The wiiw Balkan Observatory

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Aiding Balkans

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About

Shortly after the end of the Kosovo war, the last of the Yugoslav dissolution wars, the Balkan Reconstruction Observatory was set up jointly by the Hellenic Observatory, the Centre for the Study of Global Governance, both institutes at the London School of Economics (LSE), and the Vienna Institute for International Economic Studies (wiiw). A brainstorming meeting on Reconstruction and Regional Co-operation in the Balkans was held in Vouliagmeni on 8-10 July 1999, covering the issues of security, democratisation, economic reconstruction and the role of civil society. It was attended by academics and policy makers from all the countries in the region, from a number of EU countries, from the European Commission, the USA and Russia. Based on ideas and discussions generated at this meeting, a policy paper on Balkan Reconstruction and European Integration was the product of a collaborative effort by the two LSE institutes and the wiiw. The paper was presented at a follow-up meeting on Reconstruction and Integration in Southeast Europe in Vienna on 12-13 November 1999, which focused on the economic aspects of the process of reconstruction in the Balkans. It is this policy paper that became the very first Working Paper of the wiiw Balkan Observatory Working Papers series. The Working Papers are published online at www.balkan-observatory.net, the internet portal of the wiiw Balkan Observatory. It is a portal for research and communication in relation to economic developments in Southeast Europe maintained by the wiiw since 1999. Since 2000 it also serves as a forum for the Global Development Network Southeast Europe (GDN-SEE) project, which is based on an initiative by The World Bank with financial support from the Austrian Ministry of Finance and the Oesterreichische Nationalbank. The purpose of the GDN-SEE project is the creation of research networks throughout Southeast Europe in order to enhance the economic research capacity in Southeast Europe, to build new research capacities by mobilising young researchers, to promote knowledge transfer into the region, to facilitate networking between researchers within the region, and to assist in securing knowledge transfer from researchers to policy makers. The wiiw Balkan Observatory Working Papers series is one way to achieve these objectives.

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Global Development Network Southeast Europe

This study has been developed in the framework of research networks initiated and monitored by wiiw under the premises of the GDN–SEE partnership.

The Global Development Network, initiated by The World Bank, is a global network of research and policy institutes working together to address the problems of national and regional development. It promotes the generation of local knowledge in developing and transition countries and aims at building research capacities in the different regions.

The Vienna Institute for International Economic Studies is a GDN Partner Institute and acts as a hub for Southeast Europe. The GDN–wiiw partnership aims to support the enhancement of economic research capacity in Southeast Europe, to promote knowledge transfer to SEE, to facilitate networking among researchers within SEE and to assist in securing knowledge transfer from researchers to policy makers.

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Abstract
Conceptual and theoretical issues of foreign aid in post-conflict, transition region are discussed. Two examples are presented in an informal manner. The first is about the incoherence of aid for reconstruction and policies of transition. The second is about the role of expected institutional change that the process of European Union integration provides and the comparative role of aid for institution building. Hypothesis are developed that will be considered in the further work on aid in the Balkans.

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1. Introduction

Most questions about the effects of aid remain without clear answers. Econometric analysis does not support strongly the claims either that aid does harm or does good (Rajan and Subramanian, 2005). Perhaps the most that can be gotten from the rather extensive literature on various aspects of the effects of aid on developing countries, and in other settings, is that if the conditions are right, aid can have positive consequences for growth, welfare and equality. When it comes to conditions, it seems that there is a growing consensus that everything works better, aid included, with good institutions (Burnside and Dollar, 2004). It is not clear, however, whether aid contributes to the improvement of the institutions over time or it is the case that good institutions should have already existed for aid to have made a positive contribution. Also, it is not altogether clear which are the institutions that should be improved and what does improvement exactly mean? In some studies, the institutions that are described include rule of law, those that support sound economic policies and good governance and then a question arises why would countries with all these good institutions need aid to finance their development rather than investments and other financing on commercial basis?

In this paper some conceptual and theoretical issues will be raised and those will be set against the recent experience of the Balkans. This is a region that has seen massive aid in various forms and from different sources. It is an interesting case because it is a post-conflict, developing and post-socialist region. The aid has been channeled together with significant international involvement in state and nation building. The donors have also had strong influence on the policies pursued by the aid recipient countries. The aims of the aid effort as well as the way that the aid was delivered had been changing over time too. This case can also be usefully compared with the other countries in transition both those within and without the Balkan region.

The paper relies on the ongoing work on the Balkans in areas of trade, investment, regional cooperation, transition and macroeconomic development and policy design. It is also a part of a set of papers on the effects of aid in this region. The other papers include two country studies, on Bosnia and Herzegovina and on Kosovo, and one comparative study. The final version of this paper will use the results of the other papers to check the claims made here against the findings in the other papers. The purpose of this paper is primarily to generate questions and hypothesis on the basis of the existing literature on aid and development and on the accumulated knowledge of the economic and political developments in Southeast Europe or the Balkans. It is also intended to have policy relevance, which is why parts of it are framed in the format of "lessens learned".

2.1. Means and ends: a theory of economic policy framework

There is a difference between identifying a causal and an instrumental or policy relationship. It may be the case that a causal relationship between two variables is established, but the effect may not be a policy or any other objective while the cause may not be the means relied on to achieve any objective, aim or end. In other words, instrumental rationality may not be underlying the causal relationship that can be established: causes and effects may not reveal the relationship between means and ends (Heckman, 1999).

In principle, an instrumental relationship, i.e., a policy relationship between ends and means implies the existence of a causal relationship (though perhaps not in a simple way), but not *vice versa*. This is not to be understood, however, that every causal relationship has a policy rationalization. In other words, it is not the case that once a causal relationship has been determined a policy advice can be immediately formulated.

More formally, let **C** be a cause and **E** an effect. Then an instrumental hypothetical (if an end, **X**, is sought, the means, **Y**, should be used) cannot be immediately established; i.e., it cannot be advised that if, for instance, a particular **E** was desired, **C** should be done, even if **C** is a decision variable. More generally, causal relationship does not generally have a policy rationalization. The relationship between a cause, **C**, and an effect, **E**, may also mediate the instrumental relationship. In other words, if **Y** is the means to achieve a goal **X**, that may be because it is supported by an underlying causal relationship which is independent of the instrumental relationship and would not by itself produce the desired goal. This is so even if it is true, as it should be, that a feasible instrumental relationship implies the existence of a causal relationship. It may be true that if **X** is desired and it is feasible to achieve that end by using **Y**, that will mean that **Y** is a cause and **X** is an effect.

Two additional points are worth making here. One is that different causal relationships may support an instrumental relationship. In other words, policies can work in different causal environments or structures. The other is that from the fact that **X** produces **Y** it does not follow that other instruments could not do the same. Some may be infeasible given a causal relationship, but others may not be. Also, in general, with richer causal structures, feasible instrumental relationship for any desired goal may be numerous. From this it follows that various policy instruments can be substituted for each other. Thus, once the aim is chosen, the instruments are not yet determined. This is even more so once various goals are targeted and the menu of instruments is available.

These are rather simple, but perhaps important, points to have in mind when the research on the policy of aid is considered. An overview of some of the research in this area is a good illustration.

2.2. An example: aid and growth

Most of the work on the effects of aid, at least in economics, looks at the issue whether aid speeds up growth or not (Easterly, 2006). This question is pertinent if the aim of the aid that was extended was indeed to speed up growth. For instance, aid to the health services in a country may not be usefully evaluated by checking the growth rate of that country. It may indeed be the case that building hospitals in a developing country will spur up growth (if there is a causality that works that way), but the aim of that aid project is certainly to improve the health of the population (which is the instrumental rationality in that case). Also, aid that aims to alleviate poverty may also support economic growth (if a causality exists), but even if it did not it would still be a successful project if it reduced the number of people living in poverty (which is the intended goal of the aid effort). Similarly, all the aid money that goes to improvement of education need not be justified by its contribution to the growth rate; it could be that the aim is to increase social equality or to make the distribution of opportunities fairer. It is to be expected that growth effects exist too given what we know about the way an economy works, but those are not the primary aims of these aid programs and thus should not be the basis for the evaluation of the success of these projects (Sachs, 2005).

This may perhaps be true of reconstruction aid in post-conflict societies in general. In the Balkans, for a considerable period of time, aid targeted security, stability and post-war reconstruction rather than economic growth. Initial growth rates were of course high, but proved generally not to be sustainable once the reconstruction was over and aid inflow decreased or dried out. That does not mean that the aid effort was not successful in achieving the goal that was primarily targeted, which was security, stability and social and personal welfare.

Thus, in order to evaluate a specific aid effort means and ends, targets and instruments should be clearly specified so that the judgments about the success or failure could be substantiated in the appropriate manner.

Another set of studies looks at the conditions in which aid is extended. If public governance is better, aid effectiveness of publicly implemented programs is higher. However, aid is often being extended precisely because public governance in a developing country is poor. International aid also often goes to areas in distress, to those that suffer from social or violent conflicts, so the environment in which aid happens is often that of weak states. It is not self-evident why aid would be the appropriate instrument of development in the case of a country that has exemplary public governance. In the case of post-conflict states or regions, it is to be expected that public governance will be weak so for a considerable period of time the aid effort has to take place in weak institutional environments.

Thus, it is not only the issue of whether an instrument is efficient but also whether it is the one that is appropriate.

In general, all policy instruments can be substituted, perhaps imperfectly, one for another. Theoretically, the claim that all policy instruments are substitutes in the general political-economy equilibria is perhaps a consequence of the theorem of the second-best. Assuming that it is feasible and desirable to reach a certain end, most every policy instrument could be effective in achieving the chosen end. In a sense, feasibility is a rather weak constraint. However, some instruments may be more appropriate than the others for a number of reasons. For instance, aid and investment are substitutes when it comes to infrastructure projects, but investment may be better than aid for reasons of efficient allocation of resources while aid may be preferred to investment for fiscal or balance of payments reasons.

Some studies look at aid as an instrument that should correct for certain other policy measures. For instance, it is sometimes argued that aid can be used as a compensation for distortions that exist in international economic relations. A good example is trade in agricultural goods. If a developed country wants to subsidize its agriculture it may also want to give aid to a less developed country to compensate its farmers for lost revenues from exports or indeed for being unable to compete with the subsidized enterprises. The end result would be that those who are less productive but are subsidized would be encouraged to produce while those who are more productive would be supported not to produce. That is clearly a quite distorted way to allocate resources though that may even be a Pareto-improving outcome compared to the situation with no aid being given to the farmers in the less developed country.

The more general point is that aid that supports incomes that is often relied on in post-conflict situations may interfere with the efficient allocation of resources. In the Balkans, for instance, massive inflow of aid with the aim of supporting social stability through subsidies to private incomes and public budgets has in all probability contributed to distortions in the labour and product markets. On the other hand, it is not altogether clear whether distortions in the allocation of resources are the main concern of national and international authorities in post-conflict situations.

Thus, an instrument may not be used just because it is effective, in the sense of achieving a desired goal, but some consideration to the justification of the aims for which it is used should be given.

This interplay of various policies has lead to quite a number of studies that look into the policy mixes that enhance the successfulness of aid and jointly contribute to faster growth and to overall development (Gupta, Powell and Young, 2006). One issue that has been studied more than the others is the appropriate mix of aid and trade policies. There is no doubt that foreign aid will increase imports *ceteris paribus*. The effect, from the balance of payments point of view, is similar to that of investments. In the latter case, however, it is in principle clear what should be the appropriate exchange rate and interest rate policies. If foreign investments are to be increased, it makes sense to liberalize trade and then a flexible exchange rate with inflation targeting seems as the most appropriate policy mix.

In the case of inflow of aid the policy mix may be more difficult to design. The actual policy mix that is chosen or could be recommended as being the appropriate one may depend on the reasons that aid is resorted to rather than investments, for instance. If, for instance, investments are not flowing in due to too high risk, than the trade policies that are appropriate may be different ones than those that are optimal for the free flow of investments.

In some cases, foreign aid is combined with protectionism with the idea that the money should be spent domestically rather than on imports. That can increase wages and thus lead to the convergence of price levels with those in the more developed countries. Alternatively, tariffs may be lowered which may lead to growth of imports and eventually to addiction to aid. In both cases, there is a question whether it makes sense to liberalize current and capital account transactions in countries that are recipients of aid. This is similar to cases where there is significant inflow of remittances. If money is spent in the country, prices may increase leading to a problem with competitiveness. If not only trade but also financial transactions are liberalized, issues of monetary and exchange rate policies and ultimately fiscal policy need to be addressed.

Thus, issues of policy design emerge that are similar though not identical to those in the cases of significant inflows of financial resources either as investments or as remittances. There could be a difference, however, between the design of the policy regime, i.e., of the rules on which various policies are based and the actual policies or the ways in which these rules and the attached instruments are being implemented in order to achieve the desired or chosen policy objectives. The issue of policy design is of course broader especially in cases, admittedly the most common ones, when aid is being disbursed in countries with weak institutions or weak states, for instance in post-conflict situations.

An example of problems with the policy design in the Balkan countries that were recipients of significant aid will be looked at in more detail below. The additional issue that emerged in this region was the need to implement significant institutional or structural reforms in the context of post-war reconstruction and of weak and rather non-standard institutions of public governance. Thus, aid was used for many purposes, for reconstruction, social cohesion, institution building and to support private investments. Thus, the issue of consistency between the aims of the aid effort and the policy design for transition has been the central one.

3. Four issues

The short overview of the literature on aid turns up at least four important issues that could be considered in the context of any particular instance of aid flows. These issues are indeed research questions that could be asked in the case of the ongoing aid effort in the Balkans.

Aims and ownership: An implicit assumption in the studies that look at the impact of aid on growth is that the government of the aid recipient country is aiming to maximize growth (or some other goal that is in accordance with economic efficiency and social sustainability). Thus, a question naturally arises whether aid contributes to that aim or not? Or does it, unintentionally to be sure, subvert that aim and create an aid dependency or similar types of distortions? The answer depends in part on the issue of ownership that is increasingly taking centre stage in the normative literature on the design of aid. Clearly, if a government is aiming to speed up growth, it will seek aid that will be conducive to that aim. In that case, either aid will indeed contribute to growth or the aims of the donors will diverge from those that the receiving government has adopted. In other words, in this second case, there will be an issue of ownership.

If, however, a government does not aim to speed up growth, aid cannot be expected to contribute to growth, except unintentionally. Another possibility is that the donors will aim to speed up growth of the recipient countries, in which case they will condition the disbursement of aid on the change of policy agenda in the recipient country. In this case, aid would be an instrument of policy change in the country that is receiving aid. The effect of aid on growth may still not materialize because of the problems with implementation of aid projects in the context of the conflict of aims and the lack of ownership on the part of the recipient country (Bauer, 1971).

Thus, the first issue: Who sets the policy objectives?

Weak states and aid: Another issue is that of when it is justified to disburse aid? Most aid goes to developing countries that often have weak institutions and, in the extreme cases, have weak states. In cases when aid goes to states with good institutions and appropriate policies, it can be expected that the effects on growth, or whatever is the objective in question, will be positive and perhaps even as strong as intended. It is different with countries that have weak states or weak institutions.

States can be weak in a number of ways. Assuming that states supply two goods, security and justice,[1] they can be weak in case they do not supply one or the other of these goods or both. If, for instance, a state is in civil war or is criminalized, it will be weak even if it disposes of a lot of resources, e.g., it has a high level of public expenditures. Many developing countries have weak states in the sense that they do not supply the necessary level of security but also have low level of public expenditures. In the case of transition economies, however, a state may be weak because it is either criminalized or is not ruled by law or redistributes a lot of resources because it is run by rent-seeking special interests. In both cases, when states control little or a lot of resources, the weakness of the state will be indicated by the lack of the clear public will or rather of the legitimate way to aggregate public preferences and reveal policies that are in the public interest.

Thus, both institutions may be weak and policies may not be geared towards the public good, in which case the state, irrespective of the level of resources that it has the command over, will be weak. It is mostly in those cases that aid is used to achieve certain policy objective. Those should, in principle, target the supply of precisely those public goods that the state itself is not supplying or is undersupplying, i.e., security and justice. In these cases, development may be more of an instrument than the target of the flow of aid. This is to a large extent the target of aid to the Balkans.

The second question is: Are the instruments chosen justifiable given the conditions in which aid policy is implemented?

Aid and other instruments: In cases in which aid works, other types of financing may work also. If a country has strong institutions and pursues right policies, investments should work as well as aid. If it is the case that public investment will be undersupplied, that could be

[1] Justice here covers not only legal but also social justice. Thus, not only rule of law but equality is what a state supplies as justice. Similarly, security should be understood in the more general social sense rather than in the narrow political sense.

substituted with public investments. Again, aid is mostly an instrument of choice if investments are not forthcoming either because the risks to private investments are too high or the state is broke and cannot invest public resources.

The interesting case is that of remittances, which tend to be high in the countries that are also recipients of foreign aid. If remittances go to private consumption rather than investment, it may be that there are no profitable investment opportunities for variety of reasons. There are cases still when private investments are significant, but there is still the need for foreign aid to spur development. Clearly, in these cases, the state is weak because it either does not raise enough revenues or misallocates them.

In the case of a poor country with good institutions and appropriate policies, the reliance on aid rather than on other types of financing may be desirable because of the different ways they affect the balance of payments. High inflows of foreign aid have been connected with an overvalued exchange rate, but the same has been observed with remittances and foreign investments. The effect should be smaller in cases when the inflow of foreign resources is used to import goods and services rather than to buy non-tradable goods and services at home.

The third question is: Is reliance on foreign aid consistent with sound economic policy?

Aid and legitimacy: Assuming that aid flows to countries with weak states, there is an issue of legitimacy to be considered. Even if the ownership issue is solved in some way, the principal-agent relationship is not necessarily a clear cut and transparent one. Even if aid comes with no strings attached, i.e., without explicit conditions on how it is to be used, it may severe the natural relation of responsibility in a country. If public investments do not come from the budget but from foreign aid, the public may not have the needed incentives to control the way the government spends the money.

The forth issue is: Does aid support or distort institutions of public governance?

The two latter issues refer to distortions that aid may be associated with. One is connected with market allocations and the other with sound public governance, in particular with sound public financing. Resources may be misallocated through aid because markets do not mediate in the allocation decisions. Thus, if the same aim could be achieved with private investments and with aid, investments should be preferred because they are allocated through markets and thus on the basis of markets prices. In the case that private investments are not forthcoming, public investments could be the substitute, but their efficiency depends on the quality of public governance. That means that there is a responsible, transparent and responsive fiscal system. Aid is usually relied on when such a system does not exist with the consequence that it cannot be expected that aid will contribute to its establishment or development. Thus, problems with misallocation of resources are almost unavoidable in cases in which aid is most needed.

4.1. Aid and policies: Lessons learned from the Balkan example

One of the questions mentioned above is that of the consistency of policies of aid and the overall policies a country that is receiving aid is pursuing. In some cases, the Balkans being such case, aid donation is conditional on the adoption of certain institutional arrangements and policies. Thus, a country that receives aid is also a policy taker. The policy makers are the aid donors. The Balkan example shows that this relationship is not all that simple and the effects are not straightforward. Here a stylized description of the policies pursued in the Western Balkans will be given.

Current state of affairs in the Western Balkans (Albania, Bosnia and Herzegovina, Croatia, Macedonia, Serbia and Montenegro, with Kosovo being a special case), which has been the recipient of significant aid, is the outcome of the violent conflicts in the post-socialist transition. The international reaction and intervention has aimed to pacify and stabilize the region. In that, it relied on the following overall policy framework:

(i) an introduction of a constitutional *provisorium*,

(ii) the adoption of the politics of ambiguity, and

(iii) on aid and other financial incentives to steer the development towards more stable and permanent political and economic structures.

Bosnia and Herzegovina provides the most typical case. Constitutional structure was imposed that lacked both legitimacy and functionality. Those were to be substituted for by heavy international involvement with both political and economic powers. Finally, aid was to lead to speedy reconstruction while very fast liberalization and privatization were to bring in incentives for both state building and development.

In a nutshell, benevolent international dictatorship and free markets were to lead to spontaneous emergence of democracy and market economy. The latter two would then resolve the constitutional issues (Gligorov, 1995).

Similar strategy has been applied to Kosovo and to an extent to Serbia and Montenegro. Somewhat different approach was applied to Croatia, Macedonia and Albania, at least eventually. In these latter cases, there was more explicit reliance on democratic procedures and on the respect for human rights. These experiences lead to the following lesson:

Lesson 1. Legitimate, democratic, authority is needed for institution-building as well as for liberalization and privatization – spontaneous market and political forces will not manage an institutional transformation in political *provisoria*.

4.2. Aid, conditionality and economic repression

The experience of transition in the Balkans provides for a useful comparison between the countries of Eastern Balkans, Romania and Bulgaria, that did not rely on aid and those in the Western Balkans that did. There are similarities in the choice of economic policies, but the institutional and international context is rather different. The main difference is that Eastern Balkan countries operated with the European Agreement while the Western Balkan countries lacked the European anchor. Instead, after most of the conflicts have ended, they faced a combination of aid of various kinds and, again, of various kinds of conditions attached to the financial support. Also, they lacked, for quite some time, firm commitment on the part of the EU on their perspective for integration.

These conditions led to the development of repressive institutions and repressive policies. Here especially the economic policy issues will be looked into. The general approach was to immobilize monetary policy, constrain fiscal policy and rely on trade liberalization and structural reforms, of which privatization and labor market reforms were thought to be the most important.

The key policy question is whether that policy mix – restrictive monetary and fiscal policies and radical structural reforms – is internally consistent and whether aid for reconstruction and institution building supports it or not? Without going into additional theoretical considerations, on the Balkan experience, the answer is somewhat mixed. In the case of Eastern Balkan countries, this mix has either not been followed strictly, in the case of Romania, or has, in the case of Bulgaria, in fact worked. In the Western Balkans, it has, for the most part, not worked. The main difference between the outcomes in Eastern and Western Balkans arises from the impetus for institution building that the process of EU accession brings in. This policy mix will not, by itself, spur institution building needed for successful structural reforms. Also, aid may not be conducive to structural reforms anyway.

Lesson 2. Restrictive and even repressive economic policies have been followed and those have had consequences for the disappointing institutional development and growth performance.

The main problem with the consistency between restrictive economic policy and fast structural reforms is that restrictiveness tends to require repressive instruments and institutions and that does not seat well with structural reforms based on liberalization and privatization. Importing institutions from the EU may help in that case, but if EU integration is not in sight, repressive institutions may stabilize and even spread.

This can be seen in the development of the Western Balkans. There are several stylized facts about Balkan economic policies. Here, initially, exchange rate, monetary and fiscal policies will be considered. Later on, trade and structural policies will be looked into.

Fixed exchange rates: The bulk of the region is on fixed exchange rates (Romania is an exception). Nominal rigidity is accompanied by diverse real exchange rate movements. It is interesting to see that in the case of some former-Yugoslavia countries, i.e., Slovenia, Croatia and Macedonia, real exchange rates have remained stable over a prolonged period of time, even in cases like Slovenia, where exchange rate was managed and mainly depreciated. Similar developments should be true for Bosnia and Herzegovina and Montenegro, though the disinflation took a bit longer in these countries. Similarly, in Bulgaria, after the introduction of the currency board, real exchange rate has been rather stable.

The reasons for the policy of the stability of the exchange rate, nominal or real or both, that most former-Yugoslavia countries have followed are twofold. They have, on one hand, inherited relatively high price levels as well as relatively higher wages. On the other hand, they were compelled to rely on fixed exchange rates in order not to misuse the flow of financial aid through monetary mismanagement. That exchange rate regime, however, requires rather restrictive monetary and fiscal policies.

Lesson 3. Fixed nominal and real exchange rates require convergence in inflation, which may put undue pressure on monetary and fiscal policies.

Restrictive monetary policy: An advantage of the fixed exchange rate should be that a country pegging the currency can import the monetary policy of the anchor country. Assuming free flow of capital, the elimination of the exchange rate risk should lead to the convergence of the interest rates in the two currencies connected with the fixed exchange rate. That could have the effect that investments will flow to countries with higher productivity of capital, which should in principle be the less developed countries that are relying on the fixed exchange rates. In that case, significant current account deficit could emerge and persist, but should not lead to problems with the servicing of the foreign debt because the debt to GDP ratio need not increase.

This perhaps works for currency unions, but need not work for fixed exchange rate regimes. The reason is that in the system with fixed exchange rates, it may be necessary to keep the growth of money supply down in order to insure the convergence of the inflation rates. Otherwise, real appreciation of the exchange rate may create problems for the sustainability of the external equilibrium. Thus, it often happens that interest rates stay at a level well above that of the anchor country. This has three unwelcome consequences.

For one, monetary expansion and the expansion of credits are sapped; in other words, monetary policy is persistently restrictive. For another, currency substitution stays high, as the difference between the international and the home interest rates introduces the persistent risk of depreciation or even surprise devaluation. Finally, higher interest rates invite foreign investment inflows that tend to increase the trade and current account deficits and thus may present problems for economic stability.

Lesson 4. Fixed exchange rates do not lead to the adoption of the anchor country's monetary policy through the convergence of interest rates, but rather to the need to implement restrictive monetary policy with sustained higher interest rate, which leads to lower employment and higher unemployment.

Fiscal policies. Unlike monetary and exchange rate policies that do not differ all that much across the Balkan region, fiscal policies have diverged in a number of ways. Perhaps one similarity is the constant preoccupation with fiscal policy mainly because it has to be supportive of fixed exchange rate policy. Thus, in the region as a whole, fiscal adjustment is constantly on the agenda of the policy makers.

In most cases, and especially in the case of the post-Yugoslavia states, high public revenues were collected in order to finance quite high levels of public expenditures. Thus, Serbia, Montenegro and Croatia have large public sectors. Macedonia and Albania, however, have low levels of public expenditures, around or just above 30 per cent of their respective GDPs. In the case of Macedonia, expenditures are decreasing, while in the case of Albania they are rising slowly reflecting slow recovery of public revenues. The intermediate case is Romania, where public expenditures are somewhat lower than in most other transition economies, but that is partly the consequence of its size, Romania being the largest economy in the region. Thus, in general, fiscal policy has been relied on to support macroeconomic stability, public expenditures have tended to be high, except in cases where they have collapsed, and aid for reconstruction has distorted public expenditures towards social welfare and away from development.

Lesson 5. Fiscal adjustment, i.e., low budget deficit or balanced budget, has, as a rule, not led to the decline of public expenditures, except in cases where public revenues have collapsed, and has supported distortions in the structure of budget expenditures and high and distorted tax burden.

Trade policy. Initially, illiberal trade was the rule in most of the Balkans. That was the consequence of the wars and political disintegration. After 1999 and especially after 2000, trade has been gradually liberalized throughout the region. At the moment, the region as a whole enjoys rather liberal access to the European Union market. In addition, all the countries in the region have signed bilateral free-trade agreements with each other and there is an initiative to transform these bilateral agreements into one multilateral free-trade agreement creating a free-trade area in the Balkans.

In the last few years, foreign trade both within and without the Balkan region has increased. That is the consequence of the fact that growth has returned to the region. Indeed, in the last couple of years, this has been one of the fastest growing regions in Europe. In most cases, this has not been an export led growth. As a rule, it has been the growth of domestic demand that has led to growth and to increased foreign trade. Thus, trade liberalization has not, at least so far, been a significant engine of growth. In a number of cases, tourism has contributed to growth significantly, but exports of goods have been recovering only lately and not too convincingly.

Looking at the regional trade in particular, it is clear that exports of the countries of the region to the region have been increasing more than imports. In other words, countries in the region try to sell to other countries in the region, but tend to import from countries outside of the region. In fact, if looked into more closely, the data on regional trade seems to indicate that a number of countries in the region sell goods to Bosnia and Herzegovina and Kosovo, while the rest of the regional trade is not all that significant. It also seems not to react too much to trade liberalization measures.

This, if true, would indicate that non-tariff barriers are probably more important than tariff barriers. It is even perhaps the case that non-trade barriers are still more important than all the trade barriers put together, whether tariff or non-tariff ones. Also, the factors that create trade opportunities may have more to do with the inflow of financial resources than with trade policy as such. Aid, donations and private transfers lead to increased imports and, in some cases, to increased exports too.

Lesson 6. Trade policy has real limitations in the Balkans and may be rather less important than structural and development policy.

Structural policies. Development of market economy is lagging in the Balkans. This is the consequence of the problems with the liberalization of the economic relations, but also of the deficiencies in their institutionalization. The causes of this state of affairs are many and varied. There are problems with corporate governance, due to flawed or slow privatization, there are problems with labor market regulations, there are problems with public governance, the latter fueling especially shadow economy and corruption. Financial markets are also underdeveloped and repressed. Thus, there is a lot of scope for structural reforms.

Some of those are connected with the way state and social property was privatized and how it was not privatized. Privatizations have often been targeting redistribution of assets rather than their efficient allocation. Thus, non-standard corporate structures have emerged and also markets for products have been monopolized. In the region as a whole, competition policy hardly exists. Even if there are laws, they are not implemented. Thus, oligarchic structures have emerged that bring in quite a number of structural problems.

Perhaps main problems, besides privatization, are in the product and labor markets. The former are rather concentrated irrespective of whether they are in domestic or foreign ownership. The same could be said about the financial markets, especially of the banking sector. Labor markets are distorted in a number of ways. There are rigidities, especially in the public sector. There are also institutional deficiencies or outright lack of proper regulation and institutionalization. Also, active labor policies are either nonexistent or are not implemented properly.

Without going into details, it is enough to point out that Balkan countries are still among the worst ones on the various rankings of progress in transition, in competitiveness or in economic and overall liberty.

Lesson 7. The deficiencies in privatizations, the nonexistence of competition and active labor policies are the main structural deficiencies in the Balkans.

4.3. Conclusion on policy design

International political and economic involvement has had positive consequences for the overall security in the aid recipient states and in the region as a whole, but often negative institutional and developmental consequences in the Balkans. Also, economic policies that were advised and supported have had some positive effects for the stability, but rather less so for the development and growth in this region. It is an open question whether the main reason was the lack of coherence between the aid effort that targeted mainly security and social stability with the transitional agenda that targeted institutional change and structural reform.

5. Aid and institutional development: a different example

Most of what was said above refers to the aid effort that was directed towards post-war and post-conflict reconstruction. In the last few years, however, the focus has shifted towards regional cooperation and European Union (EU) integration. The experience in other regions in transition suggests that EU integration has significant effects on the development and growth prospects of these countries. It is sometimes argued that this is the consequence of the institutional development that integration brings together with the improvement in policies that increasing integration brings or suggests. It is argued by others that this is the consequence of the significant funds that the EU disburses during the pre-accession period and also after the accession takes place.

Stylized facts, however, can be read differently too. Many studies suggest that it is precisely the institutional development that is the slowest in transition countries. The usual indicators of rule of law, democratization and public governance tend to show that progress is rather slower than is the overall economic growth. Also, it is not altogether clear whether the transfers from the EU for regional, agricultural and the development of social cohesion do have the positive effects that are attributed to them.

One thing, however, stands out. The success of the central European transition economies that have joined the EU in 2004 is connected with the significant role that the access to the EU market has had and the significant inflow of foreign investments that helped the reindustrialization of this region. So, the main help that EU integration seems to have had to transition economies has been the increased market integration that it has provided.

Similar developments can be observed in the Balkans. It is clear that there is a relationship between the prospects for EU integration and the speed of development in the whole Balkan area. The main mechanism has to do with the flow of private investments rather than with aid. It is not difficult to see how this works. Countries that are integrating with the EU tend to experience falling risk to investments. These countries, being in general much less-developed, offer significant productivity gains and thus high returns to capital. Thus, declining risks with high returns to capital lead to significant inflows of investments that lift the growth rate. The macroeconomic imbalances that develop, often temporarily but sometimes for a longer period of time, tend not to produce problems because of the high growth rate. Thus, this growth tends to be sustainable.

The main question is why is risk falling in these countries? One explanation is that it is because of the anticipated institutional and policy improvement. Thus, it can be argued, it is not the existing but it is the expected institutions that are the driving force of sustainable growth in transition economies. Similar developments could be seen in the Balkans, though in the cases that are of interest here, progress is rather slow still.

6. Conclusion

These two examples suggest that it may be the case that aid is good for reconstruction purposes, but it is the expectations of institutional clarity and responsible policies that are more important for development. In the case of the Balkans, these two were as a rule not coordinated.

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