with inflation running at an annual rate of below 5%. And soon thereafter the country was plunged into a major crisis as, following the collapse of the pyramid schemes, the country imploded. Nowadays, Albania again has a very low inflation rate, but nobody is naïve enough to make the statements of the mid-nineties.
49 Although one could argue that the former Yugoslavia was best prepared to undertake fast, market-oriented reforms after the fall of the Berlin Wall.
50 D. Chirot (ed.),"The Origins of backwardness in Eastern Europe" (Berkeley, University of California Press, 1989). According to A. Solimano, in 1937, nominal income per capita was estimated at $440 in Great Britain, and $400, $340, $330, $306, $265, and $190 in Sweden, Germany, Belgium, Netherlands, France, and Austria respectively. The corresponding estimates for Czechoslovakia, Hungary, Poland, Romania, Yugoslavia, and Bulgaria were $170, $120, $100, $81, $80, and $75, respectively (See A. Gelb and C. Gray, "The Transformation of Economies in Central and Eastern Europe", The World Bank, 1991, p.65)
51 Central Europe took more than 50% of the FDI that flowed into the post-communist countries in Europe during the years 1990-1998.
52 Some analysts relate disequilibria (including inflation), primarily, to the breakdown of the political process and rent-seeking activities by old elite. (A. Shleifer and R. Vishny, "Corruption", Quarterly Journal of Economics, 108, 3, pp.461-488; P. Boone and J. Hoerder, "Inflation: Causes, Consequences, and Cures" in P. Boone, S. Gomulka and R. Layard (eds), *Emerging from Communism. Lessons from Russia, China and Eastern Europe*, London, 1999, pp. 42-72). This paper emphasizes the magnitude of the required resource reallocation and friction, which are sometimes so large that they are likely to undermine durable stabilization.

Diversity

Despite the above generalisations, there are important disparities in the region. Croatia, the richest among the seven countries, has suffered significantly because of wars, but it does have a considerably stronger institutional set-up than do its neighbours. In addition, the recent political changes in the country would very likely put her on a much faster track towards admission into the EU. Bulgaria and Romania, too, in spite of persistent difficulties are better-situated economically than the rest They also manifest a certain ambivalence as to how much they should develop links with a highly unstable region; this ambivalence is reinforced by the fact they already have Association Agreements with the EU (and were invited to start admission negotiations last December) and do not wish to be dragged by the expected inertial influence of "inclusion" in a complicated area.

Economic distress

Most of the region can easily be qualified as a distress area, as being made up of *distress economies*. Such economies are characterised by:

- major internal disequilibria, which are not necessarily reflected by inflation rates, but glaringly illustrated by very high unemployment rates;
- over-dependency on external finance and aid-addiction;
- massive destruction of the capital stock following the military conflicts and regime change;
- prolonged periods of output decline;
- increasing poverty;
- little investment in fixed assets;
- trade disruption;
- high currency substitution; [53]
- subjection to a multitude of external shocks, including the brutality and extensive destruction caused by succeeding wars.

Aid addiction

Several countries (economies) survive only due to huge infusions of assistance from outside. Bosnia-Herzegovina is again the most conspicuous example with external finance (the current account deficit) approaching 40% of GDP. But also Albania and Macedonia rely extensively on foreign finance. And it is clear that Kosovo will experience a similar fate, being totally at the mercy of foreign donors. There are two aspects involved in this dependency relationship. One refers to the extraordinary circumstances which justify an extraordinary intervention, whether for balance of payments reasons or for economic reconstruction; this aspect should not necessarily cause worry. In such a case aid will, for a while, help domestic consumption not to fall brutally, after which, following an expected "normalisation", output would recover or grow. The second aspect is different; it refers to *addiction* to foreign assistance when the latter becomes chronic and does not focus on development projects. This would be a very bad sort of *Dutch disease*[54], with extremely negative long-term economic

53 It is noteworthy that this high currency substitution coexists with monetary stability in many parts of the region (only Albania and Bulgaria experienced bouts of hyperinflation following the financial collapses). This fact highlights the lack of trust of citizens in the existing economic arrangements. It also questions the sustainability of monetary stability unless there will be major improvements in the functioning of economies, or external finance will continue to 'keep the boats afloat".

54 In the literature *Dutch disease* refers to consequences for behavioral patterns and structure of the economy of

consequences.[55]

A special sort of war economy (society)?

Reconstruction in the region has a very dense connotation; on the one hand it means physical rebuilding - after tremendous devastation by war - , which could imply technical improvement due to embodied technological progress; on the other hand, it involves the overhaul of social and organisational structures in the context of transformation and modernisation. In practical terms, reconstruction is made extremely hard by the sort of economy which has evolved in the region: a public sector heavily dependent on financial infusions from abroad, which do not finance development projects, and an extensively criminalized private sector. It is indisputable that these traits have become more salient over time, and that the huge exodus of Albanians from Kosovo, as well as their subsequent return, involve the functioning of malign economic and social structures.

Poverty

The population of South East Europe is, by far, the poorest in Europe. The region's GDP is about 0.7% of EU GDP, while its population makes up about 15% of the EU level. If a poverty level of $ 4/day is used,[56] more than 50% of the region's population falls below it. Poverty is a very fertile ground for criminal activity.

Economy and criminality

Much of the ubiquity of lawlessness is just an outcome of activities becoming less hidden, or of poor statistics. It is also true that some of what appears as illegal activity is due to the still very fuzzy nature of the legal environment, and to the evident need to privatise contract enforcement when official law enforcement capability is almost non-existent.

Generally, one can pose the following question: what kind of capitalism is being built in these countries? An optimistic answer would be two-fold. Firstly, the picture is too multicoloured for justifying an all-encompassing answer – the intensity of the phenomenon is different in the various national environments (Croatia is very different from Albania) and, as a result, its consequences and prospects are dissimilar. In fact, different kinds of capitalism are emerging in transition countries. Secondly, the presumption could be accepted that this phenomenon might recede over time, in keeping with the unfolding of transformation. A pessimistic answer would highlight the vicious circle dynamic – as a conspicuous example of 'path dependency' – and the enhancing factor represented by rising unemployment and poverty among large segments of society, as well as the public's increasing mistrust of an apparently impotent and corrupt government bureaucracy. A pessimistic answer would also point out the danger that the tentacles of organised crime would influence increasingly the functioning of institutions, and encroach on the political process, ultimately in a resilient fashion.

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a financial "bonanza", which may come to an end and leave the economy extremely vulnerable.

55 P. Rayment remarked to me that this is the sort of extreme situation that the political opponents of aid in donor countries seize upon to attack all forms of assistance to foreign countries.

56 Suggested by B. Milanovic, "Explaining the rise of inequality during transition", The World Bank, manuscript, 1999

Weak states (weak public governance)[57]

A weak state is a feature that will increasingly dominate the debate on reconstruction in the region, for a simple reason: a public policy aimed at reconstruction involves governmental action; reforms cannot take place only at grass-root level. On the one hand, this feature is not surprising since it characterises most of the post-communist states. On the other, it acquires additional dimensions in countries ravaged by wars and inter-ethnic conflicts, where the legitimacy of public-office holders can be questioned systematically by citizens or by minorities, despite elections.

Weak states (or state collapse, as in Albania) are one of the reasons for which some analysts advocate the involvement of external actors in the region and commend the functioning of protectorates. However, the involvement of external players is not devoid of disadvantages and it may even accentuate the fragility of the local institutions.

Trade reorientation

Romania and Bulgaria now trade extensively with the EU. There has been considerable trade diversion (reorientation) among the former constituents' parts of Yugoslavia as well. Intra-regional trade is quite low, whereas significant trade takes place on special routes only (between Serbia and the Republic of Skrpska; Croatia and the Bosnian Federation; Macedonia and Serbia) and this for obvious reasons. Is it a temporary phenomenon, or is it getting back to a pattern of normality,[58] namely, trading with the rich West which can provide capital goods and many other commodities. The truth is in between, in the sense that important ties (which are currently broken because of political motives) could be restored, but it seems impossible to recreate the links that existed in the former Yugoslavia.

Increasing divides and growth prospects

Whereas the Central European transition economies embarked on sustainable growth in the early 90s[59], the Balkans continue to be mired in the realm of stagnation[60]. The positive growth rates in Albania and Bulgaria, in 1997, 1998 and 1999 represent recovery from very low levels set by the major crises of more than two years ago; consequently, they are not telling much about the future. Savings and investment ratios are pretty low in the Balkans, which further dents prospects for growth. Unless the context changes dramatically, it is very likely that the distance vis-à-vis Central European transition economies will continue to grow and that this dynamic will influence the perceptions as to the timing of EU enlargement to South-East Europe.

4. The post-war situation is no less complicated

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57 Weak public governance is one of the main themes in the paper of V. Gligorov, M. Kaldor and L. Tsoukalis, "Balkan reconstruction and European Integration", October 1999, manuscript

58 As before the Second World War.

59 Hungary had to undergo a major adjustment program in 1994-1995 (The Bokros program) and the Czech Republic is currently experiencing some difficulties linked to the insufficient pace of restructuring. Overall however, the resumption of growth can be located in the early 90s.

60 The current apparent growth resumption in Bosnia-Herzegovina is highly irrelevant.

The last military conflict focused the attention of the whole of Europe on the Balkans. Until recently, the attitude vis-à-vis this “powder keg” looked more like containment, or a damage control exercise. The *Enlargement* of the EU was very much a Central European affair, for reasons (spelled out by Brussels) connected with the functioning of market structures, democratic procedures, respect for minority rights, etc. As to the South East Europe Co-operation Initiative (SECI), which was initiated by Washington and not Brussels, it was more directed to strengthening the capacity of the states in the area to deal with the porosity of their borders, to fight drug and weaponry trafficking; regional co-operation was, in the main, seen from that perspective[61]. A substantial shift seems to have occurred in Western European capitals, recently in Brussels, which was reinforced after the new Commission took office.

The Stability Pact and the economic support pledged by the EU, IFOs and other donors signal an acknowledgement that there is need for another approach in order to avoid further conflicts and economic decline. There is now talk about a region-wide policy that should help economic reconstruction and encourage regional co-operation. Leading politicians of Western Europe mention as a target, the “europeanization” of the Balkans and its accession into the EU, even if this would take many years to be accomplished, while others have urged the “economic regeneration” of the region. However, as yet, there is nothing nearing the approach of a new “Marshall Plan”, in which regional initiatives would be co-ordinated with national development programmes, all buttressed by adequate financial and technical assistance.[62]

As analysts point out, unless arrested, the dynamics of further deterioration and conflict can plunge the whole region into chaos, which would affect the stability of the Continent.[63]

The list underneath attempts to highlight some of the intricate complications engulfing the region, and some of their economic consequences including possible strong setbacks for reform policies.

4.1. The political geography is still fuzzy

Several local dynamics were mentioned, which indicate that the process of redrawing borders is still unfolding. The situation of Kosovo will be a formidable issue to tackle, taking into account the reality on the ground (the determination of Albanians to get independence after their terrible plight of exodus and return) vs.

61 It is fair to add however that, lately, SECI has been trying to expand its activity in the field of energy conservation and finance for SMEs.
62 Italy has always emphasized the need for the EU to pay more attention to the state of the Balkans, which is a fully understandable stance in view of its geographic location. It is this country, together with Greece, which for years had to deal with floods of refugees (not only from Albania), with the other threats coming from the area. For this very reason Italy became the most vocal supporter of the inclusion of Romania and Bulgaria in NATO.
63 This is one of the main tenets of the CEPS (Center for European Policy Studies) 1999 study: M. Emerson, D. Gross, and N. Whyte, “An Economic System for Post-War South East Europe”, Brussels.

its formal status and its emotional significance to Serbs.[64] Montenegro has a propensity for the separation of Yugoslavia that is fuelled by political dissonance with Belgrade and the quest to implement radical market-oriented reforms. The tension created in Macedonia by the inflow of Albanian refugees affected a very delicate demographic balance, which bears considerably on the political make-up of the country. The Macedonian authorities, for obvious reasons, fear that, aside from the influence of economic plight on society, the political stability of the country may increasingly be undermined by the quest of the Albanian population for more saying in the governance of the country; this fear is reinforced by what some see as a design for the creation of a *Greater Albania*, which could entail the split of Macedonia.[65] Such a denouement would be catastrophic, for it may involve neighbouring countries (Bulgaria and Greece) in a major conflict.

In general, it can be asserted that the concerns of governments with the "geographic stability" of their states divert energy and resources from economic pursuits; it also helps the primacy of nationalism and it reinforces extremism. This is even more valid in the case of weak states, of weak economies, which are highly vulnerable to external shocks. Such concerns are likely to impede economic reconstruction to the extent that jurisdictional matters are important, as well as the co-operative efforts of other governments in the region. Murky and unstable frontiers and big uncertainties create a propitious environment for illegal activities, for organised crime. It is no secret that much of the economic activity in Albania, Serbia, Kosovo, Bosnia-Herzegovina, etc. is in the hands of criminal gangs, which frequently operate under the condoning eyes of authorities. The scale of this phenomenon needs to be judged in view of the weakness of institutions, in general, but also in conjunction with the visible and invisible agenda of various governments.[66]

4.2. Dislocation of people

The magnitude of the refugee phenomenon reached gargantuan proportions during the last war. Although hundreds of thousands of Albanian refugees returned to Kosovo, the situation in several countries remains tense. There are also hundreds of thousands of refugees in Serbia and Montenegro. The human tragedy of the people on the run is unspeakable and the recipient countries' capabilities of supporting them have proved to be very limited. Likewise, outside aid has not been forthcoming enough owing, frequently, to bureaucratic entanglements. Most of the refugees have a second-class status and are easy prey for the local gangs. This state of affairs is worrisome, particularly so in Kosovo.

In this context one can understand why highly-skilled people, too, think

64 See in this respect the proceedings of the conference "Kosovo and the Albanian Dimension in Southeastern Europe", Athens, January 1999 published by Th. Veremis and D. Triantaphyllou, Athens, ELIAMEP, 1999
65 "Ethnic tensions stir in Macedonia", Financial Times, 27 April 1999, p.2. L. Frckoski, former foreign minister of Macedonia is quoted as saying that "There are fears that NATO indirectly supports plans for a greater Albania, because that's what an independent Kosovo would produce" (Ibid.)
66 The information on how more than $1 billion of aid was "diverted" by public officials in Bosnia-Herzegovina is very revealing in this respect. See also the analysis of S. Pecanin (1999).

increasingly of leaving their areas. There has been an intense *brain drain* for years now. With the probable exception of Croatia, all the countries in the Balkans (including Bulgaria and Romania) face the depletion of their most valuable human capital; this is probably the worst shock for their long-term growth potential. If one adds to this the deterioration in the educational system [67](because of the lack of resources) the combination becomes more than threatening: both asset-stripping and divesting are taking place simultaneously.

4.3. Direct economic impact
4.3.1. Macroeconomic imbalances

In the wake of the Kosovo conflict the macroeconomic situation of most of the countries in the Balkans worsened in terms of GDP dynamics, current account and trade deficits, budget deficits and unemployment. For the sake of maintaining a modicum of macroeconomic stability in the area (including Bulgaria and Romania) affected by the consequences of the war, the IMF and the World Bank estimated an immediate need of $1.6-1.7 billion; but this sum was considered by most local experts as insufficient. It should be said that these developments occurred at a time of marked change in investors' sentiment following the financial crises in East Asia and Russia. This means that the local economies will have an even harder time attracting foreign capital and foreign direct investment in particular.

4.3.2. More distress

Most of the governments in the region can hardly run sensible macroeconomic policies without considerable *accommodating* inflows of capital (primarily from official creditors)[68]; and prospects are not good at all considering local and external dynamics. There are no signs that real economic growth (as against recovery, as lately experienced in Albania) can be resumed in the next couple of years, since there is hardly any basis to that end; savings ratios are low, as well as investment in fixed assets. The effects are dramatic in terms of governments' ability to improve their governance performance.

One tendency which has become an overriding concern (obsession) for politicians and governments is the size of unemployment, where the latter reflects pertinently the state of economies, the still very much depressed level of output as against 1990[69]. With about 35% in Macedonia, around 40% in Bosnia-Herzegovina, almost 20% in Croatia, nearly a similar figure in Albania, above 30%

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67 Poverty, healthcare neglect and decline of life expectancy, public education crumbling, etc. give the extent of the rapid deterioration of public goods in most of the transition economies, including those in South East Europe.

68 It is noteworthy that this high degree of vulnerability is not the result of financial liberalization cumulated with non-restructured real economies; it is the inability to cover endemic trade imbalances which explains it. However, the functioning of parallel currencies (DM and USD) and the illegal export of capital do nuance this assertion without invalidating it.

69 Even if correction is made for what, in the case of transition economies, Jan Winiecki called redundant output, the level of economic activity is disappointingly low in view of its potential.

in Serbia, etc. this phenomenon is shaping the future of these societies.[70]. Unemployment in these economies needs to be understood in a more complex way; it is not only the magnitude of *hysteresis* that matters here but the anatomy and physiology of gravely ill societies. As mentioned before, social exclusion on such a scale is a recipe for social and economic turmoil. This is why the World Bank's Comprehensive Development Framework has considerable relevance for the Balkans. However, the formulation and implementation of policies in such a framework are hardly possible so long as the sources of local conflicts are not kept under check (eradicated) and economies do not start to recover. For the latter to occur, a large injection of development-focused assistance, both financial and technical, is needed.

4.3.4. The environment

Ecological concerns are not non-existent on the policy agenda of various governments of the region. But there are significant differences as against the way these concerns are dealt with in Western countries. Firstly, it is the issue of ranking them among the range of objectives. It goes without saying that where military conflicts dominate policy-making, ecological concerns get a back-seat among priorities. Secondly, it is the budget constraint that forces governments to prioritise by focusing more on short-term goals; consequently, ecological concerns become downplayed unless there is an emergency, for example, as the need to clean up a source of drinking water. Last but not least, it is the very impact of military conflicts, namely destruction on the ground and in the air, that affects the environment with very resilient consequences. It can be said that ecological damage may be, to a large extent, irreversible.[71] It goes without saying that an un-repaired environment would not allow South East Europe to advance on the track of integration with the EU. Moreover, the impact could be heavily felt through the inability to export the products of food industry, which has a big potential in the region and which can employ millions of people.

5. A Policy Agenda for South East Europe

In general, the lessons of transition and the dramatic events of the last decade in South East Europe ask for a policy which should restore confidence in

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70 Government officials and independent analysts from the area express constantly their deep worries about the consequences of rising unemployment.

71 By making an assessment of the ecological impact of the last war the Economist Intelligence Unit states that "there is already evidence to suggest that the ecological risk to the region from the bombing campaign will be substantial, widespread and prolonged. The bombing of oil refineries, chemical plants and petrol dumps has led to major chemical and toxic spillages which are polluting the Danube and the environment throughout the Balkans with clouds of toxic fumes. Europe's largest river flows through Romania, Bulgaria, Moldova and Ukraine. These are all downstream from Yugoslavia and millions of people in that area rely on the river for drinking water. Smoke and toxic clouds caused by bombing and fires at oil and chemical plants are releasing carcinogenic dioxin into the atmosphere. There is also increasing concern about the use of depleted uranium…"EIU, "Economies in Transition", 2d Quarter 1999, p.26. See also "Ecological Damage" (pp.38-39) in Mladjan Dinkic (ed.)" "Final Account", G 17, Belgrade, 1999. On the range of environmental consequences of armed conflict see also UN/ECE, "Environmental Performance Reviews: Croatia", United Nations (New York and Geneva), 1999, especially chapter 3.

the ability of elected officials (public authorities) to deal with tremendous challenges. But this ability has to be defined in a sensible way. For, on the one hand, the policies put in place until now have failed in important respects and this experience invites deep reflection, introspection and candid debate about errors as well as possibilities for the formulation of better economic policies. On the other hand, one has to approach the myriad and scope of challenges in South East Europe with humility, and acknowledgement that miracles are not possible. Not only are the challenges ahead overwhelming, but also the development equation is far from being an easy one to solve. Moreover the intertwinement of economic and security issues can be disconcerting. What is realistic to achieve refers more to prerequisites and mobilisation of resources as ingredients for a peace and development (modernisation) process. There is thus a clear need for pragmatic and consistent public policy both at a national and regional level.

5.1. The role of public policy[72]

In history one hardly finds examples of successful economic development (catching-up) which have not involved exceptional vision and effective public policy. Therefore, the question is not whether public authorities should intervene in the economy; it is how and how much they should. [73] In the Balkans policy-makers have to proceed from a dramatic situation and, aside from security-related objectives, they have to reconcile the need to stop economic decline (and resume growth) with the social implications of rising inequality and impoverishment of people.[74]

What sort of public policy should policy-makers in the region practise? In this respect one can list two main arguments, which question the effectiveness of public policy for transition economies. One argument proceeds from effects of globalisation (liberalisation), which allegedly destroys the effectiveness of national economic policy, implicitly, of public intervention. This argument itself poses two problems. One is represented by the effects of globalisation since the ‘one-price law’ does function as a tendency only and imperfectly, and the claimed mobility of factors of production is too incomplete and asymmetric (regionally concentrated) in a world where economies of scale, agglomeration economies and *cumulative causation* are intense.[75] These effects explain rising inequality both inside and among countries[76] and the late backlash against globalisation.[77] Let us not forget

72 L. Summers remarked that, aside from integration cum national sovereignty, “a third imperative for most is the pursuit of public purposes that markets, left to their own devices, may not produce – the right opportunities for the poor, the right environmental policies, the kind of outcomes we want”(“Summers questions development policy research”, World Bank Policy Research Bulletin, April-June 1999, p.1)
73 ‘A well functioning economy requires a mix of government and markets. The balance, structure and functioning of that mix is at the heart of a development strategy’(N. Stern and J. Stiglitz, “A Framework for a Development Strategy in a Market Economy: Objectives, Scope, Institutions, and Instruments”, London, EBRD Working Paper, no.20, 1997, p.1)
74 N. Birdsell, “Inequality within Nations is the Danger”, Financial Times, 17 January, 2000
75 For a refreshing analysis of the effects of globalization see D. Rodrik, “Has Globalization Gone Too Far?”, Washington DD, Institute for International Economics, 1997
76 Increasing discrepancies between so-called knowledge have and have-nots strain social structures and create tensions; high inequalities would also impede economic growth, as World Bank studies emphasize. The Comprehensive Development Framework (CDF) promoted by the President of the World Bank, Jim

that the period preceding the First World War was one of extreme openness of trade relations and labour movement, to be followed by rising protectionism.[78] The other problem with this argument is that it espouses a sort of *technological determinism*, as the social arrangements, institutions of market economies would not primarily be dictated by individuals' economic and social motives. The other argument that questions the effectiveness of public policy is linked with the *weak state* syndrome; the latter would empty public policy of much relevance and trying to do too much may enhance the operation of the very factors which undermine policy effectiveness (that rising corruption and cronyism would be unavoidable). This is a version of the old debate *market vs. government failures*. Moreover it can be argued that, in the case of post-communist countries, one is faced with an almost innate lack of capacity to formulate and implement public policies – which is due to the legacy of communism. But as our analysis suggests, when the state is weak and institutions are fragile, it is almost wishful thinking to believe that unfettered markets will do the job of institutional build up and development: the most likely outcome, as reality clearly shows, is an expanding criminalized sector and unlawful behaviour. Thence the reform and strengthening of public administration are and should be a top priority for policy, as a precondition for the creation of an efficient market economy. And this means public policy in high gears. Even if economic development would be viewed as a "dissolution" in a modernising transitional space, such as the EU, the need for public policy would be raised at a higher level.

The bottom line is that there is need for effective national public policy and the way to forge it, and to answer the arguments highlighted above, is to strive to develop basic market institutions even if this is a time-consuming process: defining and enforcing property rights, proper regulations, instruments for monetary and fiscal control, for social insurance and conflict management[79]. The fight against corruption and criminality would be part and parcel of this endeavour. The assistance provided by the IFIs and the EU can be very helpful to this end, but this aid has to use local knowledge and allow governments to have the final say in formulating their policies.

In the context of institutional build-up and of the quest for development, public policy needs to deal with major dilemmas linked to monetary stability, trade policy, privatisation, etc. As the experience of transition indicates, clear-cut solutions do not exist and policy-makers have to be pragmatic and consider various trade-offs. For instance, currency boards have aroused interest among policy-makers in transition economies. Estonia used this device early on in order to achieve monetary stability and reinforced the view that currency boards are the most effective mean to attain price stability. In South East Europe, Bulgaria

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Wolfensohn reflects this vision, which contrasts with Simon Kusnets, the economics Nobel Prize laureate's argument, namely that growth implies and is accompanied by rising income inequality.
77 Globalization affects social psychology, and it can increase fears of and resentment towards neighbors or "those who are not like us"; xenophobia is rising in many parts of the world, including Western Europe.
78 J. Williamson makes an illuminating analysis of that period and warns that one should not consider globalization as an inexorable process. See his "Globalization and the labour market: using history to inform policy" in Ph. Aghion and J. Williamson: "Growth, Inequality and Globalization", Cambridge, Cambridge University Press, 1998, pp.103-201
79 D. Rodrik, (1999)

introduced a currency board after the big financial crisis of 1997 which proved quite successful in bringing inflation down to a one digit level. In Bosnia-Herzegovina, too, there is a functioning currency board and inflation is pretty low. On the other hand, in many transition economies low inflation has been pursued and achieved through traditional means, by a strict control of money supply. At present, some argue that currency boards should become the rule in South East Europe;[80] this argument should be judged in the context of the debate, world-wide, as to whether vulnerable economies should adopt a key currency (the USD or the Euro) as their own. There are merits in adopting a currency board, particularly when governments lack credibility, and there is need for applying strict rules as a means of fostering discipline in the conduct of monetary (and not only) policy. But there are also significant disadvantages such as[81]:

- a currency board can subject the economy to major shocks following substantial inflows and outflows of capital, especially when base money is low and financial markets are thin; substantial outflows can cause a major deflation and strain the banking system;
- a currency board reduces the number of policy instruments available; it takes away exchange rate adjustment as a means for the economy to mitigate adverse shocks;
- a currency board does not impose financial discipline automatically; although it helps reduce the fiscal deficit (through a probable reduction of public debt service via a diminution of interest payments) the quasi-fiscal deficit is likely to stay high unless there is intense restructuring of firms;
- a currency board may even become a liability unless the economy scores productivity gains, which should offset probable inflation differential vis-à-vis, the best performing economies of Europe.

Trade policy also poses numerous problems. One of the main tenets of transformation strategy is trade liberalisation as a means to help dismantle the command system. This is a very powerful argument in view of the power of old structures, of the resistance to change of vested interests. Nonetheless, this argument should not annul the discussion on the kind of trade policy a transition economy should use. For transformation means both regime change and a quest for development. Does open trade (trade liberalisation), or export-orientation mean completely free trade, or a neutral tariff policy? Is there room and need for a trade policy that should enhance development by considering imperfect markets and the need to foster domestic entrepreneurship?[82] Empirical evidence shows that the success of Asian economies rested on clever public intervention (industrial policy)[83], which considered trade policy as a means to extricate the economy out

80 "A System for Post-War South-East Europe", CEPS, Brussels, 3 May, 1999

81 See also Jeffrey Sachs and Felipe Larrain, "Why Dollarisation is More a Straitjacket than Salvation", Foreign Policy, no.116, Fall 1999, pp.80-93

82 "There is increasing doubt that growth is simple as it appears in the export-oriented arguments, and renewed emphasis is placed on the more basic characteristics of an economy, especially entrepreneurship, institutions, and knowledge accumulation"(H. J. Bruton, "A Reconsideration of Import Substitution", Journal of Economic Literature, June 1998, vol. XXXVI, 2, pp.904)

83 D. Rodrik suggests it in "Understanding Economic Policy reform", Journal of Economic Literature, vol. XXXIV, 1996, pp. 9-41. See also Jin-Tan Liu, Meng-Wen Tsou, and James Hammit ("Export Activity and Productivity: Evidence from the Taiwan Electronics Industry", Weltwirtschaftliches Archiv, 1999, vol.135(4), pp.617-689…

of a development trap.[84]. It appears that trade policy needs to reconcile acute developmental concerns with those tied to the ability not to allow policy to be captured and perverted by powerful vested interests. Therefore, trade policy in poor transition economies is a more complicated task than some argue. Most certainly, it also has to refer to the kind of trade arrangements between the EU and these countries, and to the role of EU aid in this context.

Another major policy dilemna is linked with privatisation. Should governments privatise as fast as possible or should they be concerned, primarily, with *corporate governance* and the development of SMEs? The answer to this question is complicated by the financial distress of most governments, which compels them to see privatisation as a means to fill in the holes of budgets.

5.2. Economic reconstruction (regeneration) in South east Europe

Some pundits make an analogy with the end of the Second World War in evaluating the prospects of the region. There are several motives for arguing that a plan for economic regeneration, and achieving durable peace and security in South East Europe, would be a more complex and arduous endeavour than the Marshall Plan. Firstly, in those days there was no process of state-formation (state dissolution) and, thence, no ensuing conflicts; this fact favoured, a few years later, the start of the process of economic integration by the setting up of the Coal and Steel European Communities. Secondly, there was a clear distinction between victor and loser in the war which did not involve revision of borders.[85] This is not the case in the Balkans nowadays, where borders are still questioned more or less loudly. Thirdly, the Marshall Plan meant primarily, an infusion of funds for energising economic reconstruction in an area that possessed the institutional ingredients of a market economy; and the funds contained many grants. Fourthly, there was, at that time, a big common enemy: communism, both external and internal (with the latter represented by the strength of the communist parties in Italy and France). Who, nowadays, is the big common enemy of the peoples in the Balkans and to security in Europe? A candidate would be poverty, underdevelopment at a large periphery of a prosperous Europe. But this is an imprecise enemy and not easy to deal with by looking at world-wide experience; such an enemy is less easy to generate support for a coherent policy response before conditions cause a violent crisis. All these differences magnify the need for a grand plan for South East Europe, in view of the institutional fragility and the distress state of most of the local economies.

A Grand Plan[86], a new policy, is badly needed, but it should be wisely

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84 “less developed countries undergoing trade liberalization and structural adjustment programs, unaccompanied by requisite technological change, may get locked in a development trap as they specialize in low technology and resource-intensive industries” (Saty dev Gupta and Nanda K. Choudry, “Globalization, Growth and Sustainability: an Introduction” in S. D. Gupta (ed.), “Globalization, Growth and Sustainability”, Dordrecht, Kluwer Academic Publishers, 1997, pp.4)

85 Certainly, the division of Germany could be mentioned as a counterexample, but it does not change the thrust of the assertion.

86 David Steiberg, who served in Marshall Plan in Washington and London, argues that the Marshall Plan can provide vital lessons for Balkan policy (Financial Times, 29 January, 2000). He highlights not the plan itself

calibrated (with properly defined targets) and implemented. Assistance needs to take into account the complexity of inter-regional relations, the still murky political geography of the area, the existence of latent conflicts, etc. This extremely complex situation links inextricably, national economic objectives (including economic security) with other goals such as peace and security. At the same time, the stability of the region as a whole can be viewed as a collective good, a public good for Europe. Nonetheless, whereas goals can be easy to define in abstract terms (peace and security, social cohesion, economic progress, "market-oriented reforms", etc) they are much harder to formulate and pursue practically – particularly when they imply hardly reconcilable objectives of non-cooperating governments,[87] or have to be pursued under very adverse circumstances. In the Balkans this situation is ubiquitous and explains the heavy presence of outsiders (including economic aid) and the existence of protectorates. But foreign presence does not automatically simplify the solution to problems. Can the Stability Pact fulfil the requirements of such a Grand Plan? The Stability Pact (SP) is a palpable embodiment of the growing concern in the West about instability in the Balkan region. It is noteworthy that the Pact takes clear cognisance of the very intricate linkages between economics, security and politics in the area, which is illustrated by the functioning of specialised roundtables. Through various high-level meetings (such as the summit in Sarajevo, in 1999) the SP aroused many hopes and helped focus the attention of Western public opinion on concrete issues. The SP could become the lynchpin of a massive assistance program for the region to the extent that a series of practical questions are answered. For instance, there is need to define better the relationship between the EU aid programs for the region and the activity of the SP. In a wider context, the SP, as an institutional framework and a process, has to be embedded into the overall policy of the EU vis-à-vis South East Europe. Although the Pact appeared as a German initiative, its effectiveness hinges on its functioning as part and parcel of EU policy aimed at regenerating the region economically. Thence emerges the necessity for better policy coordination and better definition of attributes. Likewise, the Pact has to give a stronger voice to the "locals" in terms of policy formulation and implementation. Last but not least the Pact, by assuming that it itself will not fall prey to policy fatigue, has to become a driving force in maintaining Western financial support for the region. In any case, the SP can and should become part of the new Strategy.

5.2.1. A new Strategy

Tackling the problems of South East Europe requires a vision that should frame the policies of both domestic (local governments) and external actors. This new vision and policy need to consider: the consequences of the years of immense destruction brought about by military conflicts; the failures of reform efforts; and the still very complicated nature of relations inside the region – all

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(since "the problems and the needs of the Balkans are indeed far different…") but the process. Steinberg says that a regional strategy be "committed not only to sound economic policies but also to democracy, protection of human rights, advancement of labor rights, pursuit of private enterprise, etc"

87 This is why the ECE Economic Survey of Europe no.2, 1999, talks about aid as a means for raising the cost of non-cooperating governments (pp.20). The recent agreement between Romania and Bulgaria to build a bridge over the Danube, is the result of pressure exerted by the EU, and the prospects of financial assistance.

these in conjunction with a development challenge. In this respect policy-makers need to take into account lessons of development experience such as[88]:

- development needs a comprehensive approach;
- sustained development must be socially inclusive;
- the importance of macroeconomic stability for growth;
- growth trickles down too slowly, so development efforts must address human needs directly;
- development needs peace and security.

The Strategy should consider what is realistic to achieve without shunning bold action; it also has to put the whole endeavour into a longer term timeframe, keeping in mind the intricacies of the situation on the ground. The Strategy should be cast under three major headings: crisis management; economic reconstruction; and economy reforms (institutional change).

The need for crisis-management

The end of the last military conflict does not rid South East Europe (the Balkans) of its deep-seated, latent animosities and other sources of conflict (of future conflicts) Therefore it makes sense to talk about crisis management in a dual, temporary perspective *cum* economic assistance.

Crisis management has to be seen over the short term and the longer term. Over the short term it refers to mitigating the losses and pains related to the recent military conflict, or avoiding new bloody clashes. It can be submitted that *crisis management* in this region is of a different sort, in the sense of having to be projected long-term as well; it has to be an exercise linked with the nature of conflicts among the local players. It may take years and years, if not decades, for injuries to heal, and it may require the presence of "outsiders" for a long period of time.

Several assumptions can be submitted with regard to crisis management:

- unless the region gains a certain amount of stability and mutual tolerance among the local players, it would be hard to embark on region-wide reconstruction;
- mutual tolerance would involve changes in collective psychology;
- crisis management needs to be more prevention- rather than reaction-oriented; to this end there is need for a better understanding of the roots of collective psychology in the region;
- crisis management and conflict resolution involve tremendous effort in confidence-building (injury-healing), which would be well-addressed by restoring gradually economic ties among the local players; this means strenuous efforts at developing economic cooperation in the region, among the former components of the old Yugoslavia;
- crisis management does not exclude starting economic reconstruction;
- crisis management has to consider the institutional frailty of the countries in the region, and their high vulnerability to both domestic and external

88 "1998 World Bank Development Report". See also S. Yussuf, "Development challenge: think globally but act locally", International Herald Tribune, 17 September, 1999.

shocks.

Economic reconstruction

Economic reconstruction should proceed from facts and assumptions such as:

- clear prospects of economic reconstruction (in both a physical and institutional sense) would give the people in the region hopes and, particularly, incentives to think less about the past and more about a better future;
- hopes are critical in creating *positive expectations*, which are essential if the policies are to get popular (social) support;
- changing expectations in a positive direction hinges on the existence of credible plans (policies) and concrete measures cumulated with tangible results;
- credible plans (policies) are meant to bring about economic recovery, and later, growth;
- there is a need for considerable and creative aid (from outside), in the context of the Grand Plan, on the basis of close policy coordination among the donors. Aid would supplement domestic resources, and thereby help recovery in the short term and growth over the longer term.
- because of the way the region is perceived by investors, official creditors will play a major role for years to come;
- aid should include substantial grants, both to avoid further indebtedness in those countries which are already heavily indebted, but also to move matters on more rapidly (loans are subject to many bureaucratic hurdles and delays). This is one of the relevant lessons of the Marshall Plan, which can be applied to South East Europe;
- aid should focus on development projects so that consumption-related aid addiction is eliminated over time.
- the Plan should include major infrastructure projects of regional importance which would hook up South East Europe with the European Union; the positive slip-over effects would be enormous. The European Investment Bank and the World Bank have a major role to play in this field.

Public works would help deal with the problem of enormous unemployment in some of the countries; it would provide lots of people with jobs in the official economy, and help combat crime. In the same vein should be judged the stimulus given to the construction industry in the areas that suffered major destruction during the wars.

- it would be more than useful to favour local companies as far as possible in the various projects; positive discrimination makes sense in view of the unemployment rates in the region;
- South East Europe needs soft loans, both for major infrastructure projects as well as for helping small- and medium-sized enterprises (the private sector);
- in order to reduce risk-aversion on the part of private investors, guarantees should be provided by specialised Western institutions;
- Bulgaria and Romania should be covered by such a plan. Both countries can operate as in-built political stabilisers, but they are themselves in need of economic support;

- the Strategy should consider more forceful measures for dealing with various social and institutional evils that plague the region (drug trafficking, arms-smuggling, etc). This would be also part of the long-term exercise in crisis management (confidence building);
- it is essential that Yugoslavia (Serbia) be part of the process of reconstruction; it is a key country in the region with a strategic location, and its infrastructure needs to be rebuilt; isolating Yugoslavia would not necessarily enhance democracy in that country, it may even prove counter-productive[89]. Sanctions proved to be ineffective; they accentuated rent-seeking and enhanced corruption in a country where influence is so much concentrated at the top of the political hierarchy;

A possible virtuous circle of higher savings

Most of the region is trapped in a vicious circle which is mirrored by low saving and investment ratios, economic stagnation, poor export growth, rising external indebtedness, etc. In addition, the impoverishment of the population diminishes the propensity to save and causes a worsening of the business climate (rising criminality). Therefore, breaking this vicious circle should be a top priority of the strategy (policy) of economic regeneration. The simple mechanics of creating a virtuous circle demands economic recovery plus a change in expectations (which should reduce capital flight). Economic recovery would likely entail corresponding rises in incomes (unless the rise of GDP is totally aborted by paying external debts), which would further help savings to get back to higher levels. And considerably higher rates of domestic savings would favour higher investment rates, which would permit economies to grow.

In order to achieve economic recovery and enhance growth, foreign aid can play a decisive role. For instance, 5 billion euros for the entire region in one year would mean about 5% of its GDP (of about 100 billion euro). This would translate into an additional supplement of domestic savings of a similar magnitude. Following consistent policies and focus on development projects, after a period of time the level of domestic investment could be maintained with less levels of foreign aid. Maintaining the level of foreign aid could even raise the investment ratio higher (assuming that capital does not flee). Economic growth would rise should diminishing rates not set in.

It goes without saying that these causal relations are much simplified, since recovery and further growth depend on institutional factors as well. Nonetheless, this sketch of linkages shows how economic aid could provide a major impetus to the entire process of regeneration. Many questions remain, but they can be dealt with; a valid question relates to the workability of the multiplier in economies that have a low monetisation level and thin financial markets, so that inflation should not get out of control. In this respect, the answer would highlight the importance of targeting projects that have the highest multiplier effect, so that the injection of liquidity should not be excessive. In addition, central monetary authorities would have to try to sterilise excess liquidity. Exchange rate policies need to help so that exports play a supporting role. The latter issue highlights a disadvantage posed by

89 C. Bild, International Herald Tribune, 29 August 1999. See also Q. Peel's article "Perilous Policy", Financial Times, 12 August, 1999, p.10

currency boards. In general, a whole range of policies that are mutually consistent and supportive of development (growth) is needed.

Providing assistance

Assistance to the region can be conceived from several angles sketched below:

- immediate humanitarian aid;
- macroeconomic support for the sake of dealing with balance of payments gaps, budget deficits, labour dislocation impact, trade disruption and loss of markets;
- infrastructure projects for the short term such as pontoon bridges to be built over the Danube, and facilites for water supplies in Albania;
- advancing reforms (privatisation and corporate governance, build-up of legal and enforcement frameworks, etc);
- the strengthening of local banks;
- over the longer term, aid needs to cover infrastructure development and institutional build-up (including governance capabilities).

Policy coordination needs to focus on both temporal sequencing and on country-specific programs within a regional framework. This policy coordination needs to be effective and to this end the EU should do it. This strategy should be generous financially, and it has to translate into actions that empower the policy-making and governance capabilities of the national governments. Economic assistance should not be devoid of conditionality, but it should be part of national economic programs. Policy coordination needs to consider the various tasks that can be fulfilled by the IFOs.

5.2.2. Hindrances for and threats to reconstruction

Aside from the big unresolved issue of the place of Yugoslavia (Serbia) within the whole matrix of economic regeneration in South East Europe, this process has to cope with hindrances of domestic nature and developments outside the area. Among the main domestic barriers are:

- weak institutions, weak states, which have a very low capacity to formulate and carry out reforms. This institutional poverty should be judged in relation to the capacity of the state to mobilise resources for development.[90]
- meager resources and very strained budgets;
- the size of informal sectors and the extent of criminalization of the economy;
- absorption of resources by non-economic goals;
- low propensity for regional cooperation when the political geography of the area is still to be defined[91], and when there is genuine fear that

90 Weak states can also be seen as states with low legitimacy. It is noteworthy that the latter can be detected in both states with high ethnic homogeneity (Albania) and where there is supposedly, "multi-ethnicity" (Bosnia-Herzegovina).

91 At a recent Halki (Greece) symposium (September 1999) Woodward remarked that, in the aftermath of the war, border controls were likely to be strengthened, which would not foster regional cooperation. Likewise, V. Surroi, a leading journalist in Pristina and a leader of the Albanian Kosovars, forecasts a dynamic of links in the

neighbours may “export” their networks of organised crime.

External threats to reconstruction need to be judged in conjunction with the current attitude vis-à-vis South East Europe and the need for serious, long-term commitment to help the region get out of its doldrums. Would the current mood persist in view of the proliferation of crises, whether in Europe or elsewhere? Would the span of attention turn into a long-lasting commitment? These are justified questions considering:

- the unambiguous indication by the US Administration that it wants the EU to foot the bill for reconstructing the region;
- the message sent by the World Bank that it wants the EU to be the main donor and assistance coordinator;[92]
- Brussels (EU) has still to work out a solid plan for dealing with South East Europe, aside from the ideas emanating from the Stability Plan (which was put forward by the German government);
- since the EU does not seem to have a long-term plan for the region it is fair to assume that there is not yet a solid financial commitment to this purpose.[93]The March meeting of donors in Brussels was encouraging but far from sufficient in terms of meeting the financial requirements for assisting the region (not all the money is new cash, but a redirection from existing Balkan aid programmes);
- Western European governments have serious budgetary problems of their own;
- a growing resentment in the EU member countries towards *enlargement* (rising xenophobia);
- the front-runners for joining the EU have expressed concerns that the current focus on the Balkans may slow down their process of admission; they are also worried that more resources for South East Europe would automatically mean less aid for them.

6. Looking ahead

One can use a matrix of circumstances and challenges in order to differentiate the transition countries. Among circumstances can be ranged: the state of economies; the strength of institutions (including state institutions – which becomes a key variable); inter-ethnic relations; geopolitical location; commitments to join the EU and NATO; dynamics inside the EU and in the world, etc. Short-term challenges include: resume (sustain) growth; check (stop) inter-ethnic strife[94]; fend off attacks on state institutions (dealing with organized crime).

Longer term challenges are: strengthening institutions, including state

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region which would favor “bilateral and trilateral ties” – following the consequences of the last war.

92 S. Voyadzis, the World bank representative for the Balkans in Brussels, stated that the sums assigned by the IMF and WB to the region came from other uses, which means that those sums were diverted. One can hardly escape the feeling that potential recipients in the rest of the world will put increasing pressure on the IFOs to do the same.

93 “Stability Pact Challenges”, Oxford Analytica, 7 February, 2000.

94 In the case of Russia this is more complicated when it involves separation attempts (recently, in Dagestan)

institutions[95]; achieving sustainable growth (catching up); social cohesion (fighting poverty); social capital (fighting corruption); empowering citizens (strengthening democracy).

A thesis needs repetition. Aside from policy consistency and a sense of direction, the countries which have scored better results have done so as a result of better preconditions (the legacy of the past including histories of partial reforms) and the geographic proximity to the EU. Investments, foreign capital, which poured into those countries, were attracted by policies pursued by the government. But clearly there was also a set of initial circumstances that favoured good results. For most of the lagging countries, for those at the periphery of Europe, a bad path-dependency has been developing, which will afflict them for a long period of time. The former ideological and political divide, which existed in the pre-1989 Europe, is being replaced by new divides which have essentially an economic dimension. These new divides are likely to affect the security concerns of governments all over Europe.

Unless firm decisions are made by political leaders the unification of Europe, in the sense of "economic inclusion" - to use a term much in vogue among the politicians of Europe - of most of the transition countries, will remain a very distant goal. To these developments one has to consider the implications of a feeling among the citizens in the lagging countries that they do not really belong to the clubs of Europe, to the relevant institutional Europe; this may only accentuate disappointments and identity crises.

In order to overcome such a new "great divide", vision needs to be accompanied by a strategy which should combine much more commitment by Brussels (by the EU governments) with the efforts towards in-house reform by the candidate countries. The EU governments have to labour on three fronts: at home; the reform of the EU (the institutional reform, the common agricultural policy, regional development, etc); and the international dialogue which deals, inter alia, with the international financial architecture. All these fronts have, directly or indirectly, an impact on *enlargement*.

Governments in transition countries, in South East Europe in particular, have to persist in building up institutions, in undertaking structural reforms and in strengthening financial systems. All these challenges assume the restoration of lasting peace as an overriding objective. There is also a need for the development of a strong middle class, a civil society, as the backbone of well-functioning market economies and democratic policies, where citizens feel empowered economically, political friction is avoidable and energies translate into better economic performance.

The dialogue about *enlargement* and assistance to the Balkans poses a major question from the perspective of the political economy of the process. How can people in the West get a level of comfort with this process which should facilitate it? Because, ultimately, it is not Brussels which will decide on the speed, the pace of admission, but national governments - governments which are

95 Strong state institutions refer to the effectiveness of pursuit of a common good (public purpose)

accountable to their electorates. If Western citizens do not feel comfortable with admission, if they will think that that is going to increase structural employment, politically articulated interests will not retard to reflect those anxieties. And this politically articulated opposition is likely to cause a delayed process of admission. An enlightened pragmatism would acknowledge the various constraints for rapid *enlargement*, but also caution against losing sight of the target and the level of momentum.