

OCCASIONAL PAPERS

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SOUTH-EASTERN EUROPE REVISITED. CAN ECONOMIC DECLINE BE STOPPED?

Daniel Daianu

INSTITUTE FOR SECURITY STUDIES - WESTERN EUROPEAN UNION
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SOUTH-EASTERN EUROPE REVISITED

Can economic decline be stopped?*

Daniel Daianu **

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SUMMARY

This paper attempts to evaluate the situation in South-Eastern Europe by focusing on two major sources of economic plight in the region and on the prospects for economic regeneration. One source of difficulties relates to the dissolution of former Yugoslavia. The wars in the region caused enormous pain and suffering that led to the deaths of a large number of people. There has also been enormous material destruction, 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 remains 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 reason for economic failure is linked to the difficulties of transforming command economies. Economic dynamics in most post-communist countries have dashed the high hopes of the early 1990s. Post-communist transformation has proved to be a much more complex and complicated process of institutional change than expected. At the same time, the magnitude of the required resource reallocation (*strain*) and the friction caused by regime change (*disorganisation*) have made restructuring a very painful and protracted process; the scope of the latter can be linked to the legacy of communism and, here, one can point out the importance of history, geography and culture. Clearly, much of South-Eastern Europe was badly placed in this respect and bad *path dependencies* have been put in motion or reinforced during the last decade. *Strain* and *disorganisation*, as well as very weak institutions, explain much of the failure of reform during transition and, frequently, have rendered allegedly correct policy choices irrelevant. These factors have significantly reduced policy-makers' room for manoeuvre.

The lessons of transition in general, and the dramatic events of the last decade in South-Eastern Europe, demand a policy that can restore confidence in the ability of elected officials (public authorities) to deal with the tremendous challenges at hand. 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 range and magnitude of the challenges facing South-Eastern Europe with humility, and acknowledge that miracles are not possible. Not only are the challenges ahead overwhelming but the development conundrum is far from being an easy one to solve. Moreover, the intertwining 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 a regional level.

There are several motives for arguing that a plan for the economic regeneration of and the achievement of a durable peace and security in South-Eastern Europe would be a more complex and arduous endeavour than the Marshall Plan. First, in the late 1940s there was no process of state-formation (state dissolution) in the region, and hence no ensuing conflicts. Secondly, there was a clear distinction between the victors and the losers in the war, which did not involve revision of borders. Thirdly, the Marshall Plan meant, primarily, an infusion of funds for energising economic reconstruction in an area which possessed the institutional ingredients of a market economy. Also, these funds included many grants. Fourthly, there was, at that time, a big, common enemy: communism, both externally and domestically

(represented by the strength of the communist parties in France and Italy). Who is the big common enemy of the peoples in the Balkans and of security in Europe today? One candidate could be poverty or underdevelopment on the wider periphery of a prosperous Europe. But this is an imprecise enemy, one that is not easy to deal with if one considers the global experience. Such an enemy makes it more difficult to generate support for a coherent policy response before conditions cause a violent crisis. All these differences reinforce the case for a Grand Plan for South-Eastern Europe in view of the institutional fragility and the depressed state of most of the local economies.

A Grand Plan is badly needed but it should be carefully calibrated (with properly defined targets) and implemented. Assistance needs to take into account the complexity of intra-regional relations, the still murky political geography of the area, and the potential for conflict, among other factors. This extremely complex situation inextricably links national economic objectives (including economic security) with other goals, such as peace and territorial 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. None the less, 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 in practice – particularly when they imply hardly reconcilable objectives of non-cooperating governments, or have to be pursued in very adverse circumstances. In the Balkans, this situation is ubiquitous and explains the strong presence of outsiders (including economic aid) and the *de facto* existence of protectorates. But a foreign presence does not simplify the solution to problems automatically.

Unless firm decisions are made by the political élite, 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 countries in transition, will remain a very distant goal. In these circumstances, one has to consider the implications of a feeling among the citizens of the countries lagging behind that they do not actually belong to Europe’s ‘clubs’ (the relevant European institutions), thereby accentuating disappointments and crises of identity.

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

Governments in South-Eastern Europe have to persist in building up institutions, undertaking structural reforms, and strengthening their financial systems. All these challenges presuppose the restoration of lasting peace as an overriding objective. There is also a need for the development of a strong middle class and a civil society as the backbone of well functioning market economies and democratic polities. Where citizens do not feel empowered economically and politically, friction is unavoidable and energies do not 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 take some comfort from this process, which should facilitate it? Ultimately, it is not Brussels

which will decide on the pace of admission, but national governments – which are accountable to their electorates. If the citizens of West European countries do not feel comfortable with enlargement because they think that it is going to increase structural employment, politically articulated interests will not take long to reflect those anxieties. This politically articulated opposition is likely to delay the process of admission. Enlightened pragmatism would acknowledge the various constraints on rapid enlargement, but also caution against losing sight of the target and the momentum.

INTRODUCTION

The signals we are receiving at the start of the new millennium are pretty confusing. On the one hand, there are bouts of optimism which rely on the advent of the 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’ could usher in another long-term economic upswing in the world.¹ In this context, there is talk of 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 growing apace; there are numerous interethnic conflicts; financial and economic crises have been a constant and alarming feature of the last decade; rising income inequality, both within and among countries, puts pressure on governments and strains trade relations; domestic and international terrorism is on the rise; and there is growing resentment to globalisation in both rich and poor countries. Similarly, the record of post-communist transition is below expectations. The current mood is a strange combination of hope and alarm in contrast to the overriding optimism that reigned at the start of the last decade.²

‘The end of history’ injunction expressed the *Zeitgeist* of the early 1990s.³ In a fundamental way, Francis Fukuyama was right, in that 1989 marked a watershed in history, signalling the demise of communism. In another sense, his analysis simplified and obscured resilient forces at work in history, such as those which maintain ideological, religious and ethnic differences. These forces, when unconstrained by democracy (through a system of checks and balances) and mutual tolerance, and in the absence of economic progress, can lead to great human suffering, such as interethnic conflicts and wars.⁴ The early 1990s were also gripped by a euphoria and a sort of *naïveté* as to the ease with which prosperity could be created, almost overnight, from the ashes of communism. One easily forgot that development (modernisation) is very much a historical product, that *natura facit saltus* only in exceptional circumstances.

The Balkans provide 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, insightfully remarked that ‘[F]or Europe, the last century began and ended with strife and conflict in the Balkans... This abominable practice is still taking place today ...’⁵ What went wrong with the societies and economies of South-Eastern Europe? The 1999 paper of the Economic Commission for Europe (ECE) on South-Eastern Europe stressed, *inter alia*, that:

- the process of economic and political transformation during the past decade, in South-Eastern Europe, proved to be much harder than in Central Europe and, as a result, the region had fallen further behind the rest of Europe;
- the problems of the postwar reconstruction and economic development of South-Eastern Europe and the eventual reintegration of its component countries into the European economy is an issue of pan-European importance;

¹ A new Kondratieff cycle with intense Schumpeterian creative destruction.

² For an upbeat interpretation see Th. Friedman, *The Lexus and the Olive Tree* (New York: Farrar, Strauss and Giroux, 1999). For a downbeat view see J. Gray, *False Dawn* (New York: The New Press, 1998) and E. Luttwak *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 For a highly pessimistic response to the euphoria of the early 1990s, see R. Kaplan, *The Coming Anarchy* (New York: Random, 2000).

⁵ C. Bildt, ‘Winning the broader peace in Kosovo’, *Financial Times*, 19 January 2000.

- the costs of the efforts to bring the region closer to Europe (not only to repair the immediate effects of military conflicts but to set the region on a sustained path of growth) are considerable even by the standards of the industrialised world;
- there is need for a carefully thought out, long-term regional programme for economic rehabilitation and growth, and secondly, for adequate institutional arrangements and an appropriate managerial infrastructure to implement such a programme.⁶

This paper attempts to evaluate the situation in South-Eastern Europe by focusing on two major sources of economic plight in the region and on the prospects for economic regeneration. One source of difficulties relates to the dissolution of former Yugoslavia.⁷ The wars in the region caused enormous pain and suffering that led to the deaths of a large number of people. There has also been enormous material destruction, 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 remains 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 reason for economic failure is linked to the difficulties of transforming command economies. Economic dynamics in most post-communist countries have dashed the high hopes of the early 1990s. Post-communist transformation has proved to be a much more complex and complicated process of institutional change than expected.⁸ At the same time, the magnitude of the required resource reallocation (*strain*) and the friction caused by regime change (*disorganisation*)⁹ have made restructuring a very painful and protracted process; the scope of the latter can be linked to the legacy of communism and, here, one can point out the importance of history, geography and culture. Clearly, much of South-Eastern Europe was badly placed in this respect and bad *path dependencies* have been put in motion or reinforced during the last decade. *Strain* and *disorganisation*, as well as very weak institutions, explain much of the failure of reform during transition and, frequently, have rendered allegedly correct policy choices irrelevant. These factors have significantly reduced policy-makers' room for manoeuvre.

⁶ 'Postwar reconstruction and development in South East Europe', *Economic Survey of Europe* (Geneva: Economic Commission for Europe, 1999), pp. 1-17.

⁷ For an historical account see M. Glenny, *The Balkans, 1804-1999. Nationalism, War, and the Great Powers* (London: Granta, 1999). An earlier analysis is provided by S. Woodward, *Balkan Tragedy. Chaos and Dissolution after the Cold War* (Washington, D.C.: Brookings Institution, 1995).

⁸ The distinction between *transition* and *transformation* was first suggested by J. Kornai.

⁹ O. Blanchard, *The Economics of Post-communist Transition* (Oxford: Clarendon Press, 1997).

CHAPTER ONE: DECIPHERING TRANSFORMATION

The map of transition is quite diverse. There are clusters or groups of countries in transition which differ among themselves as to economic performance and the way institutions function. It is noteworthy that the best performers, possessing the highest income per head, are in the EU's neighbourhood.¹⁰ Bulgaria and Romania, which also have Association Agreements with the EU, have had a much more difficult trajectory, and their prospects of joining 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, and to judge policies on their own merits.¹¹ Some years ago, those who emphasised the *structural nature* of the problems facing post-communist countries constituted a minority. They warned about the lack of realism in the theses and conceptions which sought to compress time at will. Developments seem to vindicate their views.

There has been an excessive temptation to lump countries together, in various groups, by assuming a deterministic (mechanical) relationship between preordained results and policies implied by conventional wisdom. As in the old Latin saying *post hoc, ergo propter hoc*, close performances were ascribed more to presumed similar policies than to commonalities in initial circumstances, structural factors and policy peculiarities.¹²

1.1 Major underlying issues

The burden of the past

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

¹⁰ 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 W. 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.' See S. Fischer and R. Sahay, 'The Transition Economies after Ten Years', paper prepared for the conference 'Ten Years after: Transition and Growth in Post-communist Countries, CASE, 15-16 October 1999, Warsaw, manuscript.

¹¹ 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.' See D. Rodrik, '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.' See J. Stiglitz, *Whither Socialism* (Cambridge, MA: MIT Press, 1995), p. 267.

¹² Poland became the 'classical example' of shock therapy regarding price liberalisation, but not privatisation. At the same time, Hungary, in spite of a remarkable policy consistency can be viewed as an example of clever gradualism. Its economic performances are also due possible due to reforms initiated before 1989. As to the Czech Republic, it applied a big-bang to privatisation and a sort of heterodox stabilisation policy. Slovenia, on the other hand, applied a gradualistic policy.

why market institutions vary qualitatively among the national environments;¹³ and why macro- and micro-disequilibria differed among them on the eve of 1989. Partial reforms before that year also explain the scope of *disorganisation* during regime change. 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 programmes, although their recipes were not, as some would argue, similar.

The magnitude of required resource reallocation: the emergence of strain

In transition countries the structure of the economy and the legacy of resource misallocation placed 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* is arrears (inter-enterprise debt) which, apart 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.¹⁴ An implication of intense *strain* is that policy-makers face extremely painful trade-offs and, in most cases, unless policy is consistent and sufficient external support is available,¹⁵ the room for manoeuvre is in practice quite limited. Macroeconomic stabilisation in certain countries hides deep-seated tensions which, sooner or later, emerge unless profound 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 former Soviet Union (FSU) and former Yugoslavia. The impact of the collapse of CMEA markets can be judged in the same vein.¹⁶

Poor microfoundations of macroeconomic policy during transition

Years ago, a debate erupted among professionals on the ‘poor micro-foundations’ of Keynesian macroeconomics.¹⁷ 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, the legal framework is fuzzy and institutions for contract enforcement are missing, the behaviour of firms becomes ‘perverse’. This behaviour is enhanced when the magnitude of required resource reallocation is

¹³ As P. Rutland points out, ‘in a travesty of Hayekian logic, it was assumed that market institutions would be self-generating.’ See P. Rutland, ‘Has Democracy failed Russia?’, *The National Interest*, Winter 1994-1995, p. 11.

¹⁴ A recent World Bank study confirms this causality. See Brian Pinto, Vladimir Drebentsov, and Alexander Morozov, ‘Give Growth and Macrostability in Russia a Chance. Hardened Budgets by Dismantling Non-Payments’, World Bank Technical Paper Series, forthcoming 2000. Also see, ‘Russia’s unique economy may have led to the 1998 crisis’, *Financial Times*, 22 February, 2000; D. Daianu, ‘Inter-enterprise arrears in a post-command economy’, *IMF Working Paper*, 54/94 and ‘Resource Misallocation and *Strain*’, in D. Daianu, *Transformation of Economy as a Real Process* (Aldershot: Ashgate, 1998), pp. 183-4.

¹⁵ J. Sachs constantly stressed the importance of aid for strengthening policy effectiveness.

¹⁶ Examining ‘stagflationary effects of stabilisation policies’ in transition economies, G. Calvo and F. Coricelli remarked the similarities between the ‘enterprise-side’ and the neo-structuralist approaches. See G. Calvo and F. Coricelli, ‘Stagflationary Effects of Stabilisation Programs in Reforming Socialist Countries: Enterprise-side and Household-Side factors’, *World Bank Review*, 6:1, 1992, pp. 71-90. They anticipated Blanchard’s work on *disorganisation*.

¹⁷ The debate was initiated by R. Clower and A. Leijonhufvud in the late 1960s. This debate preceded the arrival of the New Classical Macroeconomics.

overwhelming. Consequently, the issue of corporate governance has attracted increasing attention.¹⁸

Ownership of programmes (reforms)

Lately, the IFIs (the World Bank in particular) have stressed the importance of empowering transition governments in policy formulation by developing social and political prerequisites for a domestically grounded reform policy.¹⁹ There is a feeling that it is not sufficient to blame governments for failing to apply the strictures of IMF and World Bank-sponsored programmes, particularly when those programmes may contain flaws. In other words, governments should have more say in the formulation of their programmes, and conditionality should also be taken into account.²⁰

1.2 Inferences about transformation

Institutions are at the roots of economic performance,²¹ but institutional build-up takes time and needs to have domestic roots. Macroeconomic stabilisation is necessary, but is far from providing the benchmark between success and failure. Structural reforms are the key to achieving macroeconomic stability or stability in general but these reforms hinge on the ability of a system to undergo rapid change. Whereas the marginal costs of delayed reforms increase over time there seem to be limits to how these can be speeded up. 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 underpinned by the strength of a real economy and solid institutions. High vulnerability is a strong argument for gradualism 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 the economy, but it itself requires an institutionally friendly environment.²²

¹⁸ 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 World Bank ABCDE Conference, Washington, D.C., April 1999, manuscript. The authors argue that reforms cannot take place against the will of the main actors in the process. Also see J. Stiglitz, 'Quis Custodiet Ipsos Custodes? Corporate Governance Failures in the Transition', paper presented at the ABCDE-Europe Conference, Paris, 21-23 June 1999, manuscript.

¹⁹ The Comprehensive Development Framework (CDF) is a step in this direction.

²⁰ '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.' See R. Kanbur, T. Sandler and K.M. Morrison, 'A Radical Approach to Development Assistance', *Development Outreach*, 1:2, Fall 1999, p. 17.

²¹ M. Olson, 'Big Bills Left on the Sidewalk: Why Some Nations are Rich and Others are Poor?', *Journal of Economic Perspectives*, 10:2, 1996.

²² 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; hence the importance of aid for mitigating *strain*. Persistent and high structural unemployment can become very burdensome for reform policies, with the disturbing development of a phenomenon of *hysteresis* (where the effect lags behind the cause). 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.²³

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 economic 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.²⁴

²³ Including the potential for the appearance of aggressive extremist groups that are liable to engage in domestic and international terrorism.

²⁴ See François Bourguignon, ‘Crime, Violence, and Inequitable Development’, paper presented at the World Bank ABCDE Conference, Washington, D.C., April 1999, manuscript.

CHAPTER TWO: TRANSITION IN SOUTH-EASTERN EUROPE: 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 possess much explanatory power, which further leads to the issue of initial conditions.²⁵ Certainly domestic policy matters but, most of the time, it seems to have been quite insufficient in managing a stark reality, in the absence of favourable circumstances.²⁶

II.1 Late Stalinism in action

Late Stalinism was practised in Albania, Romania and Bulgaria until the very end of communist rule. In Bulgaria, there was a slightly milder form of Stalinism than in Romania, but ultimately, the command system was, essentially, unaltered. Both Bulgaria and Romania relied extremely heavily on Comecon markets, which amplified the shock of the collapse of external markets after 1989 and gave more salience to resource misallocation.²⁷ This should be contrasted with the steady reorientation of Hungary and Poland towards Western markets during the eighties. Albania for a long time practised a policy of ideological rigidity and isolationism. Its links with China, which were much reduced after Beijing embarked on market reforms after 1978, further increased the strains on the Albanian economy. Albania was poverty-stricken (actually, the poorest country in Europe) and superautarkic, even by communist standards.

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

²⁵ The *1999 EBRD Transition Report* states that '[T]he development of institutions and of behaviour depends strongly on history and culture,' p. 6.

²⁶ Some are tempted to assert that Poland and Romania had similar conditions at the start of transition. *Ibid.*, p.27. Thus, they seem to ignore that, under communism, Poland had always been more open than Romania. Poland undertook partial reforms; it had a significant private sector (not only in the farming sector); and that the Catholic Church and Solidarnosc formed powerful structures of resistance, which bargained with the communist government.

²⁷ Bulgaria relied on the markets of the FSU for more than 70% of its foreign trade. In the 1980s, Romania 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 R. Dobrinsky and M. Landesmann from the Wien Institute for Comparative Economic Studies shows that Bulgaria and Romania witnessed a downgrading of the structure of their exports after 1989 whereas the opposite occurred in Poland, Hungary and the Czech Republic. See their studies 'Economic transformation and the changing patterns of European East-West trade', pp. 86-115 and 'The pattern of East-West European integration: catching-up or falling behind', pp.116-40 in M. Landesmann and R. Dobrinsky, eds., *Transforming Economies and European Integration* (Aldershot: Edward Elgar, 1996). One can establish a certain similarity between the impact of the collapse of eastern markets for 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.

It appears that the principal explanation for the failure of economic reform in Romania and Bulgaria has been the inability of governments to deal effectively with the legacy of huge resource misallocation²⁸ and its consequences for the financial sector, against a background of very weak institutions and of *disorganisation*.²⁹ This policy paralysis led to a major economic and financial crisis in Bulgaria in 1997 and the introduction of a currency board. In Romania, 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 were substantially more effective? The answer is in the affirmative, but arguably the probability of being 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 Romania and Bulgaria. Although extremely *weak states* are characteristic of this region of Europe, 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, and the clan-based pattern of social interaction. One can therefore question the nature of democracy in such an environment.

II.2 The dissolution of former Yugoslavia

In the very early 1990s, a number of experts would have agreed that most of the republics of former Yugoslavia had the best prospects of more rapid transformation, as they benefited from human capital and market-required skills, a relatively decentralised economic system based on 'labour management',³⁰ substantial cultural and economic intercourse with the West and the exposure to Western labour markets of hundreds of thousands of *Gastarbeiter*. In addition, Croatia and Slovenia had a relatively high per capita income. Yugoslavia had been a member of the IFIs, an associate member of the OECD, and it 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 landscape and the prospects for the republics.

President Tito's strong grip on power and his international stature helped keep the Federation together during the Cold War era. The substantial amount of credits which Yugoslavia received from Western countries during this period also helped The Yugoslav federation maintain its cohesion.³¹ But Tito's death released political dynamics inside the Federation that went beyond the succession issue and ensuing constitutional implications by unleashing national grievances. These events, together with the growing economic crisis of the 1980s, the growing dispute between the rich republics (Slovenia and Croatia) and the rest of the

²⁸ '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.' See S. Estrin, M. Dimitrov, X. Richet, 'State Enterprise Restructuring in Bulgaria, Albania and Romania', *Economic Analysis*, 1:3, 1998, p. 233.

²⁹ According to O. Blanchard, 'the evidence from those transition countries which are doing less well suggests a larger role for disorganisation. 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.' See O. Blanchard, *The Economics of Post-communist Transition*, p. 45.

³⁰ For a comparative and analytical presentation of the Yugoslav system of self-management (the behaviour of collectively-owned firms), see John Michael Montias, *The Structure of Economic Systems* (New Haven: Yale University Press, 1976), especially part five.

³¹ Yugoslavia's external debt reached around \$20 billion during the 1980s. Increased indebtedness was enhanced by the plethora of petrodollars following the oil price shocks of the 1970s.

Federation as to the redistributive policies of the federal government in Belgrade, and rising nationalism, created the prerequisites for the ensuing violent conflicts.³² Separation and fragmentation became almost unavoidable against the background of intensifying economic difficulties.³³ 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 self-identity is a phenomenon which encompasses most of the post-communist world, for totalitarianism shackled the longings of communities for self-identity be it national, religious, or ethnic. One should also acknowledge that inter-ethnic and religious conflicts precede the advent of communism and, consequently, that their termination is not a purely ideological affair. In the Balkans more than in other regions³⁴ one finds a mixture of cultural and historical circumstances which favoured fragmentation.³⁵ Ironically, this occurred at the time that many post-communist countries expressed a desire to join the European Union. It can also be submitted that the origins of the violent separation are to be found in the intensifying economic antagonisms among Yugoslav republics brought about by 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 turning a blind eye to the behaviour of one's neighbours.

Aside from its political and security dimension, the process of fragmentation has very serious economic implications. These concern trade links (with significant trade diversion), the availability of infrastructure which supports a national economic system, and economic viability in general. For instance, can Kosovo cease completely to rely on the infrastructure of Yugoslavia?³⁶ Or, otherwise stated, how costly would this endeavour be,³⁷ and who would

³² For a thorough analysis of the Yugoslav economic crisis of the 1980s, see H. Lydall, *Yugoslavia in Crisis* (Oxford: Oxford University Press, 1989).

³³ At a conference organised by CASE in Warsaw on 15-16 October 1999, J. Sachs mentioned the short-sightedness of western countries in dealing with the Ante Markovic government by not granting him the required aid. One can speculate if a velvet revolution could have taken place or, indeed, the Federation could have stayed together although in a much looser form.

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. He also quotes 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.' See. L. Freedman, 'Now force is the only way', *The Independent*, 17 May, 1992.

³⁵ 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, prodded 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, Kennan writes: '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 these eighty years ago.' Quoted in T. Veremis, *Greece's Balkan Entanglement* (Athens: ELIAMEP and YALCO, 1995), p. 1. Veremis questions this implied 'congenital barbarism' in the region and writes 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.

³⁶ For example, there is practically no autonomous banking network in Kosovo and all transactions of the Albanian Kosovars are made in cash. In January 2000, a bank was set up with the help of the EBRD. 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.

³⁷ See 'Post war order for South East Europe', a document worked out by Riinvest, a Pristina based consultancy company (1999). For the gigantic task of reconstructing Kosovo, see also the study undertaken by the British

bear the costs?³⁸ Dissolution has also brought about the formation of ‘protectorates’, as political and security-related solutions.

II.3 Protectorates vs. independent states

One motive for the emergence of protectorates stems from ‘pronounced minority links’ which complicate the search for viable solutions to political problems and crises in the various countries.³⁹ Many in the Balkans think along these lines: ‘why should I be a minority in your country when I can be a majority in my country.’⁴⁰ This sort of *collective psychology*⁴¹ - with roots in deep history⁴² - almost invites conflict and fragmentation unless there is an exogenous constraining (and hopefully pacifying) force at work. This ubiquitous collective psychology can easily be exploited by political élites for their own purposes, including the distraction of their publics from economic hardships.

Thus, in Bosnia-Herzegovina which, *de facto*, is not a multi-ethnic federation, many refugees have not returned 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.⁴³ 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, 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, the foreign troops were supposed to stay for a year and later for eighteen months, they may have to stay for an indefinite period.

consultancy company GHK International Ltd, ‘Ideas on Kosovo: Organisation and Resources’, 1999, manuscript. Herein it is argued that ‘a development perspective should replace an aid perspective.’, p. 4.

³⁸ 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 about 2 million in Kosovo) by assuming that most of the Kosovar Albanians returned from the neighbouring countries (where they had fled to or were driven to by the Serbian authorities), and not counting the Serbs who left the region after the end of the military conflict.

³⁹ S. Borisitz, ‘The Southeast European Nonassociated Countries- Economic developments, the impact of the Kosovo Conflict and relations with the EU’, *Focus on Transition*, Oesterreichischer Nationalbank, 1/99, p. 87.

⁴⁰ V. Gligorov, who is a leading economic expert on the region, concocted this suggestive proposition.

⁴¹ A. M. Corazza-Bild, ‘Let’s stop demonising the Serbs’, May 1999, manuscript. The author writes: ‘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.’

⁴² For and historical account of pre-world war II developments in the Balkans, see I. Berend, *Decades of Crises* (Berkeley: University of California Press, 1998). Also see, R. Kaplan, *Balkan Ghosts* (1995) and M. Glenny *The Balkans, 1804-1999. Nationalism, War, and the Great Powers* (1999).

⁴³ S. Pecanin, the editor-in-chief of the Sarajevo weekly DANI, remarks that ‘[T]he 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 this is 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...’ See S. Pecanin, ‘Bosnia and Herzegovina and the Stabilization Pact for South East Europe’, paper presented at the Halki International Seminars, Halki, Greece, June 1999, p.7, manuscript.

There are several protectorates in the Balkans today. Bosnia-Herzegovina and Kosovo are *hard protectorates* - the administration of the entity is performed by foreigners under the aegis of the international community (UN). 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 of the region demanded outside intervention and the presence of peace-maintaining devices. Therefore, in certain cases the creation of protectorates may have been unavoidable. It might be argued that this political and governance instrument is the most effective in keeping things under control (maintenance of order) and fostering economic and political progress.⁴⁴ There are obvious merits to this solution but important pitfalls as well. One is that it may only 'freeze' a complicated situation, which sooner or later will explode. Secondly, it does not *empower* local leaders to run their own affairs, and it may raise their inclination to form 'parallel' governance structures or to pretend compliance with the strictures of the formal acts of the official authorities.⁴⁵ 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 self-identity.⁴⁶ Herein lies, probably, the biggest threat to and difficulty in implementation of the rules of a protectorate, and hence their capacity for establishing the bases for sustained economic development.

⁴⁴ 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 Papers* 32 (Paris: Institute for Security Studies of WEU, May 1998).

⁴⁵ 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 programmes and ideologies on the ethno-religious representation of their respective peoples, and who acquired this exclusivist 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' See S. Pecanin, 'Bosnia and Herzegovina and the Stabilization Pact for South East Europe', p. 2.

⁴⁶ In several instances, at conferences which this author attended,, E. Busek, the SECI Coordinator, emphasised that it would be a grave mistake for the external actors to adopt a 'colonial attitude' in dealing with the local authorities.

CHAPTER THREE: ECONOMIC TRANSITION IN SOUTH-EASTERN EUROPE

III.1 The relevance of economic indicators

It is useful to first make a few remarks on the relevance of some economic indicators, which have considerable bearing on any description of 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 1970s and the 1980s, 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 matters too. In the case of transition economies, single-digit inflation was seen as a very ambitious target, hard to achieve even by the front-runners. But low inflation, however commendable it is in itself, cannot be of much help in addressing, for instance, the issue of very high unemployment. When low inflation coexists with huge unemployment this 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. None the less, there are limits to what the informal sector can do in this respect, given that it introduces another issue through the back door – namely, the transparency of the economy and rules of behaviour.

The parallel (informal) sector

Not surprisingly, there are 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 little transparency and the 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, Spain) where they reflect widely disseminated habits as well as a quest for 'beating the system' in an unlawful way. The big threat to society occurs when the informal sector is expanding 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 major slump – with important social costs – growth resumption acquired particular significance in terms of responding to the normal demands by citizens for improved quality of life (after the end of communism), but also as a sign that transformation was 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 of 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 speak of 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 evince constant upgrading (rising value-added). This requires high saving and investment ratios, and the build-up of human capital. Where the latter do not exist, stagnation or regression is the most likely scenario.

III.2 Judging economic performance in South-Eastern Europe

Prima facie, South-Eastern Europe may seem to have been pursuing reforms strenuously, in spite of enormous difficulties. Markets have been largely 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.⁴⁷ Aggregate numbers on GDP dynamics between 1989-1998 also compare the region not unfavourably, 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.⁴⁸

There are two layers of perceptions which condition the relative neglect of the deeper causes of economic failure in the region. One layer is formed by the consequences of the dissolution of former Yugoslavia, by the wars which produced *distress economies*. Thus, the effects of reform policies are less visible – particularly where the dissolution of former Yugoslavia is intertwined with military conflicts. This layer suggests 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 and of reform policies.⁴⁹

The simplistic vision has underestimated, *inter alia*:

- the relative backwardness of most of the region,⁵⁰ which goes far back into history;⁵¹

⁴⁷ 1999 EBRD Transition Report, p. 82.

⁴⁸ Ibid..

⁴⁹ An example of how deceptive stabilisation can be is the experience of Albania. A few years ago, that country was branded as a model of democratic and market reforms, with inflation running at an annual rate of below 5%. Soon, thereafter, the country imploded as it was plunged into a major crisis following the collapse of the pyramid schemes. Albania has, now, again a very low inflation rate, but nobody is naïve to repeat the statements of the mid-1990s.

⁵⁰ Although one could argue that the former Yugoslavia was best prepared to undertake fast market-oriented reforms after the fall of the Berlin Wall.

⁵¹ D. Chirot, (ed.), *The Origins of Backwardness in Eastern Europe* (Berkeley: University of California Press, 1989). 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

- 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 a compensating growth in services, and a big surge in unemployment;
- the proliferation of the unofficial economy and the pervasive activities of organised crime;
- *social exclusion* on a very large scale;
- the congenital fragility of the banking systems; and
- the low level of foreign direct investment.⁵²

Together with *strain*, institutional fragility helps to explain stop-go policies (*boom and bust cycles*) as well as many of the setbacks and inconsistencies of the transition process.⁵³

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 its neighbours. In addition, the late political changes in the country would very likely put it on a much faster track to 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 that they already have Association Agreements with the EU (and were invited to start admission negotiations last December) and do not wish to be held back 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 rates of inflation, 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 change of regime;

\$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.

⁵² Central Europe took more than 50% of the FDI which flowed into the post-communist countries in Europe during 1990-1998.

⁵³ Some analysts relate disequilibria (including inflation), primarily, to the breakdown of the political process and rent-seeking activities by old elite. See A. Shleifer and R. Vishny, 'Corruption', *Quarterly Journal of Economics*, 108:3, 1993, pp. 461-88. Also see 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* (Cambridge, MA: MIT Press, 1998), pp. 42-72. This paper emphasises the magnitude of the required resource reallocation and friction, which is sometimes so large that it is likely to undermine durable stabilisation.

- prolonged periods of declining output;
- increasing poverty;
- little investment in fixed assets;
- trade disruption;
- high currency substitution;⁵⁴ and
- subjection to a multitude of external shocks, including the brutality and extensive destruction of successive 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. Albania and Macedonia also rely extensively on foreign finance. It is clear that Kosovo will experience a similar fate, being totally at the mercy of foreign donors. There are two aspects to this dependency relationship. One concerns 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 would help prevent domestic consumption from falling dramatically for a while, after which – following an expected ‘normalisation’ – output would recover or even grow. The second aspect 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*,⁵⁵ with extremely negative long-term economic consequences.⁵⁶

A special sort of war economy (society)?

Reconstruction in the region has a very specific connotation. On the one hand, it means physical rebuilding after tremendous devastation by war, which could imply technical improvement due to 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 criminalised 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.

⁵⁴ 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 by the 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’.

⁵⁵ In the literature, *Dutch disease* refers to consequences for behavioural patterns and structure of the economy of a financial ‘bonanza’, which may come to an end and leave the economy extremely vulnerable.

⁵⁶ P. Rayment remarked to me this sort of extreme situation that the political opponents of aid in donor countries seize upon to attack all forms of assistance to foreign countries.

Poverty

The population of South-Eastern Europe is by far the poorest in Europe. The region's GDP is about 0.7% of the EU's GDP, while its population makes up about 15% of the EU's. If a poverty line of \$4 per day is used, more than 50% of the population of the region fall below that line.⁵⁷ Poverty is a very fertile ground for criminal activity.

Economy and criminality

Much of the ubiquity of lawlessness is just a consequence 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 legal environment, and to the need to privatise contract enforcement when official law enforcement capability is almost non-existent.

One can, normally, pose the following question: what kind of capitalism is being built in these countries? An optimistic answer would be twofold. First, the picture is too multicoloured to justify an all-encompassing answer – the intensity of the phenomenon is different in the various national environments (Croatia is very different from Albania) and, therefore, its consequences and prospects are dissimilar. In fact, different kinds of capitalism are emerging in transition countries. Second, it might be presumed that this phenomenon might recede over time in keeping with the process of transformation. A pessimistic answer would highlight the vicious circle dynamic – as a conspicuous instance of 'path dependency' – and the enhancing factor represented by rising unemployment and poverty among large segments of society, as well as the increasing mistrust of the citizenry of an apparently impotent and corrupted government bureaucracy. A pessimistic answer would also point out the danger that the tentacles of organised crime could increasingly influence the functioning of institutions and encroach on the political process, ultimately, in a resilient fashion.

Weak states (weak public governance)⁵⁸

A weak state is a feature which 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 at grass-roots level only. 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 holders of public office can be questioned systematically by citizens or by minorities, despite elections.

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

⁵⁷ Suggested by B. Milanovic, 'Explaining the rise of inequality during transition', *The World Bank*, 1999, manuscript.

⁵⁸ 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.

Trade reorientation

Romania and Bulgaria now trade extensively with the EU. There has been considerable trade diversion (reorientation) among the former constituent parts of Yugoslavia as well. Intra-regional trade is quite low, with significant trade taking place along special routes only (between Serbia and Republika Srpska; Croatia and the Bosnian Federation; Macedonia and Serbia). Is it a temporary phenomenon, or is it getting back to a pattern of normalcy,⁵⁹ namely, trading with the rich West, which can provide capital goods and many other commodities? The truth lies somewhere in between, in the sense that important ties (which are currently broken for political motives) could be restored, but it seems impossible to recreate the links which existed in former Yugoslavia.

Increasing divides and growth prospects

Whereas the Central European transition economies embarked on sustainable growth in the early 1990s,⁶⁰ the Balkans continue to be mired in the realm of stagnation.⁶¹ The positive growth rates in Albania and Bulgaria in 1997, 1998, and 1999 represent recovery from very low levels, due to the major crises of the preceding two years. Consequently, they are good indicators of the future. Savings and investment ratios are pretty low in the Balkans; further denting 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 perceptions as to the timing of EU enlargement to South-Eastern Europe.

⁵⁹ As before the Second World War.

⁶⁰ Hungary had to undergo a major adjustment program in 1994-1995 (the Bokros program) and the Czech Republic is experiencing currently some difficulties linked with the insufficient pace of restructuring. Overall, however, the resumption of growth can be located in the early 1990s.

⁶¹ The current apparent growth resumption in Bosnia-Herzegovina is highly irrelevant.

CHAPTER FOUR: THE POSTWAR SITUATION IS NO LESS COMPLICATED

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' was one of containment or a damage control exercise. The *enlargement* of the EU was very much a Central European affair, for reasons (as spelled out by Brussels) connected with the functioning of market structures, democratic procedures, respect for minority rights, etc. As for the South-East Europe Cooperation Initiative (SECI), which was initiated by Washington, it was more directed at strengthening the capacity of the states in the area to deal with the porosity of their borders, to fight drug and weaponry trafficking.⁶² A substantial shift seems to have occurred in Western European capitals and in Brussels, lately, which has been reinforced since the new Commission took office.

The Stability Pact and the economic support pledged by the EU, IFIs, 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 of a region-wide policy which should help economic reconstruction and encourage regional cooperation. Leading Western European politicians mention the 'Europeanisation' of the Balkan states and their accession in to the EU as a target, even if this could take many years to accomplish. Others have urged the 'economic regeneration' of the region. But, as yet, there is nothing nearing the approach of a new 'Marshall Plan' in which regional initiatives would be coordinated with national development programmes, all buttressed by adequate financial and technical assistance.⁶³

As analysts point out, unless arrested, the dynamics of further deterioration and conflict could plunge the whole region into chaos, which would affect the stability of the Continent.⁶⁴ The list below attempts to highlight some of the intricate complications engulfing the region, and some of their economic consequences, including possibly severe setbacks for reform policies.

IV.1 The political geography is still fuzzy

Several local dynamics have been mentioned which indicate that the process of redrawing borders is still unfolding. The situation of Kosovo will be a formidable issue to tackle, given the reality on the ground (the determination of Albanians to get independence after their terrible plight of exodus and return) versus its formal status and its emotional significance to the Serbs.⁶⁵ Montenegro has a propensity for separation from Yugoslavia which is fuelled by

⁶² 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.

⁶³ Italy has always emphasised the need for the EU to pay more attention to the state of the Balkans, which is a position that is fully understandable in view of its geographic location. Together with Greece, Italy has for years had to deal with floods of refugees (not only from Albania), as well as the other threats coming from the area. For this very reason Italy became the most vocal supporter of including Romania and Bulgaria into NATO.

⁶⁴ This is one of the main tenets of the CEPS (Centre for European Policy Studies) 1999 study. see M. Emerson, D. Gross, and N. Whyte, 'An Economic System for Post-War South East Europe', Brussels, 1999.

⁶⁵ In this respect, see the proceedings of the conference 'Kosovo and the Albanian Dimension in Southeastern Europe', held in Athens in January 1999 published by Th. Veremis and D. Triantaphyllou, *Kosovo and the Albanian Dimension in Southeastern Europe: the need for regional security and conflict prevention* (Athens: ELIAMEP, 1999).

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 considerably affects 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 be increasingly undermined by the quest of the Albanian population to have a greater say 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 break-up of Macedonia.⁶⁶ Such a development would be catastrophic, since it could drag neighbouring countries (Bulgaria, Greece) into a major conflict.

In general, it can be asserted that the concerns of governments with the 'geographic stability' of their states diverts energy and resources from economic pursuits. It also helps the primacy of nationalism and reinforces extremism. This is even more valid in the case of weak states and weak economies, which are highly vulnerable to external shocks. Such concerns are likely to impede economic reconstruction to the extent jurisdictional matters are important as well as the cooperative efforts of other governments in the region. Murky and unstable frontiers, combined with social and economic uncertainties, create a propitious environment for illegal activities and organised crime. It is no secret that much of the economic activity in Albania, Serbia, Kosovo and Bosnia-Herzegovina, among others, is in the hands of criminal gangs, which frequently operate with the silent consent of the 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.⁶⁷

IV.2 Dislocation of people

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 people on the move is unspeakable, and the recipient countries' ability to support them has proved to be very limited. Likewise, outside aid has not been forthcoming enough owing, frequently, to bureaucratic entanglements. Most of the refugees have second-class status and are an easy prey for the local gangs. This state of affairs is particularly worrisome in Kosovo.

In this context one understands why highly skilled people think increasingly of leaving their areas. There has been a serious *brain drain* for years now. With the probable exception of Croatia, all countries in the Balkans (including Bulgaria and Romania) face the depletion of their valuable human capital. This is, probably, the worst shock for their long-term growth potential. If one also considers the deterioration of the educational system (because of the lack

⁶⁶ 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 in 'Ethnic tensions stir in Macedonia', *Financial Times*, 27 April 1999, p. 2

⁶⁷ The information on how more than \$1 billion of aid was 'diverted' by public officials in Bosnia-Herzegovina is very revealing in this respect. Also see the analysis by S. Pecanin, 'Bosnia and Herzegovina and the Stabilization Pact for South East Europe', 1999.

of resources) the combination becomes more than threatening: both asset stripping and divesting are taking place simultaneously.⁶⁸

IV.3 The direct economic impact

Macroeconomic imbalances

In the wake of the Kosovo conflict the macroeconomic situation of most 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 although this sum is 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, but it means that the local economies will have an even harder time in attracting foreign capital, and foreign direct investment in particular

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).⁶⁹ Prospects are not good at all, considering local and external dynamics. There are no signs that real economic growth (as against recovery, which has lately been experienced in Albania) can be resumed in the next couple of years, given that savings ratios are low, as is 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 level of unemployment, as it reflects pertinently the state of economies and the still very much depressed level of output in comparison to 1990.⁷⁰ With around 35% unemployment in Macedonia, about 40% in Bosnia-Herzegovina, almost 20% in Croatia and Albania and over 30% in Serbia, this phenomenon is shaping the future of these societies.⁷¹ Unemployment in these economies needs to be understood in a more complex way; it is not only the magnitude of *hysteresis* which matters here but the anatomy and physiognomy of gravely ill societies. As mentioned previously, 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 as long as the sources of

⁶⁸ Poverty, healthcare neglect, decline of life expectancy, the crumbling of public education give the extent of the rapid deterioration of public goods in most of the transition economies, including those of South-Eastern Europe.

⁶⁹ It is noteworthy that this high degree of vulnerability is not the result of financial liberalisation cumulated with non-restructured real economies; it is explained by the inability to cover endemic trade imbalances. However, the functioning of parallel currencies (DM and USD) and the illegal export of capital do nuance this assertion without invalidating it.

⁷⁰ Even if correction is made for what, in the case of transition economies, Jan Winięcki called 'redundant output', the level of economic activity is disappointingly low in view of its potential.

⁷¹ Government officials and independent analysts from the area express constantly their deep worries about the consequences of rising unemployment.

local conflicts are not kept in check (eradicated) and economies do not start to recover. For the latter to occur, a large injection of development-focused assistance – financial and technical – is needed.

The environment

Ecological concerns are not non-existent on the policy agenda of various governments of the region but there are significant differences with Western countries as to how these are to be addressed. The first concerns the issue of ranking them among the range of objectives. It goes without saying that, where military conflicts dominate policy-making, ecological concerns receive a lower priority. Secondly, governments are forced to prioritise by focusing more on short-term goals because of budget constraints. Consequently, ecological concerns are downgraded unless there is an emergency – such as the need, for instance, 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, which has very severe consequences for the environment. It can be said that ecological damage may be, to a large extent, irreversible.⁷² It goes without saying that an unrepaired 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 the food industry, which has tremendous potential in the region as well as employing millions of people.

⁷² After assessing the ecological impact of the last war, the Economist Intelligence Unit asserts 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 spillage 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, Ukraine are all downstream from Yugoslavia and millions of people in that area rely on the river for the 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...’ See EIU, ‘Economies in Transition’, 2nd Quarter 1999, p. 26. Also see ‘Ecological Damage’ in Mladjan Dinkic (ed.), *Final Account* (Belgrade: G17, 1999), pp. 38-9. On the range of environmental consequences of armed conflict, also see UN/ECE, *Environmental Performance Reviews: Croatia* (New York and Geneva: United Nations, 1999), especially chapter 3.

CHAPTER FIVE: A POLICY AGENDA FOR SOUTH-EASTERN EUROPE

The lessons of transition in general, and the dramatic events of the last decade in South-Eastern Europe, demand a policy that can restore confidence in the ability of elected officials (public authorities) to deal with the tremendous challenges at hand. 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 range and magnitude of the challenges facing South-Eastern Europe with humility, and acknowledge that miracles are not possible. Not only are the challenges ahead overwhelming but the development conundrum is far from being an easy one to solve. Moreover the intertwining 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 a regional level.

*V.1 The role of public policy*⁷³

In history one rarely finds examples of successful economic development (catching-up) which did not involve exceptional vision and effective public policy. Therefore, the question is not whether public authorities should intervene in the economy; it is how, and to what extent, they should.⁷⁴ In the Balkans, policy-makers have to proceed from a dramatic situation, and, apart 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 the impoverishment of people.⁷⁵

What sort of public policy should policy-makers in the region practise? One can list two main arguments that question the effectiveness of public policy for transition economies. One argument proceeds from the effects of globalisation (liberalisation), which allegedly destroys the effectiveness of national economic policy and, 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 imperfectly as a tendency only and the claimed mobility of the factors of production is too incomplete and asymmetric (regionally concentrated) in a world where economies of scale, the agglomeration of economies and *cumulative causation* are intense.⁷⁶ These effects explain rising inequality both inside and among countries,⁷⁷ and

⁷³ L. Summers remarked that, aside from integration cum national sovereignty, 'a third imperative for most of 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.' See Summers questions development policy research', *World Bank Policy Research Bulletin*, April-June 1999, p. 1.

⁷⁴ '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.' See N. Stern and J. Stiglitz, 'A Framework for a Development Strategy in a Market Economy: Objectives, Scope, Institutions, and Instruments', *EBRD Working Paper* 20, 1997, p. 1.

⁷⁵ N. Birdsall, 'Inequality within Nations is the Danger', *Financial Times*, 17 January 2000.

⁷⁶ For a refreshing analysis of the effects of globalisation see D. Rodrik, 'Has Globalisation Gone Too Far?', Washington, D.C., Institute for International Economics, 1997.

⁷⁷ Increasing discrepancies between so-called knowledge have and have-nots strain social structures and create tensions. As World Bank studies emphasise, high inequalities would also impede economic growth. The

the late backlash against globalisation.⁷⁸ Let us not forget that the period preceding the First World War was one of extreme openness in trade relations and the movement of labour, followed by rising protectionism.⁷⁹ The other problem with this argument is that it espouses a sort of *technological determinism*, as the social arrangements and institutions of market economies would not be primarily dictated by individuals' economic and social motives. The other argument that questions the effectiveness of public policy is linked to the *weak state* syndrome, which would empty public policy of much relevance. In this case, trying to do too much may enhance the operation of the very factors which undermine policy effectiveness (that is, 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 this 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 amply shows, is an expanding criminalised sector and unlawful behaviour. Thence, the reform and strengthening of public administration are and should be a top priority for policy as a precondition to the creation of an efficient market economy. This means public policy at full speed. Even if economic development were viewed as a 'dissolution' in a modernising transnational space such as the EU, the need for public policy would be raised to a higher level.

The bottom line is that there is a need for effective national public policy. 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. This includes defining and enforcing property rights, proper regulations, instruments for monetary and fiscal control for social insurance, and conflict management.⁸⁰ 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 the quest for development, public policy needs to deal with major dilemmas linked with monetary stability, trade policy, and privatisation. 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, reinforcing the view that currency boards are the most effective mean to attain price stability. In South-Eastern Europe, Bulgaria introduced a currency board after the big financial crisis of 1997 which proved quite successful in bringing inflation down to single figures. 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 such as a strict control of

Comprehensive Development Framework (CDF) promoted by the President of the World Bank, Jim Wolfensohn reflects this vision. It contrasts with Simon Kusnets', the economics Nobel Prize laureate, argument that growth implies and is accompanied by rising income inequality.

⁷⁸ Globalisation affects the social psychology and it can increase fears of and resentment towards neighbours or 'those who are not like us'. Xenophobia is rising in many parts of the world including western Europe.

⁷⁹ J. Williamson makes an illuminating analysis of that period and warns that one should not consider globalisation as an inexorable process. See J. Williamson, 'Globalisation and the labour market: using history to inform policy', in Ph. Aghion and J. Williamson (eds.), *Growth, Inequality and Globalisation* (Cambridge: Cambridge University Press, 1998), pp. 103-201.

⁸⁰ D. Rodrik, 'Institutions for High-Quality growth: What They Are and How to Acquire Them', (1999).

money supply. Currently, some argue that currency boards should become the rule in South-Eastern Europe.⁸¹ This argument should be judged in the context of the world-wide debate on whether vulnerable economies should adopt a key currency (the US\$ or the €) as their own. There are merits in adopting a currency board, particularly when governments lack credibility and there is a need to apply strict rules as a means of fostering discipline in the conduct of monetary (and not only monetary) policy. But there are also significant disadvantages such as:⁸²

- 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 makes productivity gains which could offset probable inflation differentials *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 and the resistance to change of vested interests. None the less, this argument should not invalidate discussion on the kind of trade policy a transition economy should use. 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 a need for a trade policy which would enhance development by considering imperfect markets and the need to foster domestic entrepreneurship?⁸³ The empirical evidence shows that the success of Asian economies rested on astute public intervention (industrial policy),⁸⁴ which considered trade policy as a means to extricate the economy out of a development trap.⁸⁵ It appears that trade policy needs to reconcile acute developmental concerns with those tied to the ability not to allow policy be captured and perverted by powerful vested interests. Therefore, trade policy in poor transition economies is a more complicated task than some argue. Very concretely, it also has to refer to the kind of trade arrangements between the EU and these countries – the role of EU aid in this context.

⁸¹ M. Emerson, D. Gross, and N. Whyte, 'An Economic System for Post-War South East Europe', (1999).

⁸² Also see Jeffrey Sachs and Felipe Larrain, 'Why Dollarisation is More a Straitjacket than Salvation', *Foreign Policy*, 116, Fall 1999, pp. 80-93.

⁸³ 'There is increasing doubt that growth is as simple as it appears in the export oriented arguments, and renewed emphasis is placed on more basic characteristic of an economy, especially entrepreneurship, institutions, and knowledge accumulation.' See H. J. Bruton, 'A Reconsideration of Import Substitution', *Journal of Economic Literature*, XXXVI:2, June 1998, p. 904.

⁸⁴ See D. Rodrik, 'Understanding Economic Policy reform', *Journal of Economic Literature*, XXXIV, 1996, pp. 9-41. Also see Jin-Tan Liu, Meng-Wen Tsou, and J. Hammit, 'Export Activity and Productivity: Evidence from the Taiwan Electronics Industry', *Weltwirtschaftliches Archiv*, 135:4, 1999, pp. 617-89.

⁸⁵ 'Less developed countries undergoing trade liberalisation and structural adjustment programs, unaccompanied by requisite technological change, may get locked in a development trap as they specialise in low technology and resource intensive industries.' See S.D. Gupta and N.K. Choudry, 'Globalisation, Growth and Sustainability: an Introduction', in S.D. Gupta (ed.), *Globalisation, Growth and Sustainability* (Dordrecht: Kluwer Academic Publishers, 1997), p. 4.

Another major policy dilemma 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 the holes in their budgets.

V.2 Economic reconstruction (regeneration) in South-Eastern Europe

Some pundits make an analogy with the end of the Second World War in evaluating the region's prospects. There are several motives for arguing that a plan for the economic regeneration of and achievement of a durable peace and security in South-Eastern Europe would be a more complex and arduous endeavour than the Marshall Plan. First, in the late 1940s there was no process of state-formation (state dissolution) in the region, and hence no ensuing conflicts. This fact favoured, in the span of a few years, the start of the process of economic integration by the establishment of the European Coal and Steel Communities. Secondly, there was a clear distinction between the victors and the losers in the war, which did not involve revision of borders.⁸⁶ This is not the case in the Balkans nowadays, where borders are still questioned, more or less openly. Thirdly, the Marshall Plan meant, primarily, an infusion of funds for energising economic reconstruction in an area which possessed the institutional ingredients of a market economy. Also, these funds included many grants. Fourthly, there was, at that time, a big common enemy: communism, both externally and domestically (represented by the strength of the communist parties in France and Italy). Who is the big common enemy of the peoples in the Balkans and of security in Europe today? One candidate could be poverty or underdevelopment on the wider periphery of a prosperous Europe. But this is an imprecise enemy, one that is not easy to deal with if one considers the global experience. Such an enemy makes it more difficult to generate support for a coherent policy response before conditions cause a violent crisis. All these differences reinforce the need for a Grand Plan for South-Eastern Europe in view of the institutional fragility and the depressed state of most of the local economies.

A Grand Plan is badly needed but it should be carefully calibrated (with properly defined targets) and implemented.⁸⁷ Assistance needs to take into account the complexity of intra-regional relations, the still murky political geography of the area, and the potential for conflict, among other factors. This extremely complex situation inextricably links national economic objectives (including economic security) with other goals, such as peace and territorial 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. None the less, 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 in practice – particularly when they imply hardly reconcilable objectives of non-cooperating governments, or have to be pursued in very adverse circumstances.⁸⁸ In the Balkans, this situation is ubiquitous and

⁸⁶ Certainly, the division of Germany could be mentioned as a counterexample but it does not change the thrust of the assertion.

⁸⁷ David Steinberg, who worked for the 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 (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 labour rights, pursuit of private enterprise, etc.'

⁸⁸ This is why the Economic Commission for Europe in its, talks about aid as a means for raising the cost of non-cooperating governments. See UN/ECE, 'Economic Survey of Europe No.2', 1999, p. 20. The recent

explains the strong presence of outsiders (including economic aid) and *de facto* of protectorates. But a foreign presence does not simplify the solution to problems automatically.

A new strategy

Tackling the problems of South-Eastern Europe requires a vision which should encompass the policies of both domestic (local governments) and external actors. This new vision and policy needs 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 – together with a development challenge. In this respect policy-makers need to take into account lessons of development experience such as:⁸⁹

- development needs a comprehensive approach;
- sustained development must be socially inclusive;
- macroeconomic stability is important 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 realistically achievable 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 economic reforms (institutional change).

The need for crisis-management. The last military conflict did not rid South-Eastern Europe of its deep-seated, latent animosities and other sources of conflict. 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 the pains related to the recent military conflict, or avoiding new bloody clashes. It can be submitted that *crisis-management* in this region has to be an exercise linked to the nature of conflicts among the local players. It therefore has to be projected over the long term as well. It may take years, if not decades, for the wounds 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 the collective psychology;
- crisis-management needs to be more prevention- than reaction-oriented. To this end, there is need for a better understanding of the roots of the region’s collective psychology;
- crisis-management and conflict resolution involve a tremendous effort for confidence-building (injury-healing) which would be well addressed by gradually restoring economic

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.

⁸⁹ See 1998 *World Bank Development Report*. Also see S. Yussuf, ‘Development Challenge: Think Globally but Act Locally’, *International Herald Tribune*, 17 September 1999.

ties among the local players. This implies strenuous efforts at developing economic cooperation in the region, among the former components of the old Yugoslavia;

- crisis-management does not preclude 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 shocks.

Economic reconstruction. Economic reconstruction should proceed from facts and assumptions such as:

- clear prospects of economic reconstruction (in both physical and institutional senses) would give the people of 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 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, to avoid further indebtedness in those countries which are already heavily indebted but also to move matters 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-Eastern Europe;
- aid should focus on development projects so that consumption-related aid addiction can be eliminated over time;
- the Plan should include major infrastructure projects of regional importance which would link South-Eastern Europe with the European Union; the positive spillover 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 plight of very high unemployment in some of the countries; it will provide many people jobs in the official economy and help combat crime. Similarly, the stimulus given to the construction industry in the areas which suffered major destruction during the wars is crucial;
- 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-Eastern 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. Although both countries can operate as in-built political stabilisers, they are themselves in need of economic support;
- the Strategy should consider more forceful measures for dealing with various social and institutional evils which plague the region (such as drug-trafficking and arms-smuggling).

This would also be 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, having a strategic location, and its infrastructure needs to be rebuilt. Isolating Yugoslavia would not necessarily enhance democracy in that country; it may even prove counterproductive.⁹⁰ Sanctions proved to be ineffective; they accentuated rent-seeking and enhanced corruption in a country where influence is very much concentrated at the top of 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 and rising external indebtedness. 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 in GDP is totally absorbed by paying external debts), which would further help savings to get back to higher levels. Considerably higher rates of domestic savings would favour higher investment rates, which would permit economies to grow.

Foreign aid can play a decisive role in achieving economic recovery and enhancing growth. For instance, €5 billion for the entire region, in a year, would mean about 5% of its GDP (of about €100 billion). This would translate into an additional supplement of domestic savings of a similar magnitude. By following consistent policies and focusing on development projects, the level of domestic investment could be maintained with lower levels of foreign aid after a period of time. Maintaining the level of foreign aid could raise even more the investment ratio (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. None the less, 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 which 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 of 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 the excess liquidity. Exchange rate policies need to help so that exports play a supporting role. The latter issue highlights a disadvantage posed by currency boards. In general, a whole range of policies that are mutually consistent and supportive of development (growth) is needed.

Providing assistance. The assistance to the region can be conceived from several angles, which are outlined 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;

⁹⁰ See Q. Peel, 'Perilous Policy', *Financial Times*, 12 August 1999, p. 10.

- infrastructure projects for the short term, such as pontoon bridges to be built over the Danube and 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 programmes within a regional framework. This policy coordination needs to be effective and, to this end, it should be done by the EU. This strategy should be generous financially and it has to be translated into actions which 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 programmes. Policy coordination needs to consider the various tasks which can be fulfilled by the IFIs.

Hindrances for and threats to reconstruction

Aside from the big unresolved issue of the role of Yugoslavia (Serbia) within the whole matrix of economic regeneration in South-Eastern Europe, this process has to cope with hindrances of a domestic nature and developments outside the area. Some of the main domestic barriers include:

- weak institutions and weak states which have a very low capacity to formulate and carry out reforms. This institutional poverty should be judged in relation with the capacity of the state to mobilise resources for development;⁹¹
- meagre resources and very constrained budgets;
- the size of the informal sectors and the extent of criminalisation 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,⁹² and when there is genuine fear that 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-Eastern Europe and the need for a 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 questions are justified, considering:

- the unambiguous indication by the US administration that it wants the EU to foot the bill for reconstruction in the region;

⁹¹ 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).

⁹² At the September 1999 meeting of the Halki International Seminars, S. Woodward remarked that, in the aftermath of the war, the likeliness that border controls will be strengthened 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 region which would favour ‘bilateral and trilateral ties’ – following the consequences of the last war.

- the message sent by the World Bank that it wants the EU to be the main donor and assistance coordinator;⁹³
- the EU still has to work out a solid plan for dealing with South-Eastern Europe, aside from the ideas emanating out of 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.⁹⁴ The March 2000 meeting of donors in Brussels is encouraging but far from sufficient in terms of meeting the financial requirements of assisting the region (not all the money is new cash but rather redirected from existing Balkan aid programmes);
- West European governments have serious budgetary problems of their own;
- a growing resentment in the EU member countries towards *enlargement* (including 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-Eastern Europe would automatically mean less aid for them.

⁹³ S. Voyadzis, the World bank representative for the Balkans in Brussels, stated that the sums assigned by the IMF and the World Bank 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 IFIs to do the same. *Ibid.*

⁹⁴ 'Stability Pact Challenges', *Oxford Analytica*, 7 February 2000.

CHAPTER SIX: LOOKING AHEAD

One can use a matrix of circumstances and challenges in order to differentiate between the countries in transition. Among the circumstances can be listed: 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; and dynamics inside the EU and in the world among others. Short-term challenges include: resuming (sustaining) growth; checking (stopping) interethnic strife;⁹⁵ fending off attacks on state institutions (by dealing with organised crime). Longer-term challenges are: strengthening institutions, including state institutions;⁹⁶ achieving sustainable growth (catching up); social cohesion (fighting poverty); social capital (fighting corruption); and 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 it owing to better preconditions (the legacy of the past including histories of partial reforms) and their geographic proximity to the EU. Investment and foreign capital which poured into these countries were attracted by the policies pursued by their governments. But clearly there was also a set of initial circumstances which favoured good results. For most of the countries lagging behind – those at the periphery of Europe – a bad path-dependency has been developing, which will afflict them for a long time. The former ideological and political divide which existed in the pre-1989 Europe is being replaced by new divides that 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 the political élite, 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 countries in transition, will remain a very distant goal. In these circumstances, one has to consider the implications of a feeling among the citizens of the countries lagging behind that they do not actually belong to Europe’s ‘clubs’ (the relevant European institutions), thereby accentuating disappointments and crises of identity.

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

Governments in transition countries, in South-Eastern Europe in particular, have to persist in building up institutions, undertaking structural reforms and strengthening their financial systems. All these challenges presuppose the restoration of lasting peace as an overriding objective. There is also a need for the development of a strong middle class and a civil society as the backbone of well functioning market economies and democratic polities. Where citizens do not feel empowered economically and politically, friction is unavoidable and energies do not translate into better economic performance.

⁹⁵ In the case of Russia, this is more complicated when it involves separation attempts (recently, in Dagestan).

⁹⁶ Strong state institutions refer to the effectiveness of the pursuit of the common good (public purpose).

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 take some comfort from this process, which should facilitate it? Ultimately, it is not Brussels which will decide on the pace of admission, but national governments – which are accountable to their electorates. If the citizens of West European countries do not feel comfortable with enlargement because they think that it is going to increase structural unemployment, politically articulated interests will not take long to reflect those anxieties. This politically articulated opposition is likely to delay the process of admission. Enlightened pragmatism would acknowledge the various constraints on rapid enlargement, but also caution against losing sight of the target and the momentum.