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Costs and Benefits of Kosovo's Future Status

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Executive summary

The current post-conflict state of relations between Serbia and Kosovo is not justifiable on economic grounds or on any other grounds for that matter. They both sustain unnecessary costs and fail to capture sizeable benefits. Thus, the benefits of normalization far outweigh the political and economic costs and benefits of the status quo.

Currently, in 2007, the actual direct burden of Kosovo on the Serbian budget can be estimated at around EUR 125 million. Those include the maintenance of the parallel structures in Kosovo. Indirect costs are hard to assess, but would include higher security costs. In addition, there are costs to trade which is below potential and slow growth in regions close to the Kosovo border.

The main future economic costs are connected with the continuation of tensions between Kosovo and Serbia and even more with the aggravation of these tensions in case the current post-conflict state of affairs is prolonged.

Kosovo will face continued economic decline or perhaps mediocre recovery and that will be hard to justify on any grounds. If the future status is such that international aid and assistance remain to be the core of Kosovo's economy, no amount of absorbable aid and assistance from whatever source will prove sufficient or efficient.

Stability and normalization should be the crucial ingredients of Kosovo's future status. If achieved, it would lead to strong economic recovery in Kosovo and to more sustainable economic growth in Serbia.

Chances for positive economic development, strong recovery and sustained long-term growth are significant if normalization is achieved. Kosovo's potential growth rate could be close to 7% to 8% per year in the medium run while Serbia could sustain a convergence growth rate above 5% per year. Both would also benefit from a 'peace dividend', i.e., lower security costs.

Of the scenarios considered: (i) full Serbian sovereignty, (ii) substantial autonomy for Kosovo, (iii) supervised independence in accordance with Ahtisaari's Plan, and (iv) Serbian and Kosovo partnership of some sort, only the last one would provide for a significant decline of risks, for increased investment and trade, for improved prospects of EU integration and for strong recovery in Kosovo and sustained growth in Serbia, whereas any solution that would be rejected by any of the parties would trigger increased fiscal and security costs and impair investment and GDP.

Any attempt to re-integrate Kosovo within Serbia would lead to considerable net fiscal costs for Serbia (in an order of magnitude of around EUR 450 million per year) even with no increase in security and other tensions and thus costs to trade and growth. The latter could be substantial depending on the resources needed to preserve political stability and depending on the international reaction.

The most important factors are the increased risks of macroeconomic instability. Serbia's macroeconomic stability is tenuous and risky in terms of costs of sovereign borrowing, a rise in interest rates and the ensuing consequences for growth prospects and unemployment, and could collapse if the solution of the status of Kosovo were to be strongly resisted.

Regional risks have also to be considered, though most of the costs of regional instability would fall on Serbia and Republika Srpska in Bosnia and Herzegovina. Indirect negative economic consequences would be also felt in Macedonia. By far the most far-reaching negative consequence would be a delay in European integration.

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Introduction

Kosovo and Serbia are basically independent of each other; in fact, too independent. The political relations are typical of unresolved post-conflict situations, the economic relations are distorted, and the legal systems, policies and public finances are practically completely separated. Thus, benefits from normalization are significant while costs to political and social integration would be forbidding. From the cost–benefit point of view, full-scale political integration would require the investment of a lot of resources – political, financial and social – perhaps in the order of those planned as institutional support, aid, assistance and cheap credits by the European Union, the United States of America, the International Financial Institutions (IFIs), and the international and donor community in general.

Existing proposals – local as well as international – for Kosovo's future status recognize the infeasibility of full-scale political, economic and social integration of Serbia and Kosovo, though for different reasons. For the most part these proposals, however, do not recognize, or do not recognize enough, the potential benefits of political and economic normalization. The potential gains of partnership of Kosovo and Serbia are significant for both parties, in economic as well as political terms.

Here, the costs and benefits of alternative solutions to the future status of Kosovo are discussed. The focus is on the fiscal sustainability of Kosovo, which depends on contributions from outside sources; of special interest are possible fiscal and other costs of Serbia. However, the broader context of political and economic relations will be taken into account in order to gauge the indirect costs of alternative solutions for the future status of Kosovo. In addition, possible consequences for the wider regional stability and development will be shortly considered. Finally, conclusions are drawn.

Existing analysis

The consequences of the Kosovo crisis were discussed extensively at the time of the military conflict, i.e., in 1999. Most analyses came to the conclusion that the potential destabilizing effects of a persistent Kosovo crisis would be quite significant for the Balkan region as a whole (Gligorov and Sundström, 1999). Also, the potential benefits of political and economic normalization were expected to be large. These analyses and conclusions have proved to be right so far. The whole Balkan region has seen significant political and economic improvement in the years since the resolution of the Kosovo crisis. The laggards have been countries and territories with unresolved post-conflict relations and with nonstandard political and economic systems. In this respect, significant foreign or international presence, as a consequence of an unresolved post-conflict state of affairs, has not been supportive of economic development, though it has contributed to local and regional security and stability.

Similar analyses for the current political process centred on the resolution of Kosovo's future status are lacking. This probably reflects the widely shared expectations that the region is not facing similar challenges of possible destabilization. Most interest is concentrated on the economic effects of a definite political separation of Kosovo from Serbia. In that, the key concern is the ability of Kosovo to finance itself and on the possible contribution that Serbia will have to make if a certain level of political and institutional integration is preserved.

The main contribution to the understanding of the public sector economics in Kosovo has come from the International Monetary Fund and the World Bank. Perhaps the main source is the extensive study by the World Bank, *Kosovo: Public Expenditure and Institutional Review* (2 Vols.) from 2006. The shorter second volume summarizes the state of affairs as of mid-2006. It points to fiscal challenges after the future status has been decided on. Those have to do with significant infrastructure investment needs and with fiscal risks, i.e., with implicit obligations by the government to public sector companies, in particular the electricity company. In addition, the fiscal costs of the future status are emphasized. Similar considerations can be found in the IMF's *Aide Memoire of the Staff Mission to Kosovo* from February 2007.

UNMIK (the United Nations Interim Administration Mission in Kosovo) has also produced a number of studies on this topic. The *Kosovo Economic Outlook* for 2006 treats 'The Economic Foundations of Status' while the same publication for 2007 is titled 'From Consolidation to Sustainability: Maintaining and Improving Achievements'. Perhaps the most comprehensive is the study, *UNMIK's Impact on the Kosovo Economy* from July 2006, which assesses the contribution of UNMIK's spending on Kosovo's GDP and discusses the possible impact on economic growth if these resources go down to zero or are gradually diminished substantially.

Thus, most studies deal with growth and the fiscal challenges of Kosovo's future status on the assumption that UNMIK will disengage immediately or gradually.

In addition to the IMF and the World Bank, the UNDP (United Nations Development Programme) produces important reports on human development and quarterly early warning reports. Also, the research and the advocacy think tanks analyse various aspects of Kosovo's economic, social and political development. Increasingly, the Kosovo institutions produce data and reports on economic development and economic policy. Most of these studies paint a bleak picture of the economic and social state of affairs and of the public's economic and political sentiments.

Thus, the overall economic situation is difficult and is unsustainable both objectively and in the eyes of the public.

With all those studies, the statistical and analytical basis for assessing developments in Kosovo is still rather weak. Even the data on foreign aid and assistance are incomplete. In the study by Mustafa, Demukaj and Kotorri (2006), written in the context of the Global Development Network Southeast Europe, it has been argued that it is hard to document the true amount of foreign aid, especially that part that targets security. It is generally acknowledged that the amount of aid is declining, though its economic impact and efficiency is perhaps improving.

Thus, the overall amount of fiscal support is not known with the necessary precision and in greater detail.

Probably the least is known about the microeconomic developments, though increasingly local communities are scrutinized for their performance and the corporate and banking sectors are analysed. The transformation has been remarkable in the financial sector as well as in the private sector. But the reports on weak public governance and problems with corporate governance are still more common than those that notice improvements.

Thus, there are problems with public and corporate governance and generally with the institutional development.

Because of the relatively poor understanding of the actual development in Kosovo and of its relations with the neighbouring countries, it is not easy to assess the challenges that the change of its current status will bring. Still, most of the studies and assessments do not suggest that the change of status would lead to major institutional and economic shocks and unmanageable challenges.

By contrast to this extensive treatment of Kosovo's economic prospects and financing needs, there is scant discussion of Serbia's contribution or of the costs that the current situation in Kosovo and of their mutual relations is imposing on Serbia. Though the political impact of Kosovo's current and future status on Serbia is clearly substantial, no official or unofficial analysis of the existing or expected costs and benefits of the current economic relations or of the future developments exists. Some consideration has been given to emerging trade between Serbia and Kosovo and there is some indication that investment needs and opportunities, both private and public, are being considered, but no detailed analysis or firm commitments can be detected as of this moment.

Thus, it could be concluded that the perception of the costs to Serbia is that they are low and the potential benefits of normalization are not yet being considered.

The current state of Kosovo's economy

In order to come to some kind of determination of the costs of Kosovo for Serbia at the moment and in the future, the current economic developments in Kosovo and their prospects in the immediate and more distant future need to be assessed. This determines the crucial part of the costs and benefits assessment, both the direct and even more so the indirect ones.

The most recent assessments of Kosovo's economic development are more positive than they were in the past. The decline of foreign aid in the past few years had led to economic stagnation and even to economic decline. A recent UNDP assessment puts GDP growth at 0.3% in 2005. However, by all accounts, GDP grew by 3% in 2006. This year's estimates are that growth is continuing. The 2007 EU Commission Report on Kosovo quotes the most recent IMF assessment that puts 2005 GDP growth at 0.6% and that of 2006 at 3.8%.

Thus, after years of stagnation, Kosovo seems to have moved to a path of growth in spite of the decline of foreign aid.

The main drivers of growth are domestic consumption and increased exports. There is the impression that the private sector is expanding, in particular small and medium-sized enterprises. Exports are also rising rather strongly, albeit from a very low level. This is also reflected in the brisk credit expansion, of over 25% p.a. in 2006 and 2007, similar to the one to be found in other countries in the region. Growth has also been supportive of the fiscal sector, as revenues are rising too. Public expenditures are, on the other hand, kept under control, though mostly through cuts in public investments. As a consequence, the general government budget was in surplus in 2006. Also, the deficits expected this year and in the medium run should not be too large. This improvement in the fiscal sector has had positive effects for inflation and price stability, and even deflation has been the rule in the past few years.

Thus, macroeconomic stability has been achieved and it looks sustainable, at least as far as prices and fiscal balances are concerned.

There is an agreement among the observers that privatization has contributed to this positive economic development. Efficiency has improved in the privatized companies and costs to the budget have declined with the closing down of unviable firms. The financial system has continued to improve and trade liberalization, with the launching of CEFTA, has been helpful to export-oriented industries. This can also be seen from the constant growth of the inflows of remittances that are supporting the construction industry and small and medium-sized enterprises in addition to consumption. Effectively, remittances are higher, and have been for some time now, than aid, at least that part of aid that is spent in the country. Also, foreign investments have picked up and investors are expected to continue to show interest in the country. Growth has mostly occurred in the services sector, but there has been some growth in industry too, and agriculture seems to have improved slightly.

Thus, both macro stability and micro growth can be observed in the last year or so. This, however, does not mean that the current developments are altogether sustainable, especially if the further decline in foreign spending and assistance is taken into account. UNMIK estimates that GDP could decline as much as 7% if its operations were to be discontinued completely. Obviously, if they are only downsized, as they have been in the past few years, the effect would be more moderate. Nevertheless, that is seen as the major challenge faced by Kosovo were it to be declared an independent state. These assessments do not look more closely into the more general effects of Kosovo independence. Also, the domestic and regional reactions on independence are not taken into account.

In general, the overall economic situation can be assessed as being difficult in view of the high rate of unemployment and the high external imbalances in spite of recent signs of improvement in production and exports – exports cover imports by around 10%. Still, the imbalances in the labour markets are certainly the main economic problem, as it is in most countries in the region, such as in Macedonia, Serbia, Montenegro, and Bosnia and Herzegovina. Most reports put the unemployment rate around 40% (44.9% according to the labour force survey in 2006) with the employment rate being quite low, especially among the young and women. In view of these longstanding imbalances, social and political stability, which is improving, suggests that the risks of destabilization due to the gradual decline of foreign assistance do not seem to be unmanageable.

Thus, the overview of Kosovo's economic development suggests that it is trade and investments that are the main problem, while fiscal sustainability seems to be manageable at least in the short to medium run.

Sustainability in theory

Due to the extreme distortions that are found in Kosovo's economy, the question is often raised about its economic sustainability, especially in fiscal terms. As has been shown above, fiscal sustainability does not seem to be the most pressing problem. Similar questions were raised in the case of other newly established states in the Balkans, e.g., about Bosnia and Herzegovina, Macedonia, and most recently about Montenegro. Though their economic performance has not been stellar as a rule, economic sustainability has not proved to be their main problem. In principle, economic sustainability should be achievable even from an initial position as disadvantageous as is to be found in Kosovo, if certain conditions are satisfied (Gligorov, 2000). Four of these conditions are the most important in case of a country such as Kosovo.

The first is the reliance on the private rather than on the public sector. A small, landlocked, developing country needs significant inflows of foreign investments if it is to grow and develop. Countries in transition, including those in the Balkans, have been able to attract significant inflows of private foreign resources once the risk to the development of the private sector has declined. A recent example is Montenegro, which has attracted significant foreign investments after it became an independent country.

The second is openness. A landlocked country such as Kosovo has to have access to foreign markets if it is to grow. In Kosovo's case, regional markets are the most important ones. Recent data support the view that exports to the neighbouring markets have been growing rather fast, in particular to the Serbian market. The beneficial effects of foreign trade liberalization can be achieved only if a country is open to imports as well as for exports. In that respect, CEFTA may prove to have a greater importance for the development of Kosovo than for most other countries in the region. In addition, Kosovo's external economy, i.e., the economy of the diaspora, is bigger than the domestic economy, at least outside of agriculture. Kosovo, like a number of other Balkan economies, depends to a very large extent on the international labour and financial market. So, openness is the key.

The third condition is the development of infrastructure, physical and institutional. Kosovo's physical infrastructure is quite underdeveloped and significant investments will be necessary in order to improve it, though some reconstruction has been achieved in the past seven or eight years. Of course, the development of network (e.g., electricity) and institutional infrastructure is also important, and this is where Kosovo reports most deficiencies.

And the fourth condition, human capital development, is crucially important. Kosovo's demography underscores this point. The population is young and unemployment is particularly high among the young and the unskilled. There are limited opportunities for unskilled labour in the Balkans, and in Europe in general, which suggests investments in education, elementary as well as secondary.

The former two conditions belong to the transition agenda while the latter two are from the development agenda. The development needs are the most demanding, from the public finance point of view. They have traditionally required significant foreign official and multilateral transfers. The situation has somewhat changed now, but still fiscal sustainability hinges very much on the ability to finance development needs; also, on the ability to use the positive effects of transition, i.e., of privatization and foreign investment inflows, to support the development agenda.

Fiscal sustainability, historically

Kosovo was the recipient of significant budget and other financial support until the late 1980s. This system was discontinued on the eve of the dissolution of Yugoslavia. After the suspension of Kosovo's autonomy and the referendum for independence in the late 1980s and early 1990s, Kosovo was increasingly fiscally independent from Serbia. The Serbian government tolerated this independence as it minimized its financial obligations. Given that the fiscal system of Kosovo's parallel state was not transparent at the time, it is hard to say anything with any kind of certainty about the costs and benefits of this dual system of public governance. Similarly, it is close to impossible to sort out the economic costs and benefits as much of what transpired in trade and investment went on under nonstandard circumstances and was not properly recorded statistically. Clearly, some of the more important resources of Kosovo – in the electricity sector and in extraction – were run by the Serbian state and must have provided it with some fiscal resources, but those would be very difficult to quantify with any precision. But the country, Serbia together with Kosovo, was under a rather severe system of international sanctions for most of the 1990s, and was also supporting several war efforts as well as the repressive regime in Kosovo, so that the economic distortions were so large that not very much can be said on the basis of that experience (Gligorov, 2002).

Still, given that Serbia collected taxes in Kosovo while it did not finance many of the public and social services, in general, it could be hypothesized that the fiscal benefits were higher than the costs for the Serbian state during the 1990s. Also, the economic decline of Kosovo was steeper than that of the rest of Serbia.

After 1999, the Serbian state lost practically all rights and obligations in Kosovo. After the settlement of foreign debts, Serbia took over Kosovo's foreign debts in accordance with the debt rescheduling agreement from 1988. In addition to that cost, Serbia finances the various needs of Kosovo's Serbian population (the current Serbian budget provides for about EUR 50 million for Kosovo with an additional about EUR 20 million for investments). In addition to these costs, Serbia has indirect costs of two types: costs of security and costs of higher risks due to the lack of normalization of relations with Kosovo. Those are much higher than the direct costs, but are not costs incurred in Kosovo: these are rather the costs of the ambiguity connected with Kosovo's currents status.

Fiscal sustainability in comparison

In theory, a country should be able to balance its fiscal sector irrespective of its level of development. It is assumed, indeed, that less developed countries should have smaller fiscal sectors, conditional on their size. In the Balkans, most states are small and their economies are not very developed, but their fiscal sectors tend to be large. Notable exceptions are Albania and Kosovo. Given the demographic similarity and similar levels of development, a comparison between these two countries seems quite appropriate.

Albania has had a hard time developing an efficient tax collection system. Things have improved after the introduction of VAT, but it still took some time for the fiscal shortfall to be diminished significantly and for the fiscal deficit to be shrunk to levels that are sustainable. This has not stopped the country from growing rather strongly for the whole period after the deep crisis of 1996-1997. At the moment, public revenues in Albania are around 25% of GDP and expenditures around 28% of GDP, with the deficit down to around 3% of GDP. The trend has been for the revenues to increase and for expenditures to decline.

Kosovo, on the other hand, has seen its public expenditures decline in relation to its GDP and its public revenues increase. Indeed, it has run fiscal surpluses due to significant inflows of foreign aid and transfers of all kinds (The World Bank, 2006). At the moment, Kosovo has still considerable fiscal reserves that it accumulated during the times it had surpluses. Still, the public sector has declined in relation to GDP and now stands roughly where it is in Albania; public revenues and expenditures are slightly below 30% of GDP. In reality, they are even lower, as there is a large informal economy that is mostly unaccounted for. Similar is the case with Albania, where also the informal sector is large and is probably not altogether included in the GDP.

Thus, the fact that both these countries have relatively small public sectors may be the consequence of the similar economic structure, of similar reliance on the private sector and remittances, similar demography, and of similar problems with fiscal efficiency. The one significant difference is in the unemployment rate, around 40% in Kosovo and just below 15% in Albania. That is the consequence, most probably, of the differences in the opportunity for outward migration. Albania has seen significant outward migration since the fall of communism, while Kosovo's outward migration, which was traditionally quite strong, has been thwarted by its relative closedness during that same period (ESI, 2006). Given Kosovo's dependence on remittances, that may be a serious problem of its economic development.

Thus, this comparison of Albania and Kosovo, two countries with similar demographics and levels of development, leads to the conclusion that fiscal sustainability may not be the most significant problem in Kosovo.

Of course, if the access to foreign labour markets and to foreign education is limited, domestic expenditures on education and on active labour market measures have to be significantly larger in Kosovo than in Albania, and may have to be closer to what is found in other countries in the region. The same goes for the expenditures on health and other welfare services and in the long run for expenditures for pensions, as those will have to be earned at home rather than abroad. Thus, the public sector in Kosovo is probably smaller than it should be, given that it is a much more closed country than is Albania. Of course, greater openness will lead to improved access to outside labour and product markets and that would be supportive of the balance of payments and fiscal balances.

Serbia's and Kosovo's economies compared

The key fact is that Kosovo is small compared to Serbia, in economic terms. Serbia's GDP is expected to reach EUR 30 billion in 2007. This is to an extent the consequence of the appreciation of the local currency, the Serbian dinar, and may be somewhat on the high end, but if it were revised by 10% downwards in the future, due to exchange rate correction, it would still be much larger than Kosovo's GDP of just less than EUR 2.5 billion. Thus, Kosovo's GDP is less than 10% of Serbia's. Their respective general government budgets compare similarly. Serbia's general government budget is around 40% of GDP while Kosovo's is now slightly below 30% of its GDP. Thus, the latter is somewhat smaller than 10% of the former. Comparisons of the foreign trade performance are even more unfavourable to Kosovo as its imports are around 10% of Serbia's while exports of Kosovo are practically negligible. In GDP per capita, Serbia's is around four times higher than Kosovo's. In addition, Kosovo's GDP per capita is declining or stagnating, as slow GDP growth cannot catch up with the relatively high growth of population, while Serbia's GDP per capita is increasing rapidly due to a high growth rate and also because of price convergence. Finally, Serbia is increasingly an attractive investment destination while Kosovo has been receiving some more substantial investments only in the last couple of years.

Thus, whatever direct and indirect costs and benefits are to be incurred or gained, those will be relatively small for Serbia and comparatively larger for Kosovo.

Conclusions so far

This review of existing knowledge and experience leads to the following conclusions:

(1) The main economic costs for Serbia as well as for Kosovo are connected with the risks that continued tensions between Serbia and Kosovo could bring.

(2) The needs for outright fiscal support are not too high in Kosovo.

(3) Investment needs are significant, but investment opportunities are significant too.

(4) Access to markets in the region, especially to the Serbian market, is important for the sustainability of the external balance of Kosovo.

(5) The chances for positive economic development, strong recovery and sustained long-term growth in Kosovo and in Serbia are significant, though more so for the former than for the latter given the small size of Kosovo's economy compared to the Serbian one.

Alternative proposals for the future status

The current state of affairs is not optimal in economic terms. The costs borne by Kosovo are significant and unjustifiable. The costs in Serbia are comparatively much smaller, but the lost benefits may be somewhat more substantial. Those depend on the outcome of the current deliberations and negotiations on the future status of Kosovo. They differ depending of the alternative chosen.

There are, realistically speaking, three proposals that are being developed for the future status of Kosovo. The fourth option, which is sometimes in the minds of those who argue for Kosovo remaining part of Serbia, which would resemble the system that existed prior to the dissolution of Yugoslavia, is not seriously proposed by anybody. A system similar to that which existed in the 1990s may be what the representatives of the Kosovo Serbs (some of them to be sure) have in mind, but that is also not proposed as a realistic alternative by anybody. Most of those who are involved in the debates about the future Kosovo status, on both sides, seem to have learned at least some of the lessons of history.

The Serbian proposal, as far as fiscal obligations are concerned, is that of clean fiscal separation, except in the areas where Serbia wants to support the Kosovo Serbs. In that, the Serbian proposal, which is somewhat imprecise and is being constantly revised, seems to be developing in the direction of minimal, essentially symbolic, sovereignty of Serbia over Kosovo.[1] That would, basically, mean that Serbia would be represented in the United Nations, while Kosovo would not be (but it would not be barred from the membership in all United Nations or other international institutions; it is questionable, however, whether that is in fact feasible). Beyond that, Serbia would not have any rights or obligations in Kosovo. Or, to put it succinctly, Kosovo would be completely internally sovereign and would share only very limited external sovereignty with Serbia. Clearly, this proposal would reduce some of the existing costs that Serbia has, but would not really bring any benefits in and by itself. In concrete terms, Serbia would stop servicing Kosovo's foreign debt, the stock of which amounts to over USD 1 billion.[2] No other costs or benefits are currently envisaged, certainly no fiscal union or fiscal sharing arrangement of any kind.

[1] The most recent proposal – that the relations between Serbia and Kosovo should be analogous to those between China and Hong Kong – underscores this fact.

[2] The proper amount still remains to be negotitated.

The Kosovo proposal is based on the plan by Marti Ahtisaari. In addition, the representatives of Kosovo propose that some special relations (‘Friendship and Cooperation Agreement’) between Serbia and Kosovo are established in specific humanitarian and social areas. That plan also assumes complete fiscal separation between Serbia and Kosovo, except for some specific purposes or on the basis of specific contracts. Compared to the Serbian proposal, there are no significant differences when it comes to fiscal rights and obligations of Kosovo or Serbia. There are certain points of conflict when it comes to the particular claims to property rights and succession of resources of former Yugoslavia, but that is a separate issue to be commented on later.

The third proposal could be geared towards the maximization of benefits rather than the minimization of costs. It is in the clear interest of Kosovo, but also of Serbia, to push strongly forward their separate and mutual economic developments. These common interests could be institutionalized, e.g., via a contract between the two states. While Serbia is potentially the major market for Kosovo, it could also be a more significant investor in Kosovo. Once trade is liberalized in practice, and is carried out by private agents, and once the market economy develops, Serbia could significantly increase its economic presence in Kosovo, which would have beneficial fiscal consequences for Kosovo and for Serbia alike. That would assume, however, that Kosovo is an independent state with a partnership contract or contracts with Serbia. That is anyway supported by CEFTA and by the various other initiatives and institutions of regional cooperation. But, in addition to these regional cooperation agreements, various bilateral agreements could exist that would support both economic development and the process of accession to the European Union.

Thus, strategically speaking, the key issues are not the costs of integration, but the benefits of normalization. Or, to put this differently, the key issue is the determination of the opportunity costs of lack of normalization. There are no illusions on either of the two sides in conflict that political and social integration of Kosovo and Serbia is desirable and thus achievable. The issue is whether the costs of a nonstandard political arrangement outweigh the benefits of stable and sustainable political arrangement.

Costs of Kosovo reconstruction

To get an impression of Kosovo’s fiscal needs as driven by the process of reconstruction, data on foreign aid for that purpose are useful. Table 1 and Figure 1 give an indication of the amount of aid spent on Kosovo reconstruction in the first five years. The decline has continued in the following period too, though it has not been as strong as in the period until 2004.

The experience with reconstruction aid in the Balkans is instructive and not fully understood. Generalizing somewhat, it could be argued that most of the forecasts of the reconstruction needs and of the efficiency of aid and other sources of assistance have proved to be wrong.

Table 1

Annual foreign aid inflow to Kosovo and share of total by sector, 1999-2004

(amounts are in EUR thousands)

Sectors	Spent 1999	Spent 2000	Spent 2001	Spent 2002	Spent 2003	Spent 2004	Total spent during 99-04	Share of Total (%)
Public utilities	16,854	127,693.6	193,210.4	94,099.7	91,703.3	54,029.1	577,621	25.92
Housing	26,895	155,530.7	90,831.7	67,572.9	14,107.0	6,888.3	361,825	16.25
Trade and industry	124.44	56,570.5	42,263.5	27,061.9	29,189.8	21,034.1	176,244	7.9
Education and science	43,256	74,503.0	65,671.8	49,493.0	31,092.8	19,908.2	283,926	12.74
Infrastructure	202	50,183.7	48,295	20,968.2	12,807.0	1,955.7	134,411	6.03
Agriculture	125.05	17,736.8	34,377.4	17,565.3	15,880.4	4,514.9	90,200	4.05
Environment	85	184.64	633.62	1,097.2	3,471.4	1,063.8	6,536	0.29
Technical assistance, capacity building and others	89,976	124,979.1	117,917.6	120,758.5	90,113.4	54,035.8	597,780	26.82
Total	143,991	273,974	260,863	215,975	169,747	100,556	2,228,511	100

Source: MEF - RIMS Database, December 2005.

If a country achieved internal stability and external normalization, the forecasted needs for reconstruction aid would prove to be overestimated. If, on the other hand, nonstandard internal and external institutional arrangements were introduced and those persisted, the reconstruction assistance would prove to be inadequate. Also, in the former cases, efficiency would tend to be higher than in the latter cases. This is in accord with the experience of massive aid and assistance in other parts of the world. It is now rather widely accepted that stability and institutional clarity are quite supportive of the efficiency and the effectiveness of aid in general and of aid for reconstruction in particular.

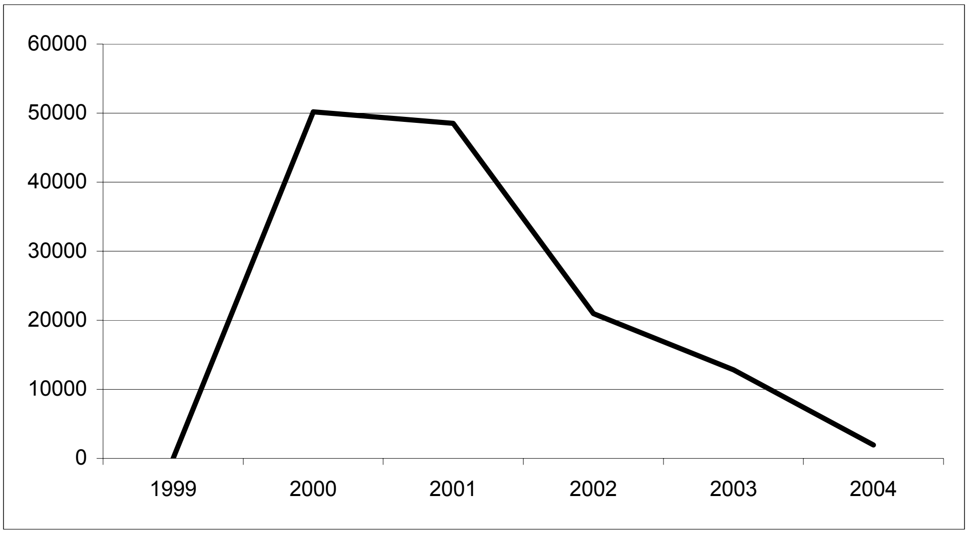
In the case of Kosovo, the costs of aid so far have been too high considering what has been achieved, especially in the reconstruction of utilities and of the electricity generating system in particular. Similar is the experience in Bosnia and Herzegovina. The costs of inefficiencies and of lack of appropriate political and economic ways to deal with them have been mostly borne by the citizens of Kosovo, both by those in Kosovo and by the refugees from Kosovo. Also, those costs have been borne by the international donors. The smallest part of the overall cost has fallen on Serbia. In fact, aid for reconstruction given to Serbia has been an example of money mostly well spent. Also, it has turned out that Serbia needed less of a financial support then had originally been planned.

Because of this asymmetry of the distribution of costs, Serbia has not been as eager as Kosovo to reach an agreement on the future status of Kosovo. This will continue to be the case if the future status were to be constructed in such a way that it essentially saps the development of Kosovo without putting too much of a constraint on the development of Serbia. If the future status is such that international aid and assistance is the core of the Kosovo economy, no amount of aid and assistance, from whatever source, will prove sufficient or efficient. This should have been learned from the prolonged period of the implementation of the policy 'standards before status' that did not advance the standards and has not resolved the issue of the future status.

Figure 1

Annual aid inflow trend in the infrastructure sector in Kosovo, 1999-2004

(amounts are in EUR thousands)



Source: MEF - RIMS Database, December 2005.

This does not mean that Serbia should share in the costs, but it means that an arrangement is needed that opens up economic and social opportunities to the Kosovo citizens. That means that stability and normalization should be the crucial ingredient of Kosovo's future status. That should also be beneficial to the minorities in Kosovo, primarily to the Serbian population. They should face increased economic and social opportunities rather than the prospect of living in ethnic ghettos depending constantly on transfers from the Serbian budget or from donor countries and institutions.

In any case, the data in Table 1 and Figure 1 are useful as they suggest the overall reconstruction needs of Kosovo that may be taken to indicate the overall fiscal cost the Kosovo budget will have to take over or that it would have to share with the Serbian budget if some kind of fiscal integration is to be envisaged. It is in any case practically the only more or less reliable data source to base the analysis on.

Benefits of Kosovo's future status

A stable Kosovo with normal relations with its neighbours could prove to be helpful to the economic development of the region. Kosovo is a landlocked country and depends on its neighbours for market access. Its economy is based, and will continue to be based for some time, on extraction and small and medium-sized enterprises supplying spare parts for bigger firms and enterprises. It will also continue to be a supplier of labour because its population is still demographically very active.

To put this in different terms, Kosovo may prove to be attractive for investments once its economy is opened up and its stability is assured. The experience of the post-2000 Balkan development suggests that it is the neighbouring, more developed economies that mostly benefit from the stability, transition and economic development. Indeed, the recovery of the Balkan post-socialist economies can be dated rather precisely on the year 2000, after stability prevailed with the resolution of the 1999 Kosovo crisis and the democratization of Croatia and Serbia. Thus, the resolution of the regional risk led to overall economic improvement (Gligorov, 2006 and 2007).

At the moment, significant investors in Bosnia and Herzegovina, Serbia, Montenegro and Macedonia originate from Slovenia, Croatia, Greece and Austria. It stands to reason that investors from Serbia could do very well in Kosovo. This would be supported by two things. One is the property issue: Serbia or rather its citizens have legitimate claims on property in Kosovo, both state and private property. Some of it, especially in natural resources, is such that it requires cooperation of Serbia and Kosovo. The other advantage is in the fact that Serbian firms, entrepreneurs and banks are natural partners for investors from further abroad. Belgrade, and to a lesser extent Skopje, are natural points of entry to the Kosovo economy.

Quantifying the potential benefits is not a simple exercise, but it can be hypothesized that they may be quite significant. They would also do more for political and economic stability in Kosovo and Serbia than any other institutional integration. Serbia will have competitors there and may lose out to these opportunities if it insists on nonstandard arrangements with Kosovo. Traditionally, Slovenia is an important economic partner of Kosovo, but there will be others as well. Lack of Serbia's participation in Kosovo's reconstruction would also not support the continued presence of the Serbian minority in central Kosovo.

Current Serbian costs

Unlike before 1999, Serbian direct costs in Kosovo have been relatively small. Certainly the largest and most enduring costs were those associated with the refugees from Kosovo, but those have been mostly borne already. The remaining costs are not known with any precision, but are not substantial.

The resources set aside for Kosovo in the Serbian central government budget have been increased and are about EUR 50 million in 2007. About EUR 20 million have in addition been reserved in the National Investment Programme for Kosovo, but the Serbian government has been complaining that the absorption capacity in Kosovo, that is in those areas where Serbs live or are the majority in the population, is low. Government officials have suggested that there have been significant inefficiencies in the spending of these funds. So, these amounts can be taken to be at the higher end of the fiscal costs if the status quo continues.

In addition, servicing Kosovo's external debt is a significant cost. At the moment, annual debt service amounts to about EUR 35 million. Recently, government representatives have suggested to the World Bank, which is the main creditor in Kosovo, that Serbia should stop servicing that debt and that even the amount it has already paid back, about EUR 250 million, should be returned to Serbia. This cannot be done immediately because the amount of foreign debt that can be allocated to Kosovo needs to be negotiated between Serbia and Kosovo, so Serbia will continue to service that debt for the time being.

Additional resources are transferred to the local communities in northern and central Kosovo, which are relatively small except for Kosovska Mitrovica and perhaps other counties in the northern part of Kosovo. These financial resources are about EUR 13 million (see Table 2).

Table 2

Direct costs to the Serbian budget, EUR million (round figures), 2007

Refugees, all (not only from Kosovo)	12
Ministry for Kosovo and Metohija	50
Local government subsidies	13
Foreign debt service	35
National investment plan	20
Total	130

There are no other direct costs, so the overall burden of Kosovo on the Serbian budget can be estimated at about EUR 100 million (perhaps as high as EUR 125 million if investments are included), which is not small, given that the whole foreign reconstruction assistance was roughly EUR 100 million in 2004 and has gone down since. However, it is slightly above 1% of Serbia's general budget and around 0.5% of its GDP.

The current indirect costs are hard to assess because those would have to rely on counterfactual reasoning in a manner that may not be easy to justify. In any case, those will be discussed in the context of the consequences of the possible solutions of the future status of Kosovo.

Perhaps a comment on the costs to security may be useful. The defence is budgeted with about EUR 800 million at the current exchange rate in 2007. That is about 10% of the central government budget and about 3% of GDP. In the 2008 budget proposal, defence should take up about 2.5% of GDP. Internal security, including the security services, has been budgeted with around EUR 600 million, which is slightly more than 2% of GDP. Altogether, security expenses are around 5% of GDP. Expenditures for defence are certainly too high and are scheduled to decline, as already mentioned. The expenses on internal security may be also somewhat high and the structure may be biased towards security services (the secret service spends slightly less than the Ministry for Kosovo and Metohija). Still, one should not jump to the conclusion that these expenditures reflect real security needs, e.g., that they are attributable to Kosovo or other genuine security concerns. These costs reflect the state of the process of democratization and of institutional transformation in Serbia rather than costs of threats emanating from Kosovo or from somewhere else in the region. They have more to do with internal political stability than with external security threats.

Costs and benefits of alternative solutions

More precise assessments of direct and indirect costs and benefits are difficult because of the lack of data and because of too many unknowns. The key uncertainty is the behaviour of the economy, e.g., in terms of growth, investments and trade, under alternative scenarios. That, to a very large extent, depends on the assessment of risks, especially to investment. Those could be influenced by the choice of the future status of Kosovo, though to an unknown extent. The risk will depend on the political reactions in Serbia and Kosovo and, perhaps to the extent those are connected, in the wider region too.

There are four scenarios to be considered:

(i) Full sovereignty of Serbia over Kosovo (the benchmark case).

(ii) Substantial autonomy for Kosovo, i.e., mainly symbolic sovereignty of Serbia over Kosovo (the Serbian proposal).

(iii) Supervised independence with or without a cooperation agreement (Ahtisaari's Plan plus Kosovo proposal).

(iv) Partnership, contractual and institutionalized, of some kind.

The costs and benefits of these alternative solutions depend on the direct fiscal obligations taken by the various budgets, so that macroeconomic stability is assured, and on indirect consequences for economic growth, for institutional development, and for security. Costs of increased political and social tensions will be looked into later.

The key qualitative assumptions are:

– The first two proposals (full Serbian sovereignty and substantial autonomy) are not acceptable to Kosovo.
– The third one (Ahtisaari's Plan with or without agreement with Kosovo) is not, as it stands, acceptable to Serbia.
– The fourth one (institutionalized partnership, for short) is currently not acceptable to both sides, but looks the most as a compromise that could be forged and could lead to either *de facto* or *de jure* acceptance by both sides or, in the minimum, could provide for a workable framework for the Kosovo status under international supervision (it would still subsume the details of the Ahtisaari Plan).

Table 3

Costs and benefits, qualitative, of alternative Kosovo status

	Direct fiscal costs	Security costs	GDP change	Trade with Kosovo	Investments
Full Serbian sovereignty	Significant to severe	High risks due to instability in Kosovo	Halved growth due to increased risks	Decline due to recession in Kosovo	Decline in both countries due to higher risks
Substantial autonomy	Debt service decline if taken over by Kosovo	Increased risks due to political instability in Kosovo	Some slowdown due to higher risks	Decline due to economic decline in Kosovo	More of a decline in Kosovo
Supervised independence	Some increase due to higher transfers to Serbs in Kosovo	Increased risks and higher costs for security	Some slowdown due to slowdown of reforms	Decline due to deteriorated relations	Decline in Serbia due to higher risks and uncertainly
Institutionalized partnership	Unchanged, except for lower debt service costs	Sharp decline in both countries and regionally	Speed-up of growth to convergence potential	Fast growth due to improved market access	Growth in both countries and especially from Serbia to Kosovo

Table 3 summarizes the proposals and the expected consequences of the qualitative assumptions. The latter two proposals are acceptable to the EU, which is to supply most of the support and assistance in the immediate future and in the long run too. However, rejection by one side and its non-cooperation could have significant consequences for the risks of doing business in both Serbia and Kosovo. The level of risk will depend on the actual political reaction by the side that will be dissatisfied and the instability that it could be a source of.

A more detailed quantification of the costs and benefits of the proposals are hard to do because of the wide margin of uncertainty about the possible reactions of the actors involved. Drawing on (i) comparative experience with the nonstandard political solutions in the Balkans, (ii) growth and investment experience of transition economies, and (iii) the behaviour of risks in post-socialist states and after political normalization in Europe and in the Balkans, it can be assumed that after normalization:

- Kosovo could quite realistically experience recovery growth rates of above 5% per year and most probably of 7% to 8% in the medium run.
- Kosovo's long-term convergence growth rates could realistically be between 4% and 5% per year as in practically all transition economies.
- Foreign investments tend to be large in transition, due to privatization, and as a consequence of falling risks, due to political normalization and economic transformation, e.g., as high as 10% of GDP in the medium run. Initially, they could be even much larger in Kosovo due to significant opportunities for investment in the mining and electricity generating sectors.
- Foreign trade grows faster than GDP in transition economies and central Europe but in the Balkans too even in the long run (e.g., ten years or more).

On the other hand, nonstandard political solutions in Europe and in most other parts of the world tend to be a significant drag on the economy, though often the costs and benefits are not distributed symmetrically. The bulk of the costs tend to fall on one of the parties in conflict with a significant share of it being taken over by the international community. This is the experience of a number of frozen conflicts in the Balkans and in Europe. Bosnia and Herzegovina, for instance, experienced a prolonged period of economic stagnation and its recovery continues to be at risk due to its non-standard constitutional set-up. Similarly, the state union of Serbia and Montenegro was not very good for Montenegro in particular.

Having these assumptions in mind and considering the current state of affairs in Serbia and Kosovo together with their respective fiscal obligations generated by the Kosovo conflict, the qualitative assessment of Table 2 can be given a more quantitative expression. Both direct fiscal costs and the indirect costs to growth, trade and investments will be investigated. Additional considerations connected with macroeconomic stability and the regional risks and their economic costs will be discussed thereafter.

The direct costs to be considered, apart from what Serbia and Kosovo spend already, could be taken to be fixed at the level that is currently being borne by the international community; the alternative solutions only determine their distribution. If current aid is estimated at around 20% of Kosovo's GDP (IMF, 2007a), that is roughly EUR 400 million (EUR 466 million in 2006 according to the IMF). The direct contribution to GNDI (GDP plus remittances plus wages of foreign residents) was around half that figure, EUR 203 million in 2006 according to the IMF. The breakdown of where and how it is being spent is given in Table 1. Since 2004, the assistance in most categories has declined further, but not significantly (UNMIK, 2006a). If figures in Table 1 cover assistance to the non-security areas, that means that the spending on security is still quite significant, effectively as high as all the rest. There is also a high level of inefficiency, as about half of the assistance is really the cost of assistance itself. It is argued in some studies that efficiency has increased in recent years, but a change in the delivery of assistance could in fact mean a new decline in efficiency.

Full integration

In the case of Kosovo integrating with Serbia, these costs would be shared by Serbia and by the international community. It can be assumed that the international community will want to diminish its contribution significantly, as it would have no sovereign responsibilities in Kosovo, so that the bulk of these costs would fall on Serbia's budget. Security costs are difficult to estimate, but they will certainly be significant. It will be assumed, unrealistically, that the level of resistance is similar to that in the 1990s, but prior to 1999. Similarly, investments in infrastructure would have to be significant (they have declined lately and that is detrimental to the development of Kosovo and thus for the sustainability of its economy under any arrangement). Additional consideration would have to be given to fiscal efficiency, in Kosovo, which may decline. For instance, current subsidies to the energy sector amount to about EUR 50 million per year (see Table 1) and those could in fact increase. This would approximate the situation that was characteristic of the fiscal costs of Kosovo during the socialist period, only it would now fall entirely on Serbia.

The other way to arrive at a figure that stands for the fiscal needs of Kosovo would be to start from the fact that about EUR 50 million is the Serbian budget for Kosovo and the beneficiaries are about 5% of Kosovo's population. Assuming no diminishing costs to scale, that implies a fiscal burden of EUR 1 billion for Kosovo as a whole. That is roughly equal to the sum of the Kosovo budget plus foreign assistance in the past couple of years.

Currently, revenues basically cover expenditures. Most of the revenues come from indirect taxes, which are predominantly levelled on imports. The huge trade deficit is covered by remittances and grants. If those are halved, tax revenues would go down too. That would increase the costs for the Serbian tax payer. Putting all these assumptions together, the overall fiscal costs of Kosovo under the assumption that it fully integrates with Serbia can be roughly calculated. Table 4 summarizes the base scenario.

Table 4

Kosovo fiscal balance, EUR million (approximate)

Public expenditures	700 (current)
Net assistance	200 (current)
Fiscal risks	150 (less revenues)
Security costs	100 (additional)
Public revenues	550 (future)
Net cost	450

If total public expenditures are put at around EUR 700 million (roughly the figure in 2006 and 2007) and if Serbia takes over the existing assistance and the fiscal risks bring the revenues down by about 20% and if there are additional security expenditures, that puts net fiscal costs at about EUR 450 million, or around 4% of the Serbian budget in 2007. Gross costs would be higher, due to inefficiencies. Unlike foreign assistance, these inefficiencies would be a burden to the economy of Serbia, but the money would be spent in Serbia and would thus contribute to the Serbian GDP. The cost of these inefficiencies would be expressed in a decline of growth in Serbia due to the higher fiscal burden.

Thus, over time, the increased fiscal burden would be a detectable drag on the Serbian economy.

The indirect costs would depend on the risks of implementation of that solution to the Kosovo status. If it is assumed that Kosovo representatives were not to acquiesce in this solution, risks to doing business in Kosovo would increase significantly as would the risks to investments in Serbia, especially in central and southern Serbia. That would push Kosovo's economy into recession, and Serbia's growth would also be at risk. These costs are difficult to estimate with any precision, but if the situation with the separation of Serbia and Montenegro is taken as a comparison, it is not unrealistic to assume that Serbia's growth could slow down to around 3% and Kosovo's economy would stagnate at best. The losses to Serbia's and Kosovo's GDP would be substantial. More importantly, most imbalances would become unsustainable. On the other hand, fiscal obligations may decline if the Kosovo public decided to develop parallel institutions similar to those existing in the 1990s. That would, however, increased the risks to Serbia's economic development due to a slowdown of integration, primarily with the EU.

Thus, the high direct and indirect costs of this solution are the reason why nobody is seriously proposing it. However, this solution is useful as a benchmark case as it puts the upper limits to the costs of the alternative solutions for the status of Kosovo.

Table 5

Indirect costs

	Serbia	Kosovo
Lost growth	2 percentage points	5 percentage points
Lost trade	EUR 200 million in exports	EUR 100 million in exports
Increased risk	5 percentage points	Too risky

Substantial autonomy

The symbolic sovereignty of Serbia, called substantial autonomy for Kosovo, which is basically the proposal of the Serbian representatives in the current negotiations, would imply no new fiscal obligations for the Serbian budget. It would also mean that the Serbian population in Kosovo would live a parallel life and would be part of Serbia's economic and political system. Except for the division of international sovereignty between Serbia and Kosovo, it would not be substantially different from the status quo.

Direct costs could increase if the absorption capacity of transfers from the Serbian budget were to improve, but these costs would still not be much higher than their current level, e.g., around EUR 50 million, plus investments in institutional and physical infrastructure. In addition, servicing of the Kosovo foreign debt would have to be considered, which amounts to another EUR 35 million; the proposal is that it should be transferred to Kosovo, but this can be assumed to be unacceptable to the Kosovo representatives. Thus, the overall direct costs would be as in Table 2. No economic boost to either Serbia or Kosovo can be expected from this solution, which cannot be expected to be accepted willingly by the representatives of Kosovo.

The bulk of the indirect costs would fall on Kosovo, however, as it cannot expect to become attractive to investors. The security costs of Serbia would also increase, but their actual level will depend on the amount of foreign assistance that the international community would be ready to extend to Kosovo. Already the amount of aid and assistance is declining and it is hard to see that it would increase significantly if this uneasy solution were to be implemented without Kosovo agreeing to it. The economic outcome should be in accordance with current projects for post-status Kosovo by the IMF and the World Bank, which are mediocre. The key consequence is a lower growth rate due to the decline of international assistance with no boost to foreign investments.

Thus, this solution pushes the costs on Kosovo and on the international community with few benefits to either Kosovo or Serbia.

Supervised independence

The solution of supervised independence is the most detailed proposal. It has been rejected by Serbia and its representatives show little inclination to changing their minds. Thus, its adoption and implementation has to count on Serbian obstruction. If that obstruction is passive, e.g., non-recognition, costs for Serbia should not be much higher than the current ones, as detailed in Table 2, except for the foreign debt service, which would be taken over by Kosovo (or more realistically mostly written off).

If the reaction is stronger, e.g., if diplomatic relations are scaled down, the costs for Serbia, due to decreased cooperation with the international community and especially with the EU, would increase, both in terms of expenditures for the Kosovo Serbs, in order for them not to leave Kosovo, and for security in order to shore up internal stability. Increased risks to doing business with Serbia would also lead to costs for trade and growth. More precise estimations of these indirect costs are hardly possible, but they could be substantial depending on the precise form of the Serbian political reaction.

If the political strategy is radically changed – and there are some non-negligible risks that this might happen – indirect costs for Serbia would be substantial (those will be discussed in the context of threats to macroeconomic stability). Kosovo's costs would be smaller if that solution were to come with international recognition and with increased EU presence.

Table 6

Costs of disagreement for Serbia

Substantial autonomy	Direct costs as in Table 2 plus no decline in expenses on defence and on internal security (i.e., both together about 5% of GDP)
Supervised independence	Direct costs as in Table 2, minus foreign debt service, and no decline in expenses for defence and internal security (i.e., around 5% of GDP)

Thus, contrary to increased direct and indirect costs for Serbia, a significant boost to economic activities could be expected in Kosovo. That would diminish the fiscal costs of the international presence.

In both these cases – substantial autonomy and supervised independence – the main costs would emanate from the lack of agreement from one of the sides. Assuming mild reactions by each of the unhappy sides, Serbian costs would essentially be as in Table 2 with two important differences as noted in Table 6.

Partnership

The fourth solution is that of institutionalized partnership of Kosovo and Serbia. That assumes that Kosovo becomes an independent state with a contract or contracts with

Serbia regulating the areas of common interests and concerns. That approach would maximize benefits rather than minimize costs. If the relationship between Serbia and Kosovo were to be normalized in that way, fiscal costs would increase for Kosovo, roughly along the lines estimated by the gradual decline of foreign assistance. On the other hand, Kosovo could experience a significant boost to growth and could recover at rates of 7% to 8% per year in the medium term and develop at rates of around 5% in the long run. Serbia could participate in this recovery with investments and trade and that could solidify its own recovery and development. In addition, security costs could go down as could the costs of refugees and resettled people. Kosovo's economy is too small to be crucially important for Serbia, but the decline of risk and the overall benefits of normalization together with the clear perspective of EU integration could boost Serbia's GDP growth by around 1 percentage point in the long run.

Thus, normalization with an institutionalized partnership between Serbia and Kosovo would provide for a significant decline of risks, for increased investment and trade, for improved prospects for EU integration for both, and for strong recovery in Kosovo and sustained growth in Serbia. The main boost to Serbia's growth would come from the sharp decrease of risks to doing business with Serbia and that would lead to increased investments. Also, speedier integration with the world economy and the EU would bring significant benefits and would shore up macroeconomic stability.

Second order costs: macroeconomic instability

The direct and indirect costs of the alternative solutions are small for Serbia, except in the case of an attempt at full integration, which is not a realistic proposal and cannot be counted on as a possible outcome. In all other cases, the costs are mostly at the same level as they are currently and the loss is essentially that of possible benefits. That is on the assumption that macroeconomic stability could be preserved even if a growth slowdown is experienced, due to increased tensions, and EU integration is delayed. Serbia, however, has a somewhat precarious macroeconomic balance and risks to instability should not be disregarded. Thus, second order costs should be considered that assume an increase in the risks to macroeconomic stability (Sorsa et al., 2007; IMF 2007b).

The assessment of risk is not an easy exercise. One way to get an idea is to look at the behaviour of the stock exchange and try to decipher the possible reaction of foreign and domestic investors to an unfavourable outcome to the Kosovo negotiations. The market seems to be factoring in three risks:

(i) Political instability risk, i.e., the probability of the governing political coalition collapsing and a right-wing coalition forming (here the May 2007 experience is crucial).
(ii) Sudden stop risks, i.e., the probability that foreign investment will decline or even reverse (Sorsa et al., 2007).
(iii) Inflationary risks due to balance of payments problems, e.g., exchange rate depreciation, decline of imports, and pressures on the domestic market.

The markets have been rather sensitive to these risks in the past. The decomposition of these risks is difficult. It does seem, however, that the key is the risk of political instability as it may lead to a worsening of Serbia's international position and thus to a decrease in foreign investments. Thus, the decline in the Belgrade stock exchange has been substantial whenever the politically sensitive risk has increased. Starting from May this year, due to primarily political instability risk, the decline was about 25% at the beginning of November 2007. In addition, the volume traded has declined significantly. This has had little effect on the rest of the economy so far, as market capitalization is quite low in Serbia. In addition, privatization sales have turned in relatively high prices for assets sold. However, there is no doubt that the underlying risks are significant. Assuming that those imply that Serbia's foreign obligations would have to be re-priced by at least 10%, that implies 10% higher refinancing needs. Given that Serbia's current account deficit will be around 15% of GDP, that implies a rise of costs of 1.5% of GDP. It is hard to calculate what would be the needed increase in the rate of interest to cover that cost, but it certainly cannot be negligible. It would probably have to be somewhat higher to compensate for the loss of confidence, which means it would probably have to go up to historically high levels, e.g., it would have to increase by about 5 percentage points. That would imply a significant drag on the economy: Serbia could very well have to count with low growth rates, perhaps as low as zero.

The consequences for employment would be quite significant as well. Currently, employment is declining and unemployment is rising even though GDP is growing by 5% or 6% per year. These growth rates are necessary if employment is to start to grow. Lower growth rates or a recession would have very significant consequences for the labour market. The consequences for social stability cannot be anticipated with any certainty as those would depend on the policies that would be adopted by the government in those circumstances.

The crucial fact is that the current macroeconomic developments are unsustainable anyway, as argued by the IMF recently (IMF, 2007b), so the Serbian economy is ill placed to risk macroeconomic instability as a consequence of political overreaction to an undesirable outcome of the Kosovo status negotiations. Therefore, a strong or extreme reaction is not to be expected, though the political economy of Serbia can often be quite complicated. Clearly, an economic crisis of one sort or another would be quite detrimental to Serbia's political development and the political leadership can be expected to try to avoid it. In the medium term, however, both the imbalances will have to be corrected for and further progress in democratization will be needed.

Other political and regional risks

The resolution of the Kosovo crisis brought recovery to the whole region after 1999. There were some setbacks in Macedonia in 2001 and in Montenegro prior to its independence. This time around, the risks are lower, but are also different. Three are more important than the others.

First, Serbia may reverse its transition and move towards a more closed and uncooperative political and economic system, and there are some risks of prolonged instability, though those are not high.

Second, Bosnia and Herzegovina may become even more difficult to govern. The reforms there have stalled as has the progress on EU integration. That may become all but impossible to unblock, if the Kosovo crisis continues in one form or another. Still, the risk of serious instability is not very high.

Third, investments may decline and more protectionist economic policies may be introduced in Serbia and the Serbian Republic in Bosnia and Herzegovina. That will create problems for regional economic cooperation and for the process of EU integration for other candidate and potential candidate countries in the Balkans. The risks of this development are moderate to significant.

It is hard to assess these risks with any precision. Taken together, they can constitute a serious drag on the economy of the region. The costs would be rather asymmetrically distributed, however, as the bulk of them would fall on Serbia itself and on Bosnia and Herzegovina. It is unlikely that the rest of the region would be seriously affected, with the possible exception of Macedonia. That suggests, on balance, that this political setback will not be supported by the political public in Serbia or, if it were to happen in one form or the other, it will be short lived.

Overall assessment

The costs of Kosovo's future status may prove to be high for Serbia if it does not take the opportunity to develop a political and economic partnership with Kosovo. These costs will be in the form of lost gain rather than outright fiscal burden, as the benefits of the normalization and EU integration would not be fully realized. In addition, a parallel Serbian community in Kosovo, particularly below the Ibar River, would lose ground and may face unsustainable economic and social conditions. Also, Serbian regions bordering on Kosovo may experience slower development due to persistent tensions and security problems. The most important costs are the increased risks of macroeconomic instability if the adverse political reaction to the solution of the future status of Kosovo is strongly resisted. Those can be substantial in the medium term.

Table 7

Serbia: selected economic indicators

	2002	2003	2004	2005	2006 1)	2006	2007	2007	2008
						January-June		forecast	
Population, th pers., mid-year 2)	7500	7481	7463	7450	7440	.	.	.	.
Gross domestic product, RSD mn, nom.	1020117	1171564	1431313	1750459	2125800	.	.	2434000	2709000
annual change in % (real)	4.2	2.5	8.4	6.2	5.7	6.6	8.1	6	5
GDP/capita (EUR at exchange rate)	2242	2408	2643	2833	3424	.	.	.	.
GDP/capita (EUR at PPP - wiiw)	5380	5530	6150	6670	7210	.	.	.	.
Gross industrial production 3)									
annual change in % (real)	1.8	-3.0	7.1	0.8	4.7	6.3	5.2	5	5
Gross agricultural production									
annual change in % (real)	-2.1	-11.4	26.0	-3.4	.	.	.	.	.
Construction output total									
annual change in % (real) 4)	-7.4	10.8	3.5	2.0	9.3	.	.	.	.
Consumption of households, RSD mn, nom.	819739	885658	998540	1221531	1475003	.	.	.	.
annual change in % (real)	.	.	.	.	.			.	.
Gross fixed capital form., RSD mn, nom.	120502	188875	253333	301962	383907	.	.	.	.
annual change in % (real)	.	.	.	.	.	.	.		
LFS - employed persons, th. Oct 5)	3000.2	2918.6	2930.8	2733.4	2630.7	.	.	.	.
annual change in %	-3.4	-2.7	0.4	-6.7	-3.8	.	.	.	.
Reg. employees in industry, th pers., avg.	648.1	605.3	562.2	536.1	493.3	503.0	463.2	.	.
annual change in %	-8.0	-6.6	-7.1	-4.7	-8.0	-6.3	-7.9	.	.
LFS - unemployed, th pers., Oct 5)	459.6	500.3	665.4	719.9	693.0	.	.	.	.
LFS - unemployment rate in %, Oct 5)	13.3	14.6	18.5	20.8	20.9	.	.	22	23
Reg. unemployment rate in %,end of period 6)	30.5	31.9	26.4	27.1	27.9	27.9	26.6	29	30
Average gross monthly wages, RSD	13260	16612	20555	25514	31745	29543	36463	.	.
annual change in % (real, net)	29.9	13.6	10.1	6.4	11.4	9.4	18.7	.	.
Consumer prices, % p.a.	16.6	9.9	11.4	16.2	11.6	14.5	4.0	8	6
Producer prices in industry, % p.a.	8.8	4.6	9.1	14.2	13.3	15.3	4.9	8	6
General governm. budget, nat.def., % GDP									
Revenues	39.9	40.3	41.2	.	.	.	.	.	.
Expenditures	43.2	44.2	42.6	.	.	.	.	.	.
Deficit (-) / surplus (+), % GDP	-3.3	-4.0	-1.4	1.4	-0.6	.	.	-2	-2
Public debt in % of GDP	.	.	.	.	.	.	.	.	.
Discount rate, % p.a., end of period	9.5	9.0	8.5	8.5	8.5	8.5	8.5	.	.
Current account, EUR mn 7)	-1323.4	-1256.9	-2308.0	-1790.2	-2906.1	-1140.0	-1954.4	-4000	-4000
Current account in % of GDP	-7.9	-7.0	-11.7	-8.5	-11.5	.	.	-13.1	-12.1
Gross reserves of NB, excl. gold, EUR mn	2076.8	2728.2	3008.0	4753.7	8841.3	6156.7	8990.8	.	.
Gross external debt, EUR mn	10768	10858	10355	13064	14885	13773	15689	.	.
Gross external debt in % of GDP	64.9	63.3	57.1	63.8	55.0	.	.	.	.
FDI inflow, EUR mn 7)8)	504.1	1208.3	777.1	1265.3	3504.3	752.3	1242.6	.	.
FDI outflow, EUR mn 7)	.	.	.	17.9	16.8	4.9	607.2	.	.
Exports of goods, BOP, EUR mn 7)9)	2347.6	2937.9	3283.8	3998.9	5155.7	2282.5	2966.8	6450	7750
annual growth rate in %	15.5	25.1	11.8	21.8	28.9	24.5	30.0	25	20
Imports of goods, BOP, EUR mn 7)9)	5773.5	6497.1	8487.9	8255.3	10107.8	4637.0	5895.4	12630	15790
annual growth rate in %	25.3	12.5	30.6	-2.7	22.4	28.5	27.1	25	25
Exports of services, BOP, EUR mn 7)9)	794.9	919.7	1188.2	1316.3	1674.8	697.0	986.4	2340	2930
annual growth rate in %	16.0	15.7	29.2	10.8	27.2	17.0	41.4	40	25
Imports of services, BOP, EUR mn 7)9)	657.0	740.9	1047.4	1321.2	1724.1	724.0	986.0	2240	2690
annual growth rate in %	59.1	12.8	41.4	26.1	30.5	24.6	36.2	30	20
Average exchange rate RSD/USD	64.40	57.58	58.38	66.71	66.82	70.56	60.16	.	.
Average exchange rate RSD/EUR (ECU)	60.68	65.05	72.57	82.91	84.06	86.92	80.25	80	82
Purchasing power parity RSD/USD, wiiw	21.80	24.00	26.30	29.50	32.90	.	.	.	.
Purchasing power parity RSD/EUR, wiiw	25.30	28.30	31.20	35.20	39.90	.	.	.	.

Note: The new ISO code for the Serbian dinar is RSD. From 2004 the term ‘industry’ refers to NACE classification C+D+E.

1) Preliminary. - 2) wiiw estimate in 2005 and 2006 . - 3) From 2004 according to NACE and new weighting system. - 4) Gross value added. - 5) From 2004 according to census 2002 and revisions based on ILO and Eurostat methodology. - 6) Until 2003 jobseekers, rate in per cent of labour force excluding farmers. - 7) Converted from USD with average exchange rate. - 8) Until 2004 FDI net. - 9) From 2006 including trade with Montenegro.

Source: wiiw Database incorporating national statistics; wiiw forecasts.

Table 8

Kosovo: selected economic indicators

	2004	2005	2006
Population th pers.	1965	1999	2033
Gross domestic product, EUR mn, nom.	2282	2238	2270
annual change in % (real)	2.1	0.6	3.8
GDP/capita (EUR at exchange rate)	1161	1120	1117
Consumption of households, EUR mn, nom.	1921	1998	2091
Investment, EUR mn, nom.	572	583	666
Consumer prices, % p.a.	-1.4	-1.4	0.7
General governm. budget, % GDP			
Revenues	26.8	28.1	31.4
Expenditures	32.8	31.2	27.7
Deficit (-) / surplus (+), % GDP	-6.0	-3.1	3.7
Current account, EUR mn	-257	-335	-433
Current account in % of GDP	-11	-15	-19
FDI net, EUR mn	20	59	222
Exports of goods, BOP, EUR mn	79	71	102
annual growth rate in %	.	-10.1	43.7
Imports of goods, BOP, EUR mn	1023	1093	1261
annual growth rate in %	.	6.8	15.4
Exports of services, BOP, EUR mn	134	133	148
annual growth rate in %	.	-0.7	11.3
Imports of services, BOP, EUR mn	-254	-247	-247
annual growth rate in %	.	-2.8	0.0

Source: IMF

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