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Prospects for Further (South) Eastern EU Enlargement:
From Divergence to Convergence?





The wiiw Balkan Observatory

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About

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



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Global Development Network Southeast Europe

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

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

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

The GDN–SEE programme is financed by the Global Development Network, the Austrian Ministry of Finance and the Jubiläumsfonds der Oesterreichischen Nationalbank.

For additional information see www.balkan-observatory.net, www.wiiw.ac.at and www.gdnet.org

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Abstract

This paper looks at the experience of South East Europe which – for the purposes of this paper – includes the former states of Yugoslavia except for Slovenia (i.e. Croatia, Serbia-Montenegro, Bosnia-Herzegovina, and Macedonia), Albania, and the two EU candidate countries, Bulgaria and Romania. For all these economies, accession to the EU will be the overriding driving force of the policy-making agenda for the foreseeable future, albeit with widely different time horizons in the individual economies. In *Part One* we describe the South East European (SEE) ‘region’ as one which has over the 1990s significantly ‘fallen behind’ in the process of economic development relative to the group of Central and Eastern European (CEE) economies which will join the EU in 2004. While developments are somewhat heterogeneous, there is, in particular, an abysmal employment record which has not even started to turn around, as well as an extremely bad productivity and export performance. In *Part Two*, we discuss in greater detail the conditions required to move towards a sustained growth and catching-up process. We analyse the problematic states of transition in some of the SEE economies as well as the basic disequilibria (fiscal, external, labour markets) which need to be resolved for sustained development to take place. The prospects of making up for the lost decade and dealing with the unresolved disequilibria will be a crucial issue in evaluating the prospects of EU accession some time in the future. We discuss the stumbling blocks both from the SEE side and the EU side in developing a clear perspective of integration with the EU.

Keywords: South East Europe, Balkan economies, convergence, EU enlargement

JEL classification: P51, P52, O11, O11, O57, O4

Executive summary

This paper looks at the experience of South East Europe which – for the purposes of this paper – includes the former states of Yugoslavia except for Slovenia (i.e. Croatia, Serbia-Montenegro, Bosnia-Herzegovina, and Macedonia), Albania, and the two EU candidate countries, Bulgaria and Romania. For all these economies, accession to the EU will be the overriding driving force of the policy-making agenda for the foreseeable future, albeit with widely different time horizons in the individual economies. The reason we treat this collection of countries as a ‘group’ is precisely the fact that for more than any other set of economies (with the possible exception of Turkey) the EU accession agenda will be dominant both in the countries themselves as well as in the way the outside world will view this ‘region’ over the coming years.

The paper discusses the prospects for further South East European EU enlargement in two parts: in *Part One* we describe the South East European (SEE) ‘region’ as one that has over the 1990s ‘fallen behind’ in the process of economic development relative to the group of Central and Eastern European (CEE) economies which have become (together with the Baltic states and Malta and Cyprus) the ‘first round’ transition economies, which will join the EU in 2004. This pattern of ‘falling behind’ was clearly visible as regards GDP growth, an abysmal employment record which has not even started to turn around, and an extremely bad productivity and export performance. External economic relations reveal behind a fragile current account situation very weak commodity trade balances and either a strong reliance on transfers from abroad or an excess reliance on sectors (tourism) which can have negative structural and exchange rate implications. We have shown that the export structure is clearly very different from the more successful transition economies, i.e. a strong dependence on export commodities that rely mostly on unskilled labour and low technology inputs. The CEE economies have, on the other hand, made strong inroads into medium-/high-skill and medium-/high-tech industries in their exports to the EU markets. The prospects of making up for this lost decade will be a crucial issue in evaluating the prospects of further EU accession.

In *Part Two*, we discuss in greater detail the conditions required to move towards a sustained growth and catching-up process. We analyse the problematic states of transition in some of the SEE economies as well as the basic disequilibria (fiscal, external, labour markets) which need to be resolved for sustained development to take place. We look at the development of foreign debt, which may prove to be an important constraint on growth, given the weak export performance. In most cases, foreign debt is growing faster than GDP and in some cases it is approaching the upper limit of sustainability. We analyse the fiscal sector and find that public expenditures, with some exceptions, tend to be high as is the case with the budget deficits too. Also, the state spends a lot on wages and salaries and on subsidies and transfers. That points to the conclusion that the public sector is still

quite unreformed, at least in most cases. Finally, we discuss the stumbling blocks both from the SEE side and the EU side in developing a clear perspective of integration with the EU. We discuss a number of ways in which the process of integration could be speeded up.

In conclusion, transition has meant divergence for the SEE countries. They have not succeeded in improving their competitiveness and have not moved on to a path of sustainable growth. The situation has been improving since 2000, but the return of growth has been accompanied by a persistence of macroeconomic disequilibria. Also, in most cases, growth has been driven by consumption rather than by investment and exports. Thus, there are still considerable problems on the way to convergence. These would be easier to address if the process of EU integration was speeded up. The SEE countries are quite dependent on the EU both economically and politically. Thus, unlike in other cases where convergence preceded integration, the opposite strategy may be the preferred one in South East Europe.

Prospects for further (South-) Eastern EU enlargement: from divergence to convergence?

Introduction

This paper looks at the experiences of South East Europe which – for the purposes of this paper – includes the former states of Yugoslavia except for Slovenia (i.e. Croatia, Serbia-Montenegro, Bosnia-Herzegovina, and Macedonia), Albania, and the two EU candidate countries, Bulgaria and Romania. For all these economies, accession to the EU will be the overriding driving force of the policy-making agenda for the foreseeable future, albeit with widely different time horizons in the different economies. The reason we treat this collection of countries as a ‘group’ is precisely the fact that for more than any other set of economies (with the possible exception of Turkey) the EU accession agenda will be dominant both in the countries themselves as well as in the way the outside world will view this ‘region’ over the coming years.

The paper discusses the prospects for further South-East European EU Enlargement in two parts: in *Part One* we describe the South East European (SEE) ‘region’ as one which has over the 1990s ‘fallen behind’ in the process of economic development relative to the group of Central and Eastern European (CEE) economies which have become (together with the Baltic states and Malta and Cyprus) the ‘first round’ transition economies which will join the EU in 2004. The prospects of making up for this lost decade will be a crucial issue in evaluating the prospects of further EU accession. In *Part Two*, we discuss in greater detail the conditions required to move towards a sustained growth and catching-up process. We analyse the problematic states of transition in some of the SEE economies as well as the basic disequilibria (fiscal, external, labour markets) which need to be resolved for sustained development to take place. We also discuss the stumbling blocs both from the SEE side and the EU side in developing a clear perspective of integration with the EU.

Part One

South-East Europe versus Central and Eastern Europe: the track record so far

As indicated in the introduction, in this part we shall contrast the economic development of the SEE region with that of the ‘first round’ transition economies of Central and Eastern Europe (the CEE economies). Table 1 presents some basic data regarding size of the different economies, their GDP per capita levels (both at current exchange rates and in purchasing power parity) and, finally, the level of the respective GDPs in relation to the 1990 levels. We can see that there is a lot of heterogeneity within both groups according to most of the indicators. Starting with the size variable, we can see that there are two

economies, one within each group, Romania in the SEE group and Poland in the CEE group which account for a very substantial share of the region (more in population than in GDP). In most of the following diagrams when we present some summary information about the two regions, we shall therefore exclude these two big entities from the two regions and present their developments separately, so that the respective regional developments will not be completely dominated by these two economies.

Table 1

Basic indicators 2002

| | Population persons mn | GDP EUR mn | GDP pc EUR | GDP pc USD at PPP | real GDP 1990=100 |
|------------------------------------|---------------------------------|----------------------|----------------------|-----------------------------|-----------------------------|
| Albania ¹⁾²⁾ | 3.1 | 4,908 | 1,590 | 4,000 | 123.3 |
| Bosnia-Herzegovina ³⁾⁴⁾ | 3.8 | 5,574 | 1,475 | 6,400 | . |
| Bulgaria ⁵⁾ | 7.8 | 16,668 | 2,125 | 8,250 | 87.9 |
| Croatia ¹⁾ | 4.4 | 23,820 | 5,368 | 10,030 | 92.9 |
| Macedonia ¹⁾⁵⁾ | 2.0 | 3,916 | 1,925 | 6,520 | 87.3 |
| Romania | 22.4 | 48,384 | 2,161 | 6,590 | 92.3 |
| Serbia-Montenegro ²⁾⁶⁾ | 8.3 | 14,000 | 1,679 | 4,500 | 52.8 |
| Czech Republic | 10.2 | 73,855 | 7,248 | 15,740 | 107.2 |
| Hungary ⁵⁾ | 10.2 | 65,852 | 6,487 | 13,550 | 115.6 |
| Poland | 38.6 | 199,549 | 5,168 | 10,510 | 146.5 |
| Slovakia | 5.4 | 25,144 | 4,675 | 12,820 | 111.6 |
| Slovenia ⁵⁾ | 2.0 | 22,367 | 11,208 | 18,530 | 127.4 |

Notes: 1) Population data 2001. - 2) Est. GDP p.c. USD PPP 2002. - 3) Population data 2000.- 4) Est. GDP p.c. USD PPP 2001. - 5) Projected GDP, EUR million 2002. - 6) Real GDP growth is based on Gross Material Product (GMP).

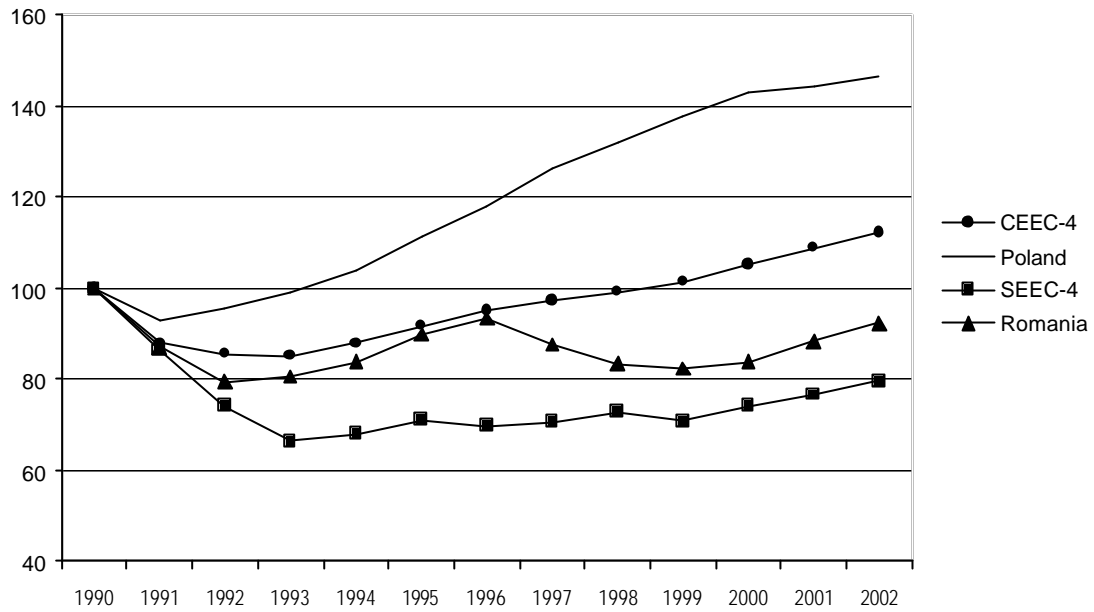
Source: wiiw Database.

Apart from size, we can see two well-known features characterizing South East Europe: firstly, the region – with the exception of Croatia – has a level of GDP per capita which is significantly below that of the CEE region; secondly, an important reason (in the case of some countries, the exclusive reason) for this developmental gap is the loss in output after 1990. It is clear that the 1990s – we shall see that over the past two to three years this tendency has stopped – was a decade in which the SEE region has significantly ‘fallen behind’ the CEE region, and even more so behind the EU.

Figs. 1 and 2 show the developments over the period 1990-2002: as mentioned above, in order not to swamp the regional figures by the two large economies, we present aggregates of CEE-4 (Czech and Slovak Republics, Hungary and Slovenia) and of SEE-4

Figure 1

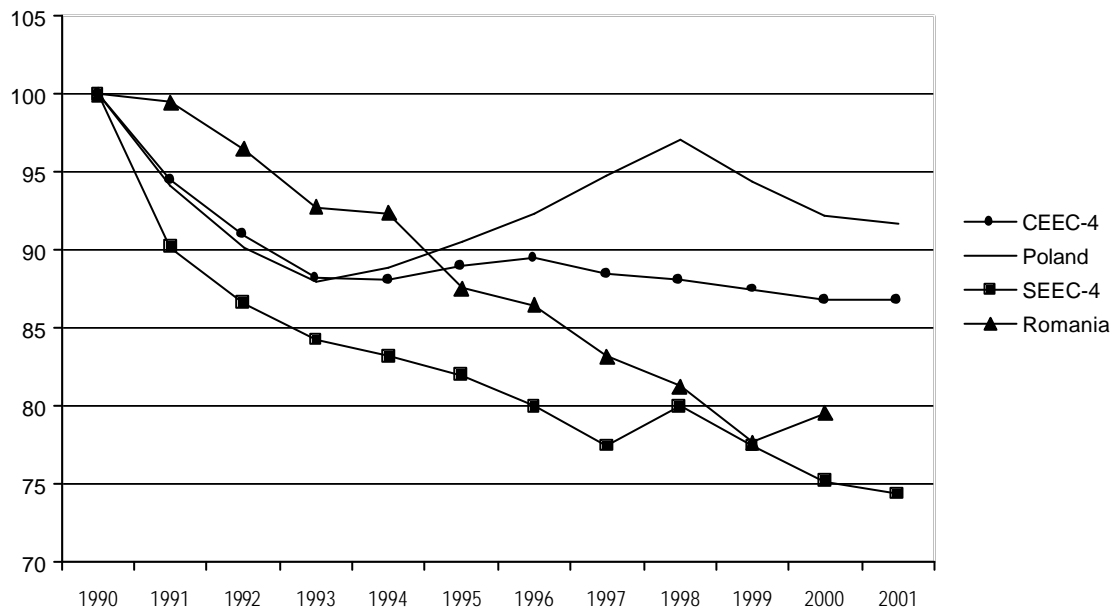
Real GDP growth in CEE and SEE 1990-2002, 1990 = 100



Source: wiiw Database.

Figure 2

Employment growth in CEE and SEE, 1990 = 100



Source: wiiw Database.

(Bulgaria, Croatia, Macedonia and Serbia-Montenegro¹), as well as information about Romania and Poland separately. What emerges clearly with regard to GDP and employment developments is a confirmation of the 'falling behind' picture between SEE and CEE. While the CEE economies started a recovery from the 'transformational recession' after 1992/93, the SEE economies experienced a significantly deeper fall over the period 1989-1993 and after that there was basically stagnation until about 1999. There were periods of weak recoveries always interrupted by political and economic ruptures: war between Serbia and Croatia in 1991/92 (and again in 1995), a major banking and exchange rate crisis in Bulgaria in 1996, a banking crisis in Croatia in 1997, the collapse of the Albanian pyramid schemes in 1997, wars in Bosnia-Herzegovina in 1992-95, in Kosovo in 1999, and a civil war in Macedonia in 2001. If one could speak of some sustained growth period, it would be limited to the most recent, period 2000-2002; however, even over this period one can hardly detect a difference in the trend growth rates between the two regions: The CEE-4 grew by 3.4%, while the SEE-4, as well as Romania, grew by 3.9% over that period. In this period, after a longer stretch with the highest growth rates, Poland grew only by a rate of 2.1%. Hence, while the 'falling behind' period seems to have come to an end, the 'catching-up' phase has barely begun.

As regards aggregate employment levels (Fig. 2), the CEE region experienced a period of dramatic labour shake-out until about 1994, after which there was a strong recovery in Poland and a mild recovery in the CEE-4, followed by further gradual declines in employment levels (a number of these economies experienced further macroeconomic recessions in the mid- or late 1990s). As compared to this picture, the SEE experienced deeper and sustained declines in employment levels throughout the period. In level terms, the CEE-4 were in 2001 at 87% the 1990 level, while the SEE-4 were below 75%. Following up on the aggregate labour market situation, Table 2 provides two estimates of unemployment rates (by registration and according to Labour Force Surveys, the latter regarded as more reliable and internationally more comparable), as well as of the economic activity rates (i.e. active labour force in total working age population): we can see that the SEE region includes countries with extremely low activity rates (Bulgaria, Croatia) as well as two countries with very high activity rates, Romania and Albania. Apart from Romania, the revealed unemployment rates in the SEE region are high and there is evidence that the figures hide substantial 'disguised unemployment'. The more recent unemployment figures for the CEE region are more reliable as they follow periods in which reforms of unemployment insurance schemes and employment exchanges, as well as improvements in unemployment and employment registers have already taken place; the two measures of unemployment are much closer for the CEE region which is in stark contrast to the strongly diverging numbers for the SEE region. An additional issue which characterizes the differences in the employment situation in the two regions are the much higher estimates for the SEE region of the 'black' or 'grey

¹ For Albania and Bosnia-Herzegovina the existing data are too patchy to allow comparisons.

economy'. The labour market situation and the role of the informal economy will be further discussed at greater length in Part Two of this paper.

Table 2

Labour market indicators, 2002

| | Unemployment rate | | Econ. activity rate ¹⁾ |
|----------------------|------------------------------|-----------------|-----------------------------------|
| | registered, end of period | LFS, average | |
| Albania | 14.5 ²⁾ | . | 66.1 ³⁾ |
| Bosnia - Herzegovina | 40.0 ²⁾ | . | . |
| Bulgaria | 16.3 | 17.8 | 49.4 |
| Croatia | 21.5 | 14.8 | 50.9 |
| Macedonia | . | 31.9 | 52.6 |
| Romania | 8.1 | 8.4 | 57.1 |
| Serbia & Montenegro | 31.2 | 13.8 | 56.3 |
| Czech Republic | 9.8 | 7.3 | 59.9 |
| Hungary | 8.0 | 5.8 | 52.9 |
| Poland | 18.1 | 19.9 | 55.4 |
| Slovakia | 17.5 | 18.5 | 60.2 |
| Slovenia | 11.3 | 6.4 | 57.5 |

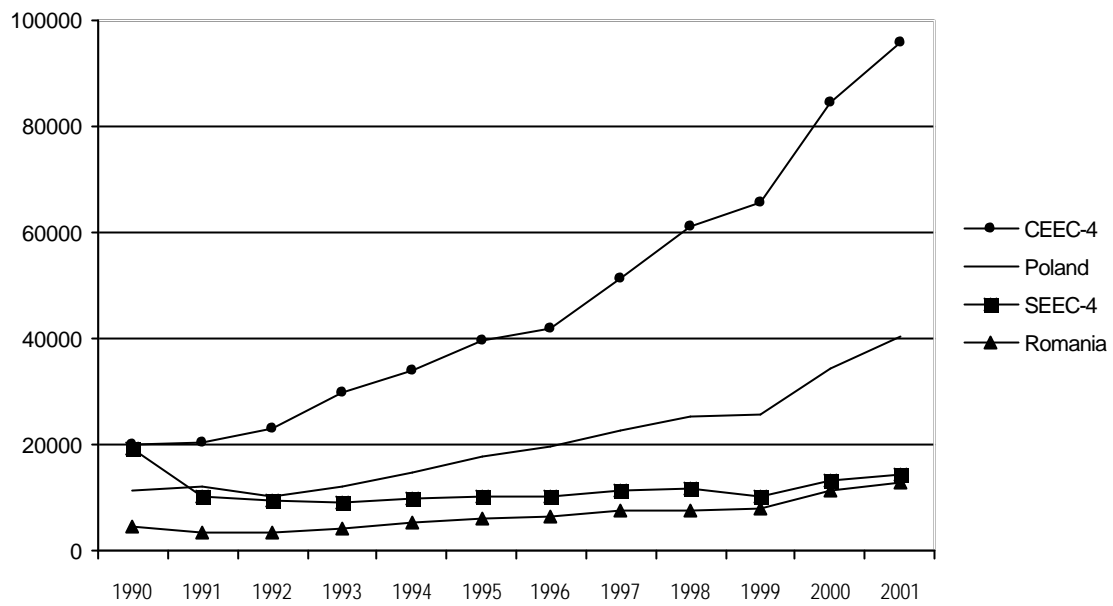
Notes: 1) Labour force in % of working age population 15+. - 2) 2001. - 3) 2000.

Source: wiiw Database, CANSTAT statistic bulletin 2002/4, IMF, national Labour Force Survey (LFS) statistics.

The next point is the abysmal performance of the SEE region in exports. Fig. 3 presents the developments in total exports for the two regions over the transition period and we can see that there was absolute stagnation in aggregate exporting activity in SEE throughout the period, while there was substantial growth in CEE. Over the most recent period there has been some modest growth in SEE, but growth in CEE exports remains much more impressive. The conspicuous weakness in exporting, as well as in export structure, will be further analysed below. As regards foreign direct investment (FDI), the political and economic risks in the SEE region clearly took a strong toll as regards attractiveness to international investors: there was no dynamic at all in this respect until 1997 after which the SEE-4 seem to follow with a considerable lag the pattern of the CEE-4 (see Fig. 4). As regards the structure of foreign investments (Table 3), we cannot detect at this level of sectoral disaggregation much difference between the CEE and the SEE: in both these two groups of economies the main attracting sectors are manufacturing, financial intermediation, the trading sector and – depending on the speed of privatization – telecommunications and transport.

Figure 3

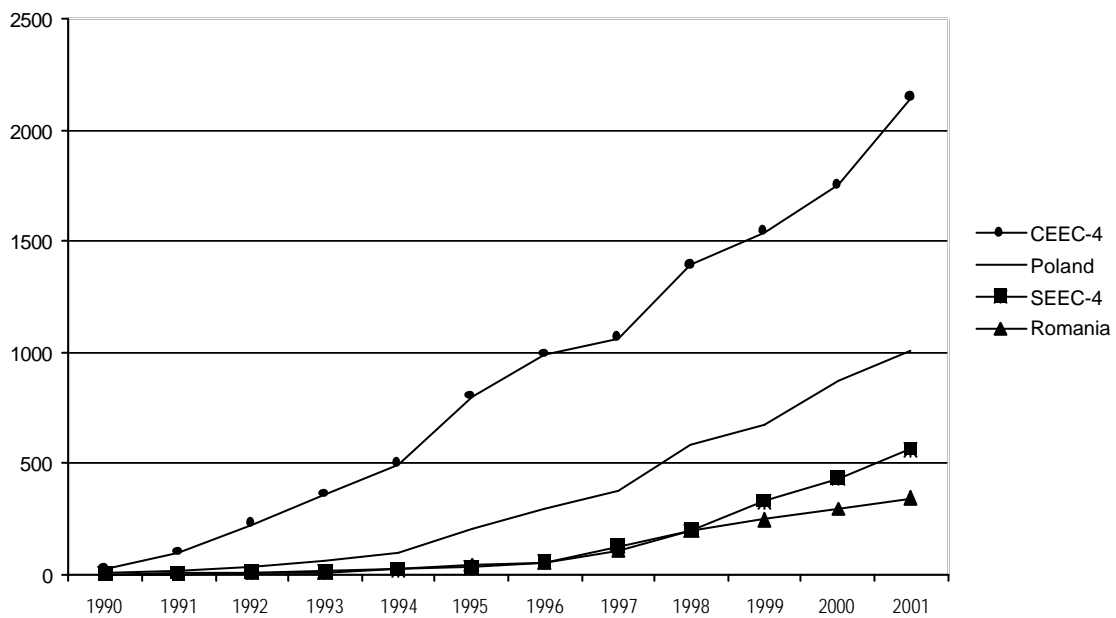
Exports in CEE and SEE, EUR million



Source: wiiw Database.

Figure 4

FDI stock, per capita, in CEE and SEE, 1990-2001, USD



Source: wiiw Database.

Table 3

Foreign direct investment by sectors, 2001

stock, shares in %, end of year

| Code NACE | Czech Republic | Hungary | Poland | Slovak Republic | Slovenia | Albania ¹⁾ | Bosnia ¹⁾²⁾ Sep 1999 | Bulgaria ³⁾ | Croatia | Macedonia ¹⁾⁴⁾ | Romania ¹⁾ |
|---|-------------------|---------------------|--------|--------------------|----------|-----------------------|------------------------------------|------------------------|---------|---------------------------|-----------------------|
| A,B Agriculture, forestry, fishing | 0.2 | 1.6 | 0.1 | 0.3 | 0.02 | . | 3 | 0.3 | 0.3 | 0.2 | 3.6 |
| C Mining and quarrying | 1.7 | 0.3 | 0.2 | 0.7 | . | . | . | 1.1 | 3.2 | . | . |
| D Manufacturing | 37.6 | 38.8 | 41.2 | 43.8 | 36.2 | 42.3 | 65 | 39.1 | 36.1 | 29.2 ⁵⁾ | 44.4 ⁵⁾ |
| E Electricity, gas, water supply | 6.1 | 8.9 | 2.8 | 0.2 | 0.8 | . | . | -0.4 | 1.0 | . | . |
| F Construction | 1.5 | 1.1 | 5.2 | 0.8 | -0.04 | 6.2 | 2 | 2.6 | 1.1 | 4.2 | 4.5 |
| G Trade, repair of motor vehicles, etc. | 15.1 | 13.4 | 11.4 | 10.5 | 13.9 | 27.2 | 1 | 16.3 | 5.2 | 2.6 | 20.1 |
| H Hotels and restaurants | 0.7 | 1.7 | 1.2 | 0.7 | 0.6 | . | . | 1.9 | 3.1 | 0.2 | 3.1 |
| I Transport, storage, communications | 10.4 | 6.8 | 10.7 | 13.9 | 4.8 | . | . | 14.1 | 29.5 | 46.0 | 7.3 |
| J Financial intermediation | 14.8 | 10.9 | 23.1 | 25.9 | 28.3 | . | 6 | 18.3 | 18.9 | 15.3 | . |
| K Real estate, renting & business act. | 11.4 | 15.3 | 1.2 | 3.0 | 12.6 | . | 19 | 3.4 | 1.3 | 1.4 | . |
| L Public administr., defence, social sec. | . | 0.0 | . | . | . | . | . | . | 0.1 | . | . |
| M Education | . | 0.03 | . | . | 0.01 | . | . | 0.3 | 0.04 | . | . |
| N Health and social work | . | 0.1 | . | 0.03 | 0.03 | . | . | 0.0 | . | . | . |
| O Other community, social & pers. activ. | 0.6 | 1.1 | 3.1 | 0.3 | 0.4 | . | . | 0.3 | 0.2 | . | . |
| Other not classified activities | . | . | . | 0.004 | 2.3 | 24.3 | 4 | 2.7 | . | 1.1 | 17.0 |
| Total | 100 | 100 | 100 | 100 | 100 | 100 | 100 | 100 | 100 | 100 | 100 |
| Total, USD million | 27092 | 11186 ⁶⁾ | 53152 | 4687 | 3209 | . | . | 3974.8 | 4656.7 | 802.5 | 4881.6 |
| | | 23562 ⁶⁾ | | | | | | | | | |

Notes: 1) Adjusted to NACE. - 2) Investments with more than KM 1 million capital. - 3) Cumulated inflow from 1998 only. - 4) Cumulated inflows 1997-2001. - 5) Industry total (C+D+E). - 6) Hungarian FDI by activities is based on a survey done among the largest FDI enterprises, according to which total FDI stock in 2001 is USD 11186 million, while the BOP arrives at USD 23562 million.

Source: National statistics.

Further to the weaknesses in external economic relations, we show in Figs. 5 and 6 the state of the current accounts and the trade balance in % of GDP. In the year 2002 the current accounts deficit reaches more than 6% of GDP in 5 of the 7 SEE economies, while this is true only for Slovakia amongst the CEE economies (in that year, the average current account deficit in GDP amounted to -7.7% in the SEE-4 and -4.8% in the CEE-4; the values for Romania and Poland were -3.4% and -3.6% respectively). With the exception of the Polish slow-down this difference cannot be attributed to higher GDP growth in the SEE region and hence reflects structural weaknesses of the SEE economies. This point gets substantiated if we look at the big difference between current accounts and the trade

Table 4a

Balance of payments structure in SEE, 2001

in % GDP

| | Albania | Bosnia & Herzegovina | Bulgaria | Croatia | Macedonia | Romania | Serbia & Montenegro |
|-----------------------------------|--------------|----------------------|--------------|--------------|--------------|-------------|---------------------|
| I. Current account | -6.3 | -23.1 | -6.2 | -3.2 | -6.9 | -5.8 | -5.9 |
| A. Goods and services, net | -19.5 | -32.0 | -7.6 | -5.4 | -15.7 | -8.0 | -22.8 |
| a. Trade balance, net | -25.0 | -36.8 | -11.7 | -20.4 | -15.2 | -7.5 | -27.0 |
| Commodity exports, fob | 7.4 | 19.6 | 37.7 | 24.4 | 33.6 | 28.7 | 19.1 |
| Commodity imports, fob | -32.4 | -56.4 | -49.4 | -44.7 | -48.8 | -36.1 | -46.1 |
| b. Services, net | 5.5 | 4.7 | 4.0 | 15.0 | -0.5 | -0.5 | 4.2 |
| 1. Transport, net | . | . | -0.8 | 0.9 | -0.5 | 0.0 | 1.7 |
| 2. Travel, net | . | . | 4.7 | 14.0 | -0.4 | -0.2 | -0.2 |
| 3. Other, net | . | . | 0.1 | 0.2 | 0.4 | -0.3 | 2.7 |
| B. Income, net | . | 5.1 | -2.2 | -2.7 | -1.1 | -0.7 | -0.2 |
| 1. Compensation of employees, net | . | . | 0.3 | 0.6 | . | 0.3 | . |
| 2. Investment income, net | . | . | -2.6 | -3.4 | . | -1.0 | -0.2 |
| C. Current transfers, net | 13.2 | 3.8 | 3.7 | 4.9 | 10.0 | 2.9 | 11.8 |
| 1. General government, net | . | . | 1.0 | 0.3 | 1.4 | 0.6 | . |
| 2. Other sectors, net | 13.2 | . | 2.7 | 4.7 | . | 2.3 | . |

Source: wiiw Database.

Table 4b

Private transfers in SEE

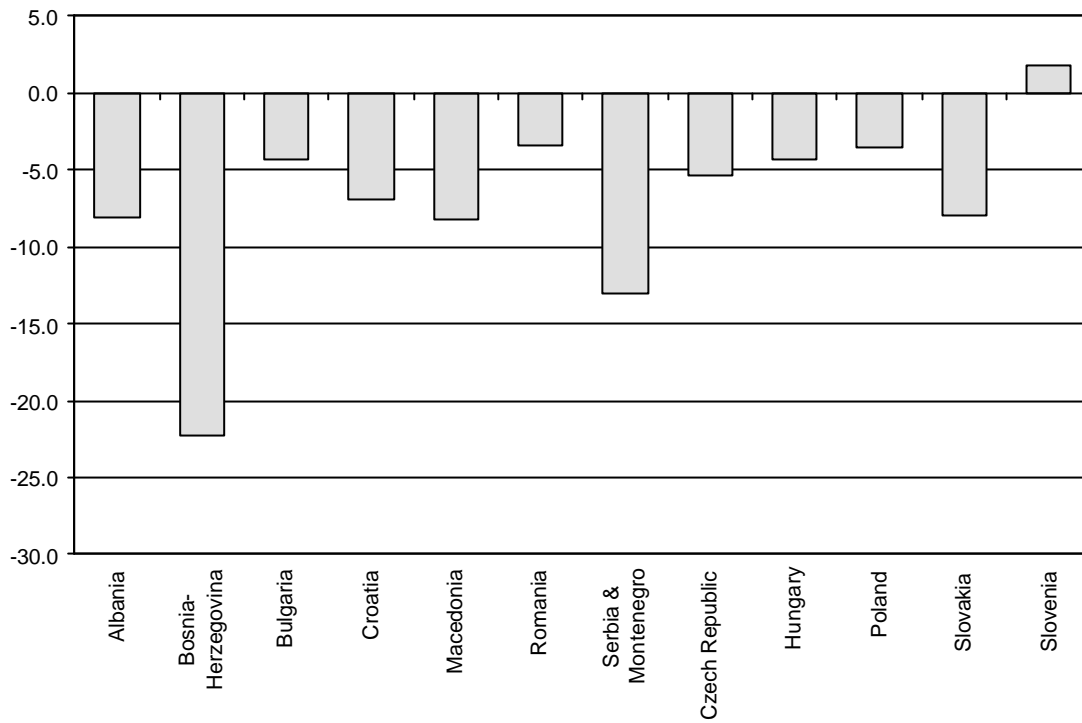
| | Albania | | Croatia | | Macedonia | | Serbia & Montenegro | | Bosnia & Herzegovina | |
|-------------------------------|---------|------|---------|------|-----------|------|---------------------|------|----------------------|------|
| | 2000 | 2001 | 2000 | 2001 | 2000 | 2001 | 2000 | 2001 | 2000 | 2001 |
| Private transfers, mn USD | 543 | 510 | 983 | 1049 | 454 | 192 | 1132 | 1698 | 172 | 165 |
| Private transfers, % GDP | 14.5 | 12.4 | 5.3 | 5.4 | 12.7 | 5.5 | 14 | 13.2 | 3.7 | 3.4 |
| Private transfers, per capita | 173 | 162 | 224 | 225 | 224 | 94 | 136 | 205 | 45 | 43 |

Note: Not completely comparable to balance of payments statistics in Table 4a.

Source: IMF.

Figure 5

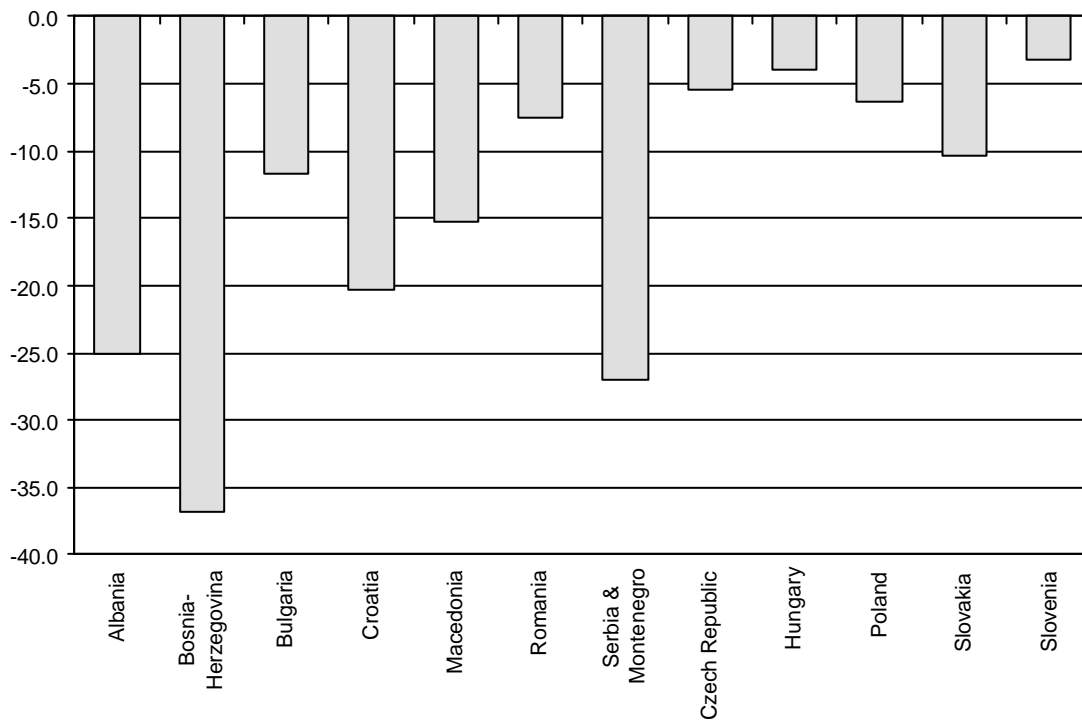
Current account in % of GDP in SEE and CEE, 2002



Source: wiiw Database.

Figure 6

Trade balance in % of GDP in SEE and CEE, 2001



Source: wiiw Database.

balance (in Fig. 6): the picture is here dramatically different between the SEE and the CEE economies as is apparent from a look at the detailed structure of the balance of payments for the SEE economies in Table 4a. We can see here that the very bad performance by SEE economies in commodities trade is partly compensated by substantial flows from tourism income in two of the SEE economies (Bulgaria and Croatia) and substantial transfers mostly from ex-patriate communities working abroad (see Table 4b). Relying on substantial transfers from abroad indicates that an economy is not able to produce by itself what it is consuming. Reliance on a substantial tourism sector for foreign exchange earnings is in itself not detrimental for an economy, but it adds the danger of, firstly, relying on a fluctuating source of income (tourism is highly sensitive to business cycle developments in the source countries) and, secondly, there is the possibility of the equivalent of a 'Dutch disease' phenomenon with high-income tourists contributing to a high domestic price level leading to an over-appreciated currency which in turn detrimentally affects the rest of the tradable sector; this phenomenon is clearly visible in Croatia.

Let us next come to some structural comparisons between the CEE and the SEE economies. Figs. 7 and 8 show the shares of the three broad sectors, the primary, secondary and tertiary sectors in GDP and in (recorded) employment respectively. It is clear that in terms of GDP, the SEE economies have a higher share of agriculture in total economic activity, and interestingly, with the exception of Serbia-Montenegro and Romania, not much of a deficit with regard to the share of tertiary activity. While, traditionally, a large share of services in an economy is taken as a sign of having reached a higher stage of economic development, we would argue that this would not be the right interpretation in this context. Rather, in line with a number of indicators already discussed and further indicators to be discussed below, we interpret this relatively large share of services in SEE economies as reflecting a weakness of industry. In fact, together with the general 'falling behind' pattern of the SEE economies over the 1990s relative to the more advanced transition economies, we observed a particularly sharp process in SEE of 'de-industrialization' which has weakened industry to a much greater extent than was the case in the CEE economies. From a sectoral perspective, we view a significant recovery of industry in SEE as an indispensable, vital component in the path towards catching-up with the more successful CEE economies².

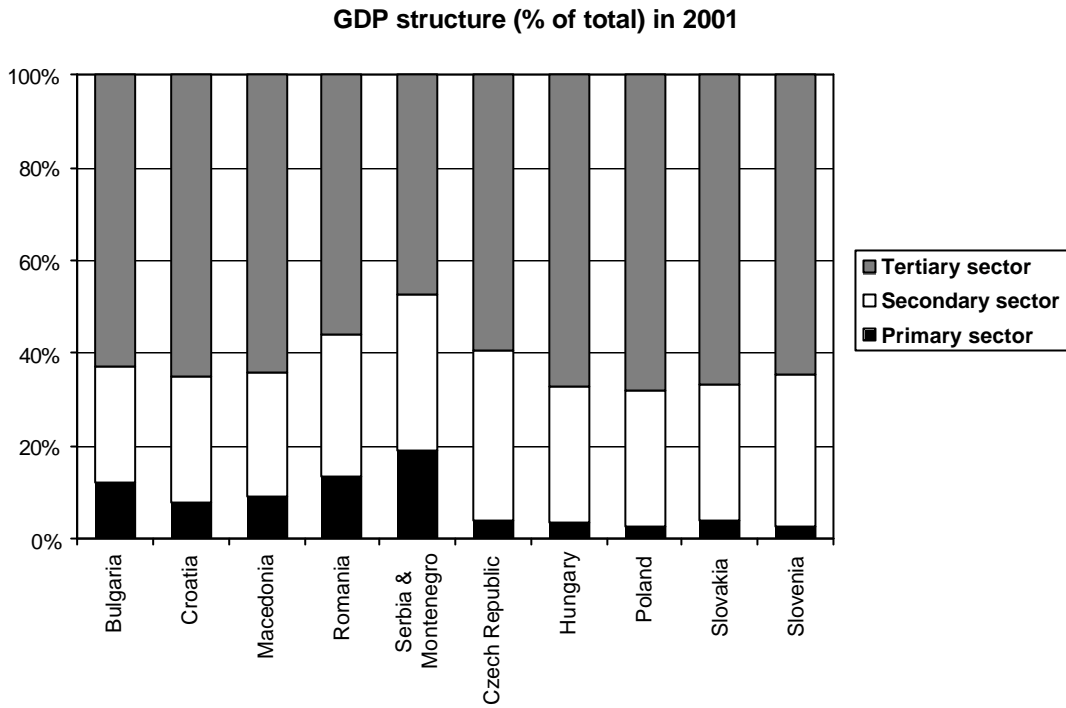
The very weak performance of industry in SEE is further evident from a comparison of productivity (Fig. 9): there was a much inferior performance relative to the CEE economies throughout the period, with the exception of the most recent period in Romania in which

² In fact, developments in CEE were also characterized by a sharp process of de-industrialization in the early phases of the transition process, but this was followed – in the case of quite a few of the CEE economies – by some degree of recovery of industry, very often induced by or accompanied by the effects of substantial FDI inflows, strong productivity growth and up-grading in product quality (for more detail on this, see Landesmann, 2000).

substantial productivity growth took place. Interesting are also the graphs on wage rates and unit labour costs (ULC) in Figs. 10 and 11, where we observe substantial wage growth in CEE economies which outpaces productivity growth and hence leads to rising unit labour costs. Wage growth is much flatter in SEE economies and so are ULC. A traditional interpretation of such a development would be to indicate that CEE have experienced a deterioration in their competitiveness compared to the SEE economies. We would counter such an interpretation, firstly, because it does not concur with what we have seen in terms of relative export developments and trade balance situations of the two 'regions' and, secondly, because the simple measurement of (labour) productivity with output at constant prices, neglects the substantial up-grading process which has taken place in CEE export industries of product quality (for more on this see wiiw, 2003, and Landesmann and Stehrer, 2002). The productivity, export and trade balance indicators for the SEE region simply indicate that the up-grading process has barely begun (with the possible exceptions of Romania and Bulgaria) and hence the economies remain uncompetitive in spite of moderate wage growth and flat unit labour costs. Fig. 12 summarizes a number of income or (alternatively interpreted) competitiveness indicators: it shows clearly the income and wage gaps between the two sets of economies. The gaps exist both at current and PPP exchange rates. What also emerges, is the rather special position of two economies: Croatia, which in terms of income indicators (but not in terms of export performance or commodity trade balance) clearly belongs more to the group of transition economies with high levels of income and wages and Slovenia, which sticks out as a high (real) income and wage economy amongst the CEE economies (and without problems in the trade balance).

We now continue with a structural examination of SEE economies in terms of patterns of trade specialization. In the following we use two taxonomic classifications of industry clusters which have recently been used in the EU-wide assessment of competitiveness (more recently, this classification has also been used to analyse competitiveness of CEE economies; for this see Havlik et al., 2003). The first taxonomy clusters industries – at the 3-digit NACE level – in terms of factor intensity and a number of industrial organization criteria (for details on this classification, see Peneder, 2001), while the second taxonomy groups industries by the relative demands for low, medium and high skilled labour. Figs. 13a-e and 14a-d examine the SEE and the CEE economies (in these figures CEE-8 refers to the CEE-4 + Poland + 3 Baltic states) export structures to the European Union markets (the EU-15 market) in terms of these two taxonomies: the analysis shows in which industry clusters a country shows relatively high or low shares in its exports to the EU-15 markets. The comparison is quite revealing:

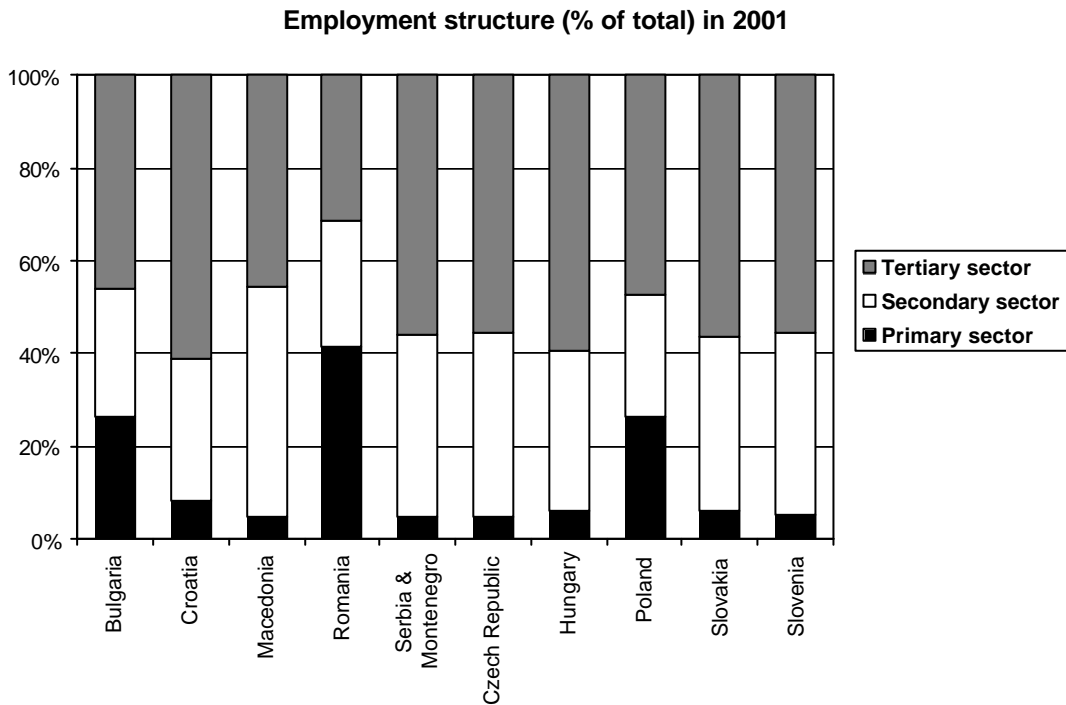
Figure 7



Note: Serbia and Montenegro year 1999.

Source: wiiw Database.

Figure 8

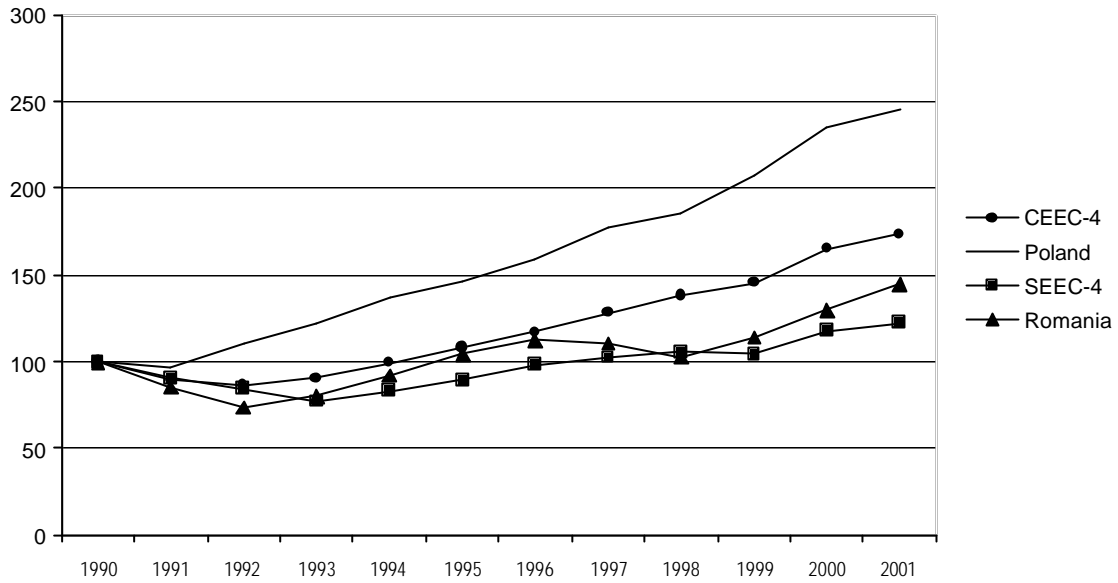


Note: For Macedonia and Serbia & Montenegro employee data.

Source: wiiw Database.

Figure 9

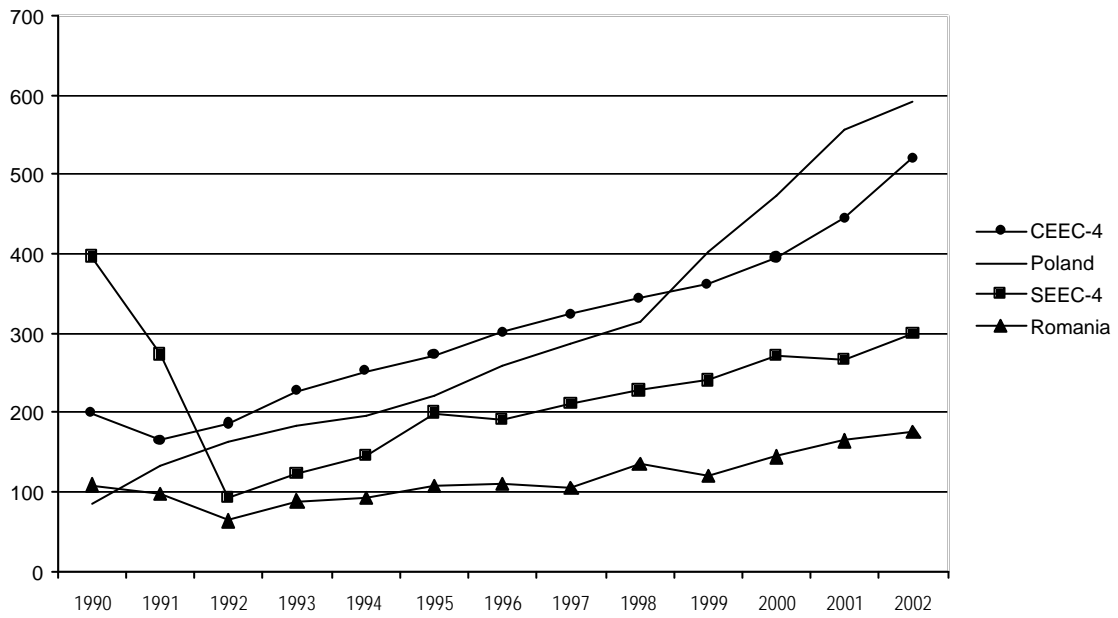
Labour productivity in industry in CEE and SEE, 1990 = 100



Source: wiiw Database.

Figure 10

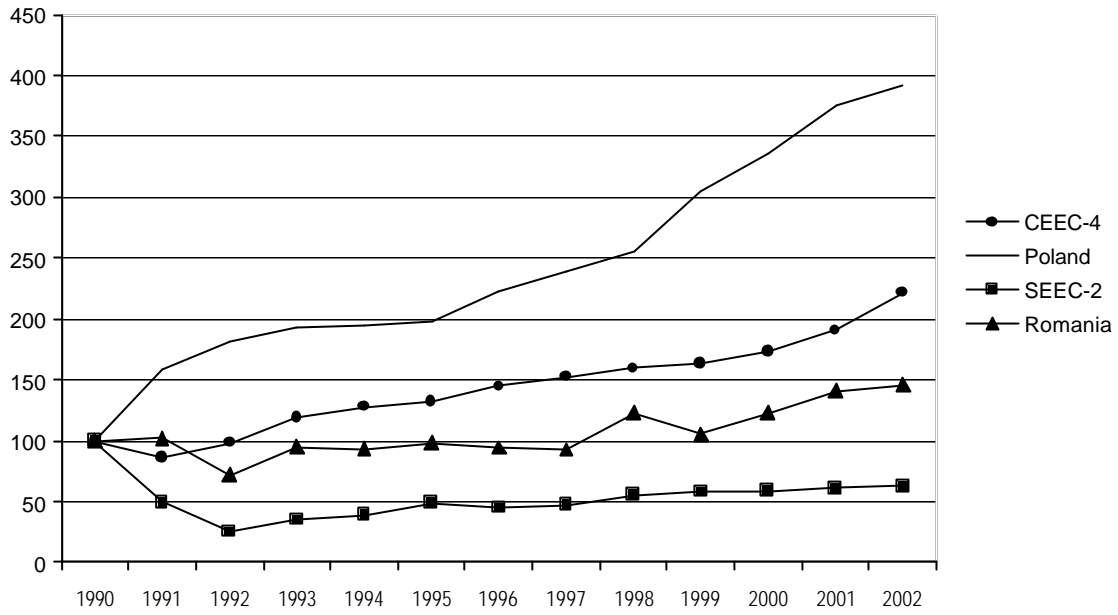
Average monthly gross wages, EUR (ER), in CEE and SEE



Source: wiiw Database.

Figure 11

ULCs, in CEE and SEE, 1990 = 100

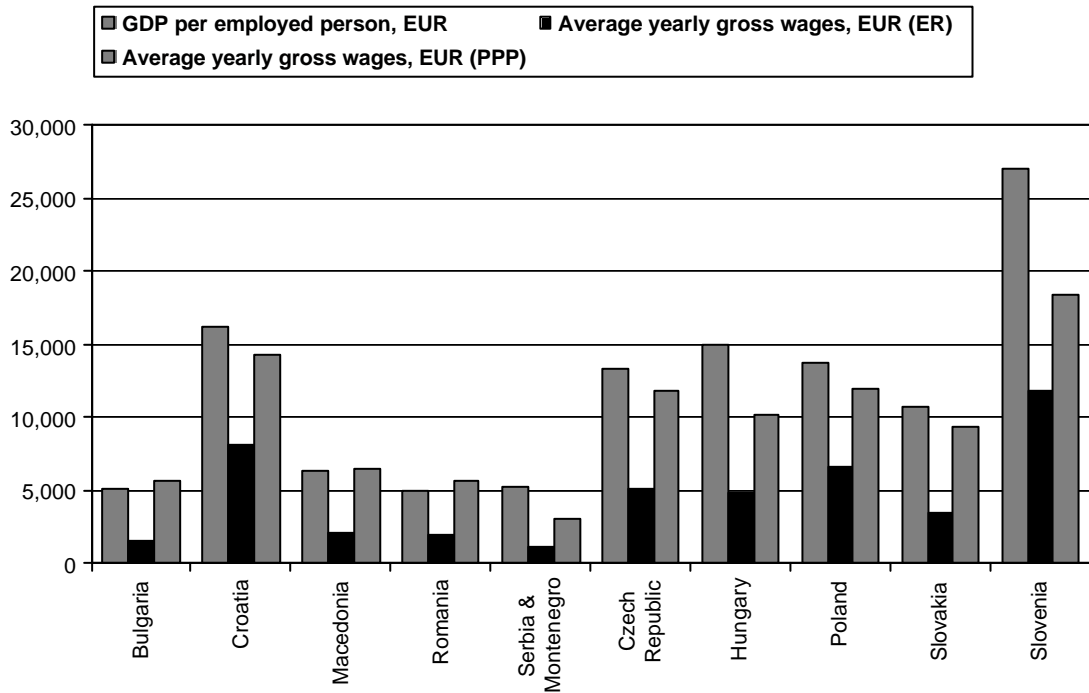


Note: SEEC-2 denotes Bulgaria and Croatia.

Source: wiiw Database.

Figure 12

Indicators of competitiveness, 2001



Source: wiiw Database.

Figs. 13a-e show the export structures with respect to the first taxonomy. In the CEE countries, a trend of increasing shares of technology-driven exports, close to 30% of total manufacturing exports, to the EU can be observed. For most SEE countries, this figure is much lower at around 5% and without an observable clear trend (note that sporadic high technology-driven exports in Macedonia are assumed to stem from repair of aircraft). An opposite picture is given with exports of marketing driven industries (including food processing industries). Here, the CEE countries are well below 10%, while most SEE countries are well above 10%, with Albania even exporting around 40% in this category. The picture of exports of capital-intensive industries is mixed. Shares of exports in labour-intensive industries (including textile industry) show the relatively great importance of these products in SEE exports. Most SEE countries export around 40% of total manufacturing exports to the EU in this group of products. Mainstream industries (including various types of machinery products) provide for about 20% of CEE exports, a value that was also reached by Croatia in the last years. Here, the values for the other SEE countries range approximately between 5% and 15%.

Figs. 14a-d show the export structures with respect to the second taxonomy. In general, compared to the CEE countries, SEE countries tend to have lower shares of high skill industries in total manufacturing exports to the EU, but significantly higher shares of low-skill industries exports. For all the SEE countries, with the exception of Croatia, low-skill industry exports make up well above 60% of their total manufacturing exports to the EU.

As regards the competitiveness of the SEE economies relative to the CEE economies, there exist a host of other important dimensions in studying this issue: issues of macroeconomic balances (internal as well as external), institutional developments and progress in the transition (reform) process, deficiencies in the workings of product, labour and capital markets, etc. A number of these issues will be discussed in Part Two of this paper. However, one should not leave the analysis of the structural characteristics of the SEE economies relative to the CEE economies without referring to an important distinguishing characteristic between these two sets of economies: the size and potential impact of the 'informal sector' in the economy.

Following the terminology of Schneider and Enste (2000) one can distinguish three types of methods to measure the size and development of the shadow economy: the direct approaches (e.g. sample surveys, tax auditing), the indirect approaches (e.g. national accounts discrepancy, official and actual labour force discrepancy, transactions approach, currency demand approach, physical input method) and the model approach (e.g. DYMIMIC). Schneider (2002) used the currency demand, the physical input and the DYMIMIC approach to estimate the size of the shadow economies of 110 countries. Table 5 shows the results for SEE and CEE countries. In most cases, SEE countries tend to have an unofficial sector well above 30% of GNP, while CEE countries range well below

Figure 13a

Technology-driven industries, as % of total manufacturing exports to the EU

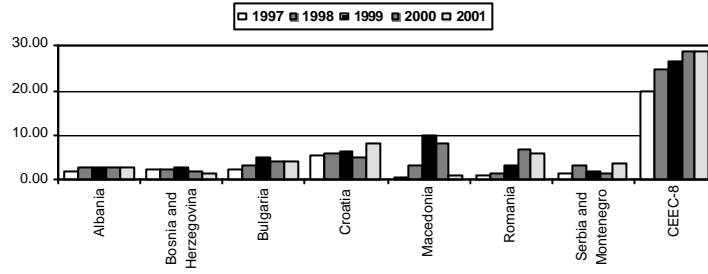


Figure 13b

Marketing-driven industries, as % of total manufacturing exports to the EU

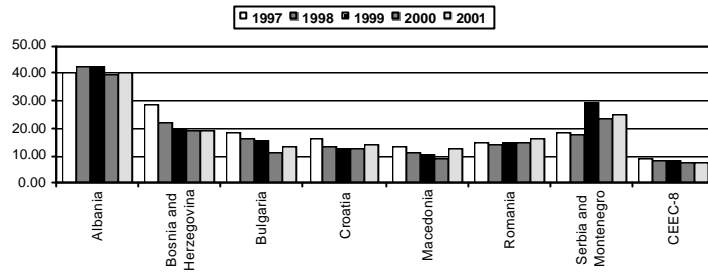


Figure 13c

Capital-intensive industries, as % of total manufacturing exports to the EU

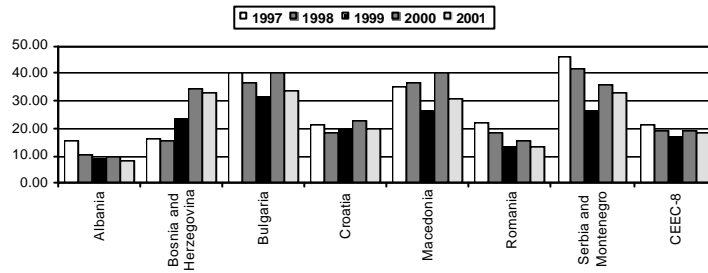


Figure 13d:

Labour-intensive industries, as % of total manufacturing exports to the EU

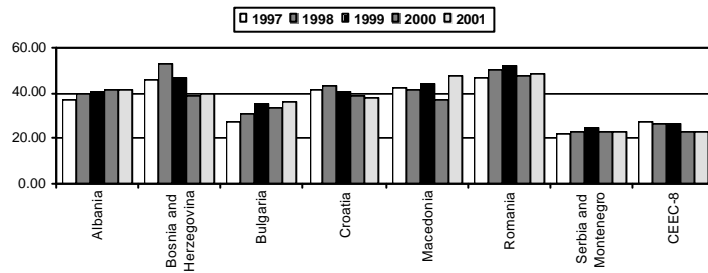
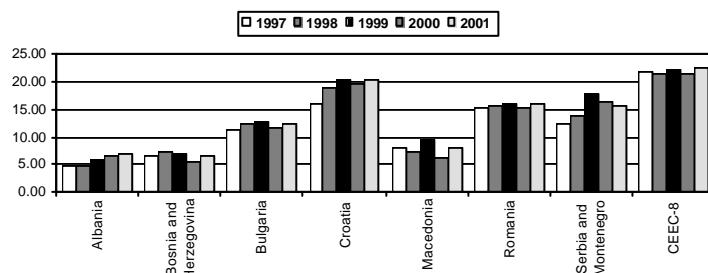


Figure 13e

Mainstream industries, as % of total manufacturing exports to the EU



Source: wiiw Database.

Figure 14a

High-skill industries, as % of total manufacturing exports to the EU

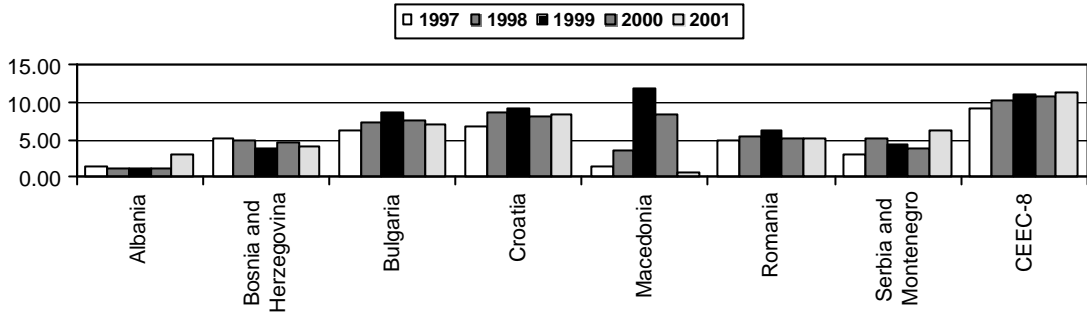


Figure 14b

Medium-skill/white-collar workers industries, as % of total manufacturing exports to the EU

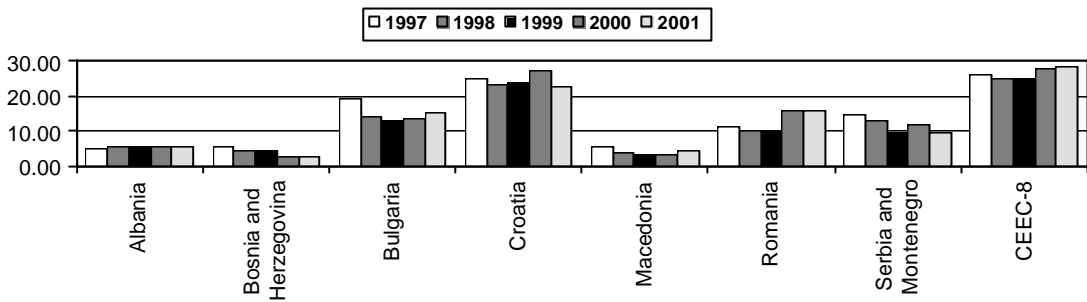


Figure 14c

Medium-skill/blue-collar workers industries, as % of total manufacturing exports to the EU

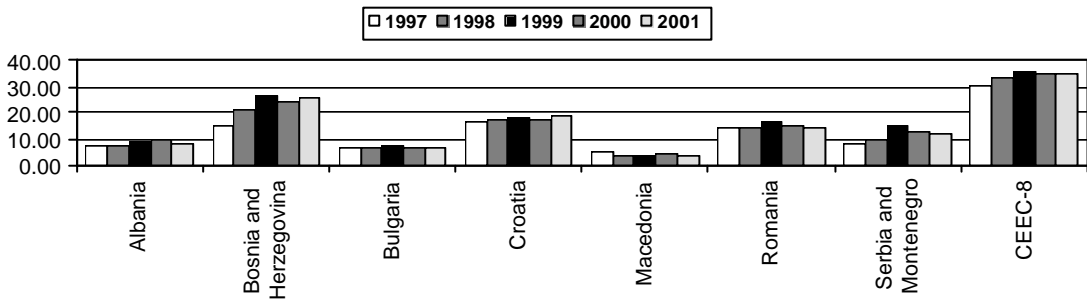
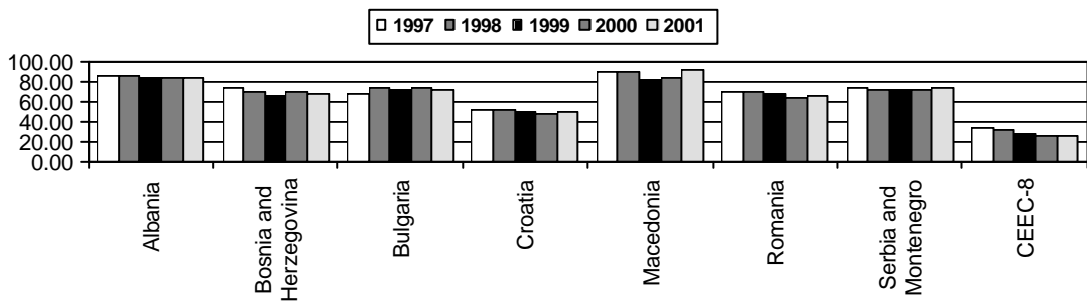


Figure 14d

Low-skill industries, as % of total manufacturing exports to the EU



Source: wiiw Database.

30% or 20% of GNP. However, Schneider admits that the figures for Albania, Bosnia-Herzegovina and Serbia-Montenegro are unreliable due to distortions stemming from war and political unrest. More reliable figures for these countries would be much higher. Recent IMF (2003) estimates for Albania indicate that in fact the majority of economic activities is informal. Bajec (2001) estimates the share of the Serbian grey economy in GDP to be above 40%. A similar estimate for Bosnia-Herzegovina is provided by Efendic (2002). Eliat and Zinnes (2000) even estimated a share of the shadow economy of more than 130% of GDP for Macedonia in 1997. Thus, the estimated size of the informal economy can vary strongly depending on the method used. Nevertheless, all studies indicate that the share of the unofficial economy in the SEE countries is considerably higher than in CEE. We shall return to the role and impact of a large informal sector in SEE in Part Two of this paper.

Table 5

Shadow economy in % of GNP, 1999/2000

Schneider (2002) using currency demand, physical input and DYMIMIC approach

| SEE | |
|----------------------------------|------|
| Albania ¹⁾ | 33.4 |
| Bosnia-Herzegovina ¹⁾ | 34.1 |
| Bulgaria | 36.9 |
| Croatia | 33.4 |
| Romania | 34.4 |
| Serbia-Montenegro ¹⁾ | 29.1 |
| CEE | |
| Czech Republic | 19.1 |
| Hungary | 25.1 |
| Poland | 27.6 |
| Slovakia | 18.9 |
| Slovenia | 27.1 |

Note: 1) Due to war and political unrest unreliable figures.

Source: Schneider (2002), p.14.

Conclusion to Part One

We have tried in Part One of this paper to compare the track records of the SEE and CEE economies since the beginning of the transition. The picture which emerged is one of a clear 'falling behind' of the SEE region vis-à-vis the CEE region. This was clearly visible in aggregate developments as regards GDP growth, an abysmal employment record which has not even started to turn around, and extremely bad productivity and export performance. External economic relations reveal a fragile current account situation behind which are very weak commodity trade balances and a strong reliance either on transfers from abroad or an excess reliance on sectors (tourism) which can have negative structural

and exchange rate implications. We have shown that the export structure shows a picture which is clearly very different from the more successful transition economies, i.e. a strong reliance on export commodities which rely mostly on unskilled labour and low technology inputs. The CEE economies have, on the other hand, made strong inroads into medium-/high-skill and medium-/high-tech industries in their exports to the EU markets.

We have also hinted at other aspects of the SEE economies, such as the large shares of the informal sector, which have implications for the ways in which labour, product and capital markets function. It is too early to deduce from this past development record that the SEE economies are either irreversibly stuck in a 'development trap' or that they are about to embark upon a development path rather similar to the more successful transition economies, only with a considerable time lag but with potentially faster speed. In our opinion, the 'lock in' to an EU accession scenario is extremely important as to which developmental path is the more likely to emerge over the next few years. We expect that in many respects, we shall observe a lot of differentiation in speeds and patterns of development across the region. The 'external anchor' is important, but not solely decisive. Internal behavioural, structural and policy responses are at least as important. We shall turn to these as well as to specific issues regarding the individual countries' paths towards EU accession in the following.

Part Two

Sustainability, growth and integration with the EU

Introduction

As a consequence of a less than successful transition and of violent and other political conflicts, the SEE countries still face some significant problems in sustaining their macroeconomic stability and in ensuring sustainable growth. As for macroeconomic stability, there are problems with the external and fiscal balances and with the levels of employment and unemployment.

Growth is elusive because some of the most important sources of growth are lacking, most importantly exports and investments. The SEE countries have either lost their competitiveness or failed to make gains in it. Parallel to that, the integration of South East Europe with the European Union has been delayed. To catch up, the SEE countries need to address the connected issues of stability, growth, competitiveness and integration.

Sustainable stability

Three balances are important here: external, fiscal and resource, i.e., in the last case particularly that of the allocation of labour.

Debt sustainability

As seen from the figures presented in Part One, unlike the Central European transition economies, those in South East Europe have failed to develop a growing export sector. There are various causes for this, but it suffices to point out that Hungary now exports much more than the Balkans or Southeast Europe (Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Macedonia, Serbia and Montenegro, Romania) as a whole. Imports, however, have forged ahead in the Balkans, so that the trade deficit is quite high. The deficit in the current account is smaller because of the surpluses that the SEE countries as a rule run in services and income balances as well as on transfers (see Tables 4a and b for details). Still, as a rule, current account deficits tend to be high, though higher in some countries than in others. This leads to the growing foreign debt.

The dynamics of growth of foreign debt in South East Europe tends to depend on at least three factors. Foreign debt tends to increase faster if a country is not initially very much indebted. The same happens if a country is not fully servicing its inherited debt. Usually, at the beginning of transition, the inherited debt is restructured with a certain grace period, during which the indebtedness tends to grow. Finally, the stock of debt tends to stagnate if a country is heavily indebted and if foreign direct investments are flowing in. Thus, Balkan countries are vulnerable to increases in the debt service, for whatever reason, and to the slowdown of foreign direct investments. In other words, Balkan's current approach to foreign debt is sustainable if the costs of borrowing do not deteriorate and there is a steady inflow of foreign direct investments.

Another way to look at the issue of debt sustainability is to determine the expected developments of the debt to GDP or debt to export ratios. Assuming the preservation of the desired level of reserves, the debt to GDP ratio can remain constant if the interest rate on the debt is the same as the growth rate of the GDP. Then refinancing the whole debt will keep the debt to GDP ratio at the same level. Otherwise, the share of debt increases. To keep the debt to GDP ratio constant, i.e., sustainable at an appropriate level, the difference between the interest rate and the growth rate should be repaid. For instance, if the growth rate is 4% and the interest on the foreign debt is 6%, that means that the interest of 2% should be repaid. If the debt to GDP ratio is 50%, that means that 1% of GDP should be repaid every year to keep the debt level constant. Clearly, every fall in the growth rate will lead to the need to repay more. Otherwise, the debt will grow.

Figure 15a

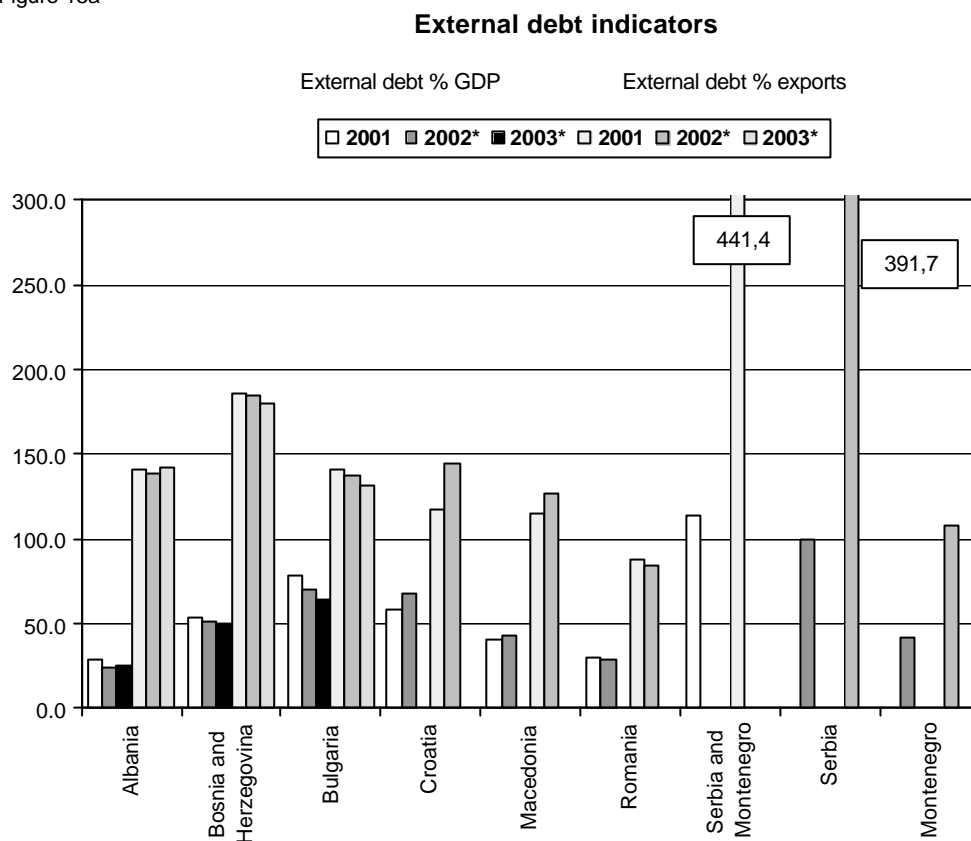
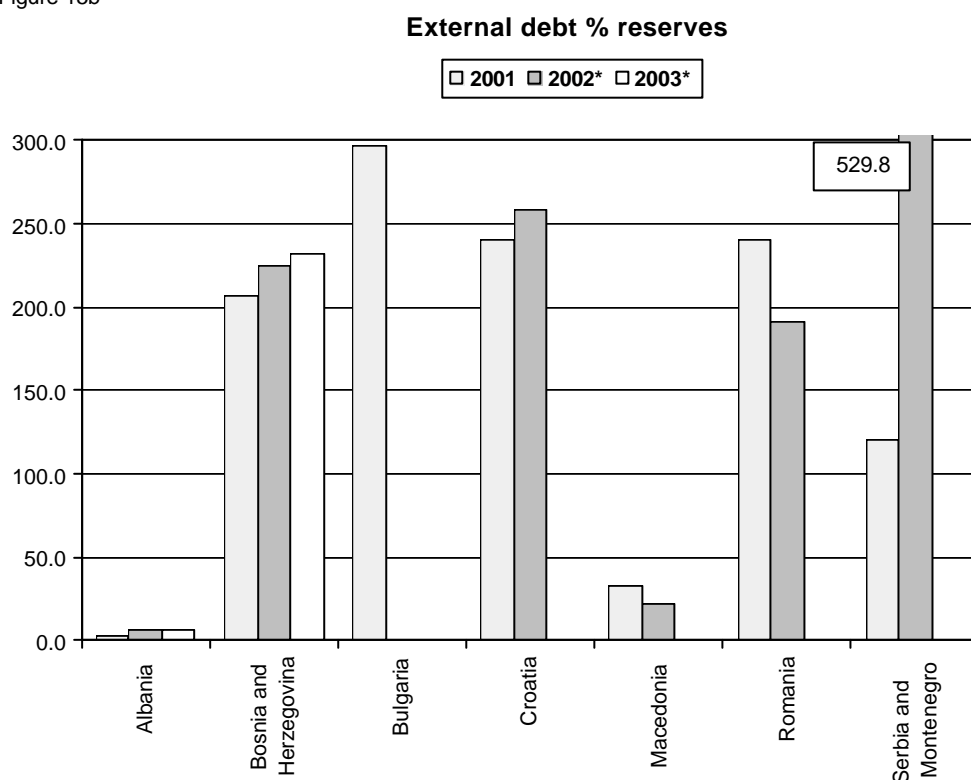
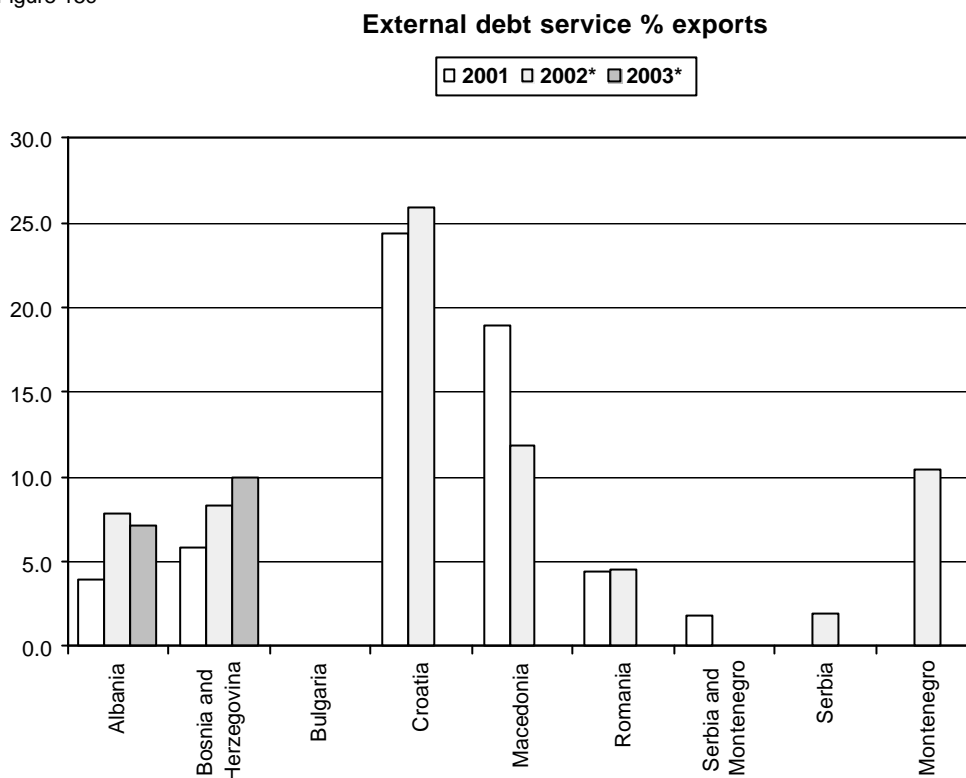


Figure 15b



Note: * projections;
 AL, MK and YU: Short-term ext. debt % reserves, YU 2002: Serbia only.
 Source: IMF and national statistics.

Figure 15c



Note: * projections;
 Montenegro: Public debt service % exports.
 Sources: IMF and national statistics.

This has implications for the trade balance (and thus the current account). If the debt is refinanced except for the difference between the interest rate and GDP growth, that difference stands also for the necessary surplus in the current account or the trade balance that is needed to keep the debt to GDP ratio constant. Otherwise, debt grows faster than GDP and becomes eventually unsustainable.

In the case of the SEE economies, the seeds of the lack of sustainability are certainly there. There is no doubt that the interest rates they have to accept are higher than their rates of growth. They also run high trade and current account deficits. Thus, as already mentioned, their debt to GDP ratios are held down only with the higher inflows of foreign direct investments. Otherwise, they have a tendency to grow. Thus, at this moment, the debts can be financed, but they are basically not sustainable under normal conditions.

It is hard to judge the severity of the problem of indebtedness. That is because it is not clear what should be the debt level at which its ratio to GDP should be stabilized. Conventionally, a ratio of 60% has been in use. Three countries are above that threshold: Bulgaria, Serbia and Montenegro and Croatia. Some have suggested a ratio of 30%, because of the unreliability of the estimates of the GDP, in which case most of the SEE countries would be above that threshold.

Perhaps more reliable measures are debt to export and debt service to export ratios. Those are, in most cases, less worrisome. In some cases, for instance Croatia and Serbia, the debt service to export ratio is quite high (in the case of Serbia this is not evident from the current data because of the grace period which expires in 2006 when the debt service to export ratio will jump to at least 25%). Also, the improvement that can be observed in some cases is the consequence of the recovery of exports of services (mainly tourism), which leads to a faster growth of exports of goods and services than of the debt service. However, this growth will inevitably slow down and the debt burden will continue to increase.

Some significant aid is still flowing into the Balkans and some countries or territories are still using credits at concessionary interest rates. At commercial interest rates, their debts would probably prove to be hard to service over a longer period of time. In any case, there is clearly a foreign debt problem, though it is not altogether easy to determine how severe it is at the moment. It should be reiterated, however, that bad export performance is certainly not contributing to the sustainability of the Balkans' foreign debt.

Fiscal sustainability

Apart from debt sustainability, there is the issue of fiscal sustainability, which is probably even more important from the developmental point of view. The fiscal picture of the Balkan economies can be summarized in the following way. Most of the countries have rather high public expenditure to GDP ratios. In some cases, they go over 50%. As a consequence, they have high public revenue to GDP ratios that, however, fall short of expenditures implying significant general government deficits. Balkan states, with some exceptions, spend a lot on wages and salaries. In some cases, quite a lot is spent on the military and the security forces in general. Also, they allocate significant resources to subsidies and grants. Finally, in some cases, they have to make significant interest payments on the public debt.

The real state of public finances is difficult to determine because of the presence of significant contingent fiscal liabilities, or fiscal risks. In a number of Balkan economies, the state had to take over costs of restructuring of various sectors, for instance of the banking sector or of parts of the state owned enterprises. These fiscal risks are hard to assess. In some cases, the state issues guarantees and these can be priced. In the case of the collapse of the banking system, as has happened in a number of Balkan economies, this is much more difficult to price ahead of the time of the collapse. The same is the case with the public services and with the utilities. It can be generally assumed that the state of the fiscal sector is much more problematic than the data on revenues and expenditures would suggest.

In most cases, with some exceptions, primary surplus is negative. In other words, general government is in deficit even if interest payments on the public debt are left out. Assuming that the deficit is financed from borrowing, stability requires that the deficit is not larger than the additional GDP. Otherwise, debt will grow faster than the GDP. Again, as in the case of foreign debt, that would imply ever larger debt repayments in order to keep the stock of debt at an acceptable level. At the moment, this consequence is mitigated by a high, though diminishing, supply of aid. It can be expected that some forms of budget support will be continued in the future, partly from the EU. More on that later.

This state of affairs – high share of public expenditures in the GDP and persistent deficit – means that taxes will have to be kept high or expenditures will have to be reduced. The growth consequences of rising taxes are most probably negative, not only because of the high fiscal burden but also because of the associated misallocation of resources. This misallocation comes from two sources: distorting taxes and the preservation of the existing structure of expenditures.³

Thus, cutting spending is a preferable policy. Some significant savings can be achieved by spending much less on security, i.e., by making use of the peace dividend. Other restructurings of the public sector can also improve the fiscal balance. By contrast, not very much can be done about social security, though there are significant inefficiencies to be found there, especially in the pension system. Still, these expenditures will remain high because the population in the Balkans, with the exception of the Albanian and the Muslim one, is rather old.

States in the Balkans do not invest much. This is because of the pressure of current expenditures and because of the existence of budget deficits that put a limit to new borrowing. Even in the cases in which external financing is available, the necessary domestic co-financing is hard to come by. This impedes the reconstruction of the infrastructure and many other types of investments that are connected with modernization.

Thus, apart from the lack of sustainability of fiscal balances, expenditures are biased towards consumption and away from investments, as well as towards the older rather than younger generation. That has significant consequences for economic development and also for outward migration. However, there are also other factors that play a role in these developments.

³ More on that in Gligorov (2000).

Figure 16a

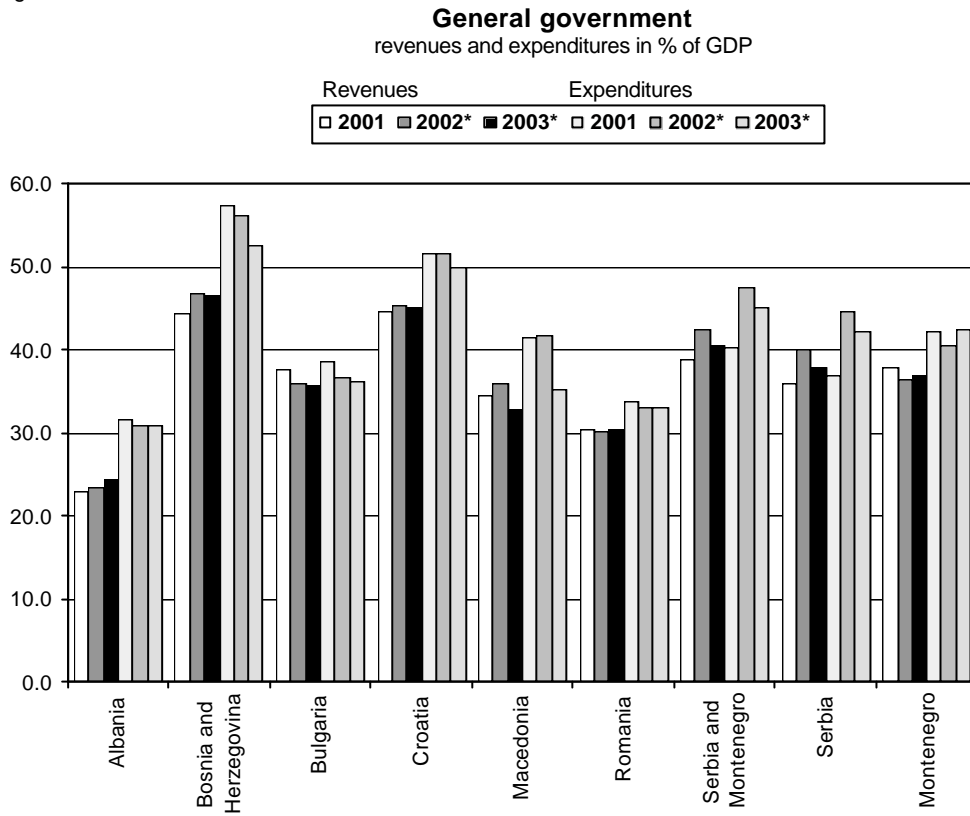
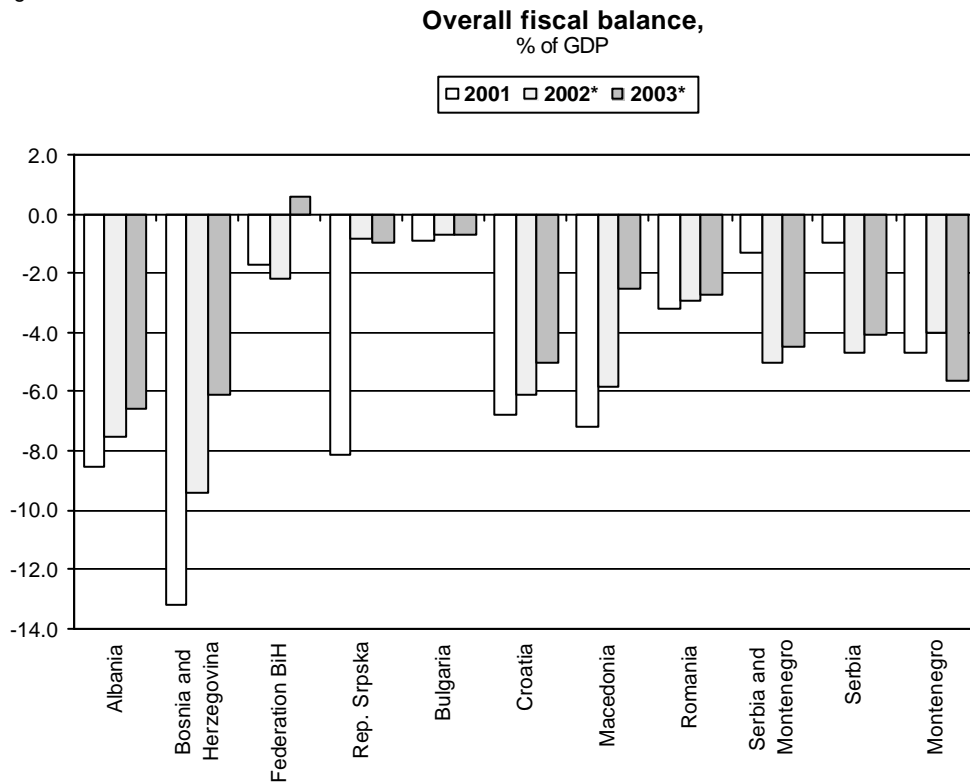


Figure 16b



Notes: *) Projections.

For Serbia as percentage of the GDP of Serbia and Montenegro. For the entities in B&H revenues with grants.
Sources: IMF and national statistics.

Table 6

General government spending on wages and salaries, % GDP

| | 2001 | 2002 proj. | 2003 proj. |
|-----------------------|------|---------------|---------------|
| Albania | 5.6 | 5.2 | 5.0 |
| Bulgaria | 3.9 | 3.9 | 3.9 |
| Croatia | 11.7 | 11.1 | 10.5 |
| Romania | 5.0 | 5.0 | 4.9 |
| Serbia and Montenegro | 9.5 | 10.4 | 10.2 |
| Serbia | 8.5 | 9.5 | 9.4 |
| Montenegro | 9.9 | 10.4 | 10.4 |
| Slovenia | 10.0 | 10.2 | . |
| CEEC average | 6.1 | . | . |

Note: Serbian and Montenegrin revenues are shares of Serbia's and Montenegro's GDP respectively. S&M revenues are a share of S&M GDP.

Sources: IMF and national statistics; wiiw estimates.

Table 7

Subsidies and transfers, % GDP

| | 2001 | 2002 proj. | 2003 proj. |
|-----------------------|------|---------------|---------------|
| Albania | 8.9 | 9.0 | 8.6 |
| Bulgaria | 16.2 | 16.4 | 17.0 |
| Croatia | 20.8 | 20.6 | 20.2 |
| Romania | 14.5 | 14.6 | 14.5 |
| Serbia and Montenegro | 19.5 | 23.8 | 22.6 |
| Serbia | 17.8 | 22.5 | 21.2 |
| Montenegro | 20.7 | 20.1 | 18.7 |
| Slovenia | 20.0 | 20.4 | . |
| CEEC average | 18.3 | . | . |

Note: Serbian and Montenegrin revenues are shares of Serbia's and Montenegro's GDP respectively. S&M revenues are a share of S&M GDP.

Sources: IMF and national statistics; wiiw estimates.

Employment and unemployment

In transition, an increase in unemployment can be expected. In the canonical case, employment falls more slowly than output, but then recovers more slowly too because, in the former instance, the predominant employment is still in the state sector and may perform a social or political purpose, while in the latter period employment is already mostly in the private sector, where the concerns over the increase of productivity predominate. This mostly happened in the Balkans too, though the violent conflicts contributed to the dynamics significantly. Thus, the fall in output and in employment was quite steep and the

recovery both of output and of employment was delayed. As a consequence and as already discussed in Part One, employment has remained low and unemployment high and in some cases very high.

Statistics on employment and unemployment in the Balkans is not reliable. This is because of the existence of a large informal sector. One indication is the discrepancy between registered unemployment and that found in labour surveys. In the former Yugoslavia countries, the difference can be as much as 10% or even 20% of the labour force. If one assumes that there are also those who are registered as employed but are working in the informal economy – full time or as moonlighting – then the size of the informal sector, due to informal employment only, can be assessed to be significant, though not necessarily all that large. The estimates appearing in Table 5 above may be exaggerated. There is no doubt that the share of the informal economy is higher in SEEC than in CEEC. However, the levels of unaccounted for employment and some common sense assumptions about the productivity of that sector do not support the conclusion that the informal sector is practically the largest sector of the economy (Albania and Kosovo may be exceptions).

The problem with the labour markets in the Balkans is that they are not efficient in the sense that there is a high likelihood that labour is misallocated both in the formal and in the informal economy. The informal economy always implies tax evasion, though that may not be the reason why it emerges. Thus, it is a subsidized sector. The labour employed is at least to some extent misallocated, because the sector would look differently if it were paying taxes. The formal economy, on the other hand, is also either subsidized or is still facing somewhat softer budget constraints. It is also probably still hoarding labour. Thus, at least some of the labour in that sector is misallocated.

If that is right, then there is still significant reallocation of labour that will have to take place. The misallocated labour in both sectors would have to move to the new private formal sector. The aggregate effect of this reallocation is not easy to determine with some certainty. What can be said, however, is that the usual understanding of the process of transition as that of reallocation of labour from the state to the private sector would have to be augmented with reallocation via the informal sector, with the additional risk of the economy being stuck in a low-development equilibrium – a characteristic of the 'transition with organized crime' that seems to be the process to be observed in many parts of the Balkans.

Sources of growth

The analysis of imbalances is important for the understanding of the sources of growth in the past and those that may be important in the future. The episodes of growth in the Balkans have been the consequence of one or more of the following:

- post-conflict reconstruction,
- increased consumption, and
- increased investment, in a number of cases public, but in some cases foreign direct investment

Only in the last case, and only when growth was based on foreign investments, did it not lead to imbalances with possible negative growth consequences. Even in these cases, the decisive fact was the target of foreign direct investments. In most cases in the Balkans, foreign direct investments have targeted sectors like telecommunications, banking and some industries with predominantly domestic markets (breweries, tobacco, oil, energy). Their contribution to the efficiency of resource allocation has been significant, but not so much to sustainable growth.

A good example is the banking sector. The share of foreign owned banks in the Balkans is higher than in Central Europe. However, their contribution to the growth of output has been rather modest. The main reason is that the banks are ready to finance consumption, but to a much lesser extent investment. This became quite clear during the euro conversion in 2002 when the liquidity of the banks in many countries increased quite significantly. Most of it went to loans to households, which were spent mostly on durable consumption goods. That contributed to the increase in imports, but had little effect on the growth of output.

Comparing sources of growth in Central European transition countries with those in the Balkans, it seems reasonably clear that export growth is quite important. Most of the Balkan economies are small, one exception being Romania. Therefore, probably the best strategy for growth is that of market integration. Quite contrary to that, Balkan economies tended to increase market disintegration. The introduction of sanctions and embargoes contributed to that. The situation started to change after the war in Kosovo in 1999. Indeed, since then, the Balkans have been doing better, with the exception of Macedonia which went through a severe ethnic conflict and is still recovering from it.

Barriers to trade, however, are still significant. Probably the more important ones are the non-tariff barriers. If one looks at the political barriers, imposed in one way or another, as prohibitively high non-tariff barriers, i.e., zero-quotas to trade between two countries and territories, it becomes clear that barriers to trade in the Balkans are quite high. This still accounts for low levels of trade within Bosnia and Herzegovina, between Serbia and Kosovo and between Serbia and Croatia (see Christie, 2002).

To address the tariff barriers, the Balkan countries have signed a series of bilateral free trade agreements. The next step is the creation of the Southeast European Free Trade Area (SEEFTA). In addition, and more importantly, the European Union has unilaterally removed all tariff and most non-tariff barriers to imports from the Western Balkans (Albania,

Bosnia and Herzegovina, Croatia, Macedonia and Serbia and Montenegro). These measures have proved to be helpful, though no dramatic increases in foreign trade have happened yet. Still, there is no doubt that the issue of market access is quite important for sustained and faster growth in the Balkans.

The same may be said of enterprise restructuring. Unlike in Central European economies, a new private sector has not sprung up in the Balkans, at least not to the extent that had been expected, except for the one to be found in the informal economy. The small and medium-size sector that has developed, either in the formal or in the informal economy, has concentrated mainly on trade and other services. The growth of a new private sector in industry has been much less pronounced, with some exceptions.

As the new private sector has failed to emerge quickly, the brunt of the enterprise sector, except for the informal economy, has remained with the former state-owned (or socially owned, in the case of former Yugoslavian countries) sector. Its performance, however, has depended very much on the speed of privatization, as the restructuring and the revitalization of the state and socially owned enterprises has not proved to be a big success. Privatization, however, has in a number of cases been guided by special interests and not by the increase in the efficiency of the use of resources. Thus, the post-privatization process, which has proved to be rather slow, should bring about the needed improvements in ownership and the structure of corporate governance.

Competition policy could contribute to the restructuring of enterprises. The state sector is populated by monopolies, but the structure of the privatized sector and even of the informal economy is not necessarily one that could be associated with a free market economy. To an extent, the combination of post-socialist structures with the lack of rule of law keep the incentives for exit low and the costs of entry high. This has been changing with the increased openness of Balkan economies, but the process is slow and is standing in the way of changes in the structure of the economy.

Partly this is so because of the large share of the informal economy. Apart from the elements of informality associated with the state sector and with the private sector, that is able to extract special concessions from the authorities in exchange for bribes, the rest of the informal economy is mostly that of small and medium size firms in low value added sectors. Informality puts a cap on the size of firms, except in the case of so-called captured states. Even if there is no rule of law, the sheer fact of informality works against large scale production. Thus, there are limits to growth of the informal economy.

As argued here, sustained growth can probably be based on the growth of exports. There, the issue of competitiveness comes in. Unlike the more successful Central European transition economies, most Balkan economies adopted one or the other version of a fixed

exchange rate. This was a consequence of the lack of belief in the ability of the monetary authorities to withstand pressures to monetize the fiscal deficit. Apart from other problems that this has brought about, the depressed exports and runaway imports are probably the most serious ones. There is a hope that real restructuring would eventually validate the adopted exchange rate policy, but that has not really happened yet. In any case, there is no doubt that competitiveness is the key condition of sustained growth and eventual convergence with the more developed transition economies and with the EU.

European integration

The Balkans are more integrated with the EU than with itself. EU is the most important trading partner, even in the cases of landlocked countries or territories of the Balkans (e.g., Serbia, Macedonia, Kosovo, Bosnia and Herzegovina). Assuming an export based growth strategy for the Balkans, that means that exports to the EU will play the key role in it, as it has in the case of the Central European transition economies. This is true not only of goods but also of services, as the Balkans have comparative advantages in tourism, in transport and perhaps in some other sectors too. Most of these services are exported to the EU member states.

The EU is also the main investor in the region. Its importance will only increase with the current enlargement as Hungary and Slovenia have been investing in the region and will continue to do so. Currently, these investments are still rather low (see Table 3), partly because of the uncertainty about the prospects of EU integration of this region. These uncertainties are still rather high, as the repeated declarations that the Balkans will join the EU at some point in the future have not been matched with real progress in the process of integration.

The EU plays an important role as a source of factor incomes and transfers (see Tables 4a and b). Due to the continuous migration from the Balkans, remittances, wages and pensions, are rather crucial for the sustainability of the balance of payments. Private transfers as a whole amount to from 5% in Croatia to over 10% in almost all the other Western Balkan countries. Data for Bosnia and Herzegovina and reported inflows are much lower than those that could reasonably be expected. Lately, increases in private transfers have been reported for Romania and Bulgaria too. Most of these originate in the EU, though in some cases the share of money coming in from overseas is also quite significant.

Finally, the EU is the main source of aid and public transfers. In the Western Balkans, most of these inflows have been connected with reconstruction and humanitarian aid. In other Balkan countries, the public transfers have increasingly been connected with the transition and with EU integration. In the future, the EU is likely to increase its financial support to the

Balkans and to target the macroeconomic stability, employment growth and institutional changes required for EU integration.

Clearly, the Balkans are dependent on, if not integrated with, the EU. The dependency goes beyond the economic relations. The EU plays a quite significant political role, in some cases a direct one, e.g., in Bosnia and Herzegovina, Kosovo, Macedonia and Serbia and Montenegro. Both the economic and the political role would be significantly helped with an appropriate strategy of EU integration. Currently the EU is committed to the enlargement process for the candidate countries and to the Stabilization and Association Process (SAP) for the so-called Western Balkan countries⁴ that it adopted in 1999. The latter consists of a Stabilization and Association Agreement (SAA) that is similar but not identical to the Europe Agreements. At the moment, the relations of SEEC and the EU are as follows:

- Candidates for membership: Bulgaria and Romania
- SAAs: Macedonia and Croatia (signed with the EU and in the process of ratification by the individual member states)
- Cooperation agreement: Albania, SAA negotiations in progress
- No contractual relations: Bosnia and Herzegovina and Serbia and Montenegro, with SAAs to be offered some time in the future⁵

This strategy is currently under revision. Probably the first item in the new strategy has to be a clear commitment on both sides to the process of integration. The next is the lead that the EU needs to take. This is both necessary and difficult to expect. There are two reasons why this is the case.

On the one hand, the Balkan countries have been slow to adopt an EU integration agenda, partly because of internal and partly because of regional problems they have faced. In the case of the latter, i.e., the regional problems, there have been few if any regional initiatives originating from the region itself. Thus, true to the concept of Balkanization, the region has been unable to come up with a regional will, that is with a regional recognition of the advantages of EU integration.

On the other hand, the benefits of Balkan integration in the EU are rather asymmetric. The benefits for the Balkans outweigh significantly those of the EU. This is evident when the extent of economic dependence of the Balkans on the EU is taken into account. Thus, it cannot be expected, in normal circumstances, that the EU would be interested in pushing for the speeded-up integration of the Balkans into the EU.

⁴ Albania, Bosnia and Herzegovina, Croatia, Macedonia, and Serbia and Montenegro.

⁵ More on all that in Gligorov (2002).

Thus, when it comes to Balkan integration into the EU, there are two types of failures to confront. One is connected with Balkanization, which precludes regional cooperation. The other is the failure of the EU to emerge as a leader in this process because of the small benefits that the EU enlargement in the Balkans would bring about.

To deal with these two types of failures, the combined process of regional cum EU integration has been devised. In other words, in order for the individual countries to qualify for an upgrade in their relationship with the EU, they have to make progress in regional cooperation. This strategy has had few results until recently. As a consequence of EU eastern enlargement and also because of the political changes in the Balkans, things have started to change, at least at the level of political will. Thus, most countries and territories in the Balkans now put their EU integration ahead of other political interests. This puts the pressure on the EU to start thinking about Balkan enlargement more operationally.

This leads to the following state of affairs. On the one hand, the most pressing economic and political problems of the Balkans are still there and are far from being resolved. On the other hand, EU accession has come to be seen as the unique instrument for the resolution of these problems. This relates as much to development and growth as to political settlements and to social issues. Thus, a speed-up in the process of EU Balkan enlargement can be expected.

The key element of the possible new strategy will be the treatment of the Balkan countries as de facto candidates for membership.⁶ That would imply the use of instruments that enable the EU to have a more pronounced role in the settlement of outstanding political issues, to extend more resources, both financial and technical, and to contribute to the economic recovery of the region through better access to EU markets and increased investments from the EU.

The implementation of this strategy would require a lot of innovative thinking on the side of the EU and also on the side of the Balkan countries. Here some of the main economic issues will be mentioned.

The key issue is that of trade within the region and with the EU. Current arrangements that rely on association agreements with the EU and on bilateral trade agreements between Southeast European countries is full of distortions. In view of the central importance of the EU market for the Balkan economies, and of their lack of competitiveness, further measures of unilateral trade liberalization on the EU side would be useful along with multilateral trade liberalization within the region.

⁶ More on that in Gligorov (2003).

As for the related issue of large inflows of investments, a lowering of the country-specific and regional non-commercial risks would be desirable. As the banking sector in the Balkans is dominated by banks from the EU member states, some scheme of loan guarantees should not be difficult to devise.

On the macroeconomic side, the EU has to rethink its role both on the fiscal and on the monetary side. Fiscal sustainability is probably the key issue. As for monetary policy, in most Balkan countries and territories, the euro is used more than the domestic currency. Because of that, most countries have adopted one or the other version of the fixed exchange rate, which has proved to be good for price stability but has contributed negatively to the region's competitiveness. Thus, the design of an appropriate monetary and exchange rate policy is a task yet to be tackled.

To address the microeconomic problems, the instruments of institution building and micro-financing will have to be used. The reliance on public resources, which may turn out to be the preferred approach, may not be the best one. Public money tends to be misused as a rule, and especially in the Balkans. Thus, the key issue will probably be the availability of private money and of the mechanism of its mobilization and utilization. In the end, it is the inflow of foreign investments and export growth that should lead to the reversal of the process of divergence to one of convergence.

Conclusions to Part Two

Transition has meant divergence for the SEE countries. They have not succeeded in improving their competitiveness and have not moved on to a path of sustainable growth. The situation has been improving since 2000, but the return of growth has been accompanied by the persistence of macroeconomic disequilibria. Also, in most cases, growth has been driven by consumption rather than by investment and exports. Thus, there are still considerable problems on the way to convergence. These would be easier to address if the process of EU integration was speeded up. The Balkans are quite dependent on the EU both economically and politically. Thus, unlike in other cases where convergence preceded integration, the opposite strategy may be the preferred one in the Balkans.

We have emphasized in this paper that one of the striking features of the Balkan transition is the stagnation or slow recovery of exports even in periods when growth is accelerating. This was noted early on⁷ and the need for both regional and integration with the EU market is routinely stressed. Indeed, after 1999 the EU has unilaterally removed most of the tariffs (including agricultural products) for exports from the Western Balkans while those with the

⁷ See Gligorov (1997).

candidate countries (Bulgaria and Romania) are quite low already. The results so far have not been all that remarkable. Still, this measure of liberalization has led to a process of regional liberalization of trade as all countries have signed bilateral free trade agreements. They should lead to the creation of a free trade area in the near future. Tackling the issue of non-tariff barriers to trade will be vital (see below).

Access to markets is important, but so is competitiveness. Most of the Balkans pursues a fixed exchange rate policy. Bulgaria and Bosnia and Herzegovina have currency boards while Kosovo and Montenegro use the euro. Croatia, Macedonia and Serbia peg their currencies to the euro more or less strictly. Albania and Romania have more flexible exchange rate policies. How much fixed exchange rates have contributed to the loss of competitiveness is hard to determine, though it seems reasonable to assume that the influence has been significant.

Low employment and high unemployment are certainly the main economic problems in the Balkans. Linked to these, a large shadow economy is associated. That distorts product markets also. Growth of the new private sector is slow because the barriers to entry into both legal and shadow economies are quite high. The risks to investments being high, banks do not finance business activity much. Furthermore, FDI is only recently increasing, though there are signs that the inflow is decreasing once the more profitable firms and sectors are privatized.

There is clearly no simple answer to furthering the process of economic development of the Balkans. Still, with the risk of violent conflicts being rather low, political and economic opportunities are improving. The key that those would not be missed is the radically enhanced prospect of EU integration. There are three reasons why that is so:

- the internal political will in the Balkan countries is often weak,
- the regional political will is also quite weak,
- the EU is politically and economically very much involved in the region.

Thus, assuming that the EU wants to integrate this region, it should take the lead in its development. The best development instrument that the EU has is exactly that of integration. It is now decided that Southeast Europe or the Balkans will accede to the EU some time in the future. Therefore, the real issue is what the EU should do to use the prospect of integration as an instrument of Balkan development.

Clearly, the main problems are connected with trade, employment and fiscal expenditures .

The EU is the main trading partner for the majority of the Balkan economies and the importance of its market will only grow. This has been realized, but the unilateral trade

liberalization should be supplemented with a similar removal of non-tariff barriers. When it comes to remaining protective measures, those are a significant cost for the Balkans and an insignificant benefit for the EU. Standards, however, could be improved through technical assistance, which could also be used to increase the level of information about the way EU markets could be accessed.

In addition, barriers to investments should be lowered. A characteristic feature of most of the Balkans is the dominance of foreign banks, mostly originating from the EU member states. EU presence in the financial markets will further increase with the accession of Slovenia and Hungary. Banks in the Balkans do not lend very much to businesses, especially small and medium-size ones. This is mostly because the risks are assessed to be too high. Those could be addressed in two ways. For one, there must be a way to insure investment and commercial risks. For another, international financial institutions should be able to support the opening up of local banks, as the lack of specific knowledge is often the reason that the bigger foreign-owned banks do not lend to small and medium-size enterprises.

These suggestions are premised on the belief that private investments are the key to development of the Balkans. Such investments could be reassured with appropriate public financial support. There is clearly the need to support infrastructure projects as a basic development tool. Beyond that, investments in institution-building are necessary. Aid and outright budget support – the instrument mostly used in the last decade or so – should be gradually phased out while the support for the strengthening of public governance and restructuring should be increased. Following from this, the EU should get more involved in reforms in the Balkans and even in some aspects of fiscal management both on the central and on the local level.

These instruments of speeded integration cannot be seen outside of the political challenges and changes that this region faces, but those have been left out in this analysis (see further on this, Gligorov, 2003).

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Appendix

Table A-1

| | | External debt indicators | | |
|-------------------------------|---------------------------------|---------------------------------|--------------|--------------|
| | | 2001 | 2002* | 2003* |
| Albania | External debt % GDP | 28.7 | 24.7 | 25.5 |
| | External debt % Exports | 140.7 | 138.8 | 141.9 |
| | Short term ext. debt % Reserves | 2.6 | 6.2 | 6.7 |
| | Ext. debt service % Exports | 3.9 | 7.8 | 7.1 |
| Bosnia and Herzegovina | External debt % GDP | 53.2 | 51.6 | 50.6 |
| | External debt % Exports | 186.4 | 184.9 | 179.8 |
| | External debt % Reserves | 207.0 | 224.3 | 231.9 |
| | Ext. debt service % Exports | 5.8 | 8.3 | 10 |
| Bulgaria | External debt % GDP | 78.3 | 70.3 | 64.8 |
| | External debt % Exports | 140.9 | 137.1 | 131.5 |
| | External debt % Reserves | 296.6 | . | . |
| | Ext. debt service % Exports | . | . | . |
| Croatia | External debt % GDP | 57.9 | 67.9 | . |
| | External debt % Exports | 117.5 | 144.5 | . |
| | External debt % Reserves | 240.6 | 259.0 | . |
| | Ext. debt service % Exports | 24.4 | 25.9 | . |
| Macedonia | External debt % GDP | 40.7 | 42.4 | . |
| | External debt % Exports | 115.6 | 126.3 | . |
| | Short term ext. debt % Reserves | 32.4 | 21.9 | . |
| | Ext. debt service % Exports | 19.0 | 11.9 | . |
| Romania | External debt % GDP | 29.6 | 28.6 | . |
| | External debt % Exports | 88.1 | 83.9 | . |
| | External debt % Reserves | 240.6 | 190.8 | . |
| | Ext. debt service % Exports | 4.4 | 4.5 | . |
| Serbia and Montenegro | External debt % GDP | 113.7 | . | . |
| | External debt % Exports | 441.4 | . | . |
| | Short term ext. debt % Reserves | 120.1 | . | . |
| | Ext. debt service % Exports | 1.8 | . | . |
| Serbia | External debt % GDP | . | 100.0 | . |
| | External debt % Exports | . | 391.7 | . |
| | External debt % Reserves | . | 529.8 | . |
| | Ext. debt service % Exports | . | 2.0 | . |
| Montenegro | External debt % GDP | . | 41.9 | . |
| | External debt % Exports | . | 108.6 | . |
| | External debt % Reserves | . | . | . |
| | Public debt service % Exports | . | 10.4 | . |

Note: *) Projections

Sources: IMF and national statistics.

Table A-2

General government data in % of GDP

| | | 2001 | 2002* | 2003* |
|-------------------------------|---------------------|-------|-------|-------|
| Albania | Revenues | 23.0 | 23.5 | 24.4 |
| | Expenditures | 31.5 | 31.0 | 31.0 |
| | Overall balance | -8.5 | -7.5 | -6.6 |
| | Interest payments | 4.3 | 3.7 | 3.8 |
| | Primary balance | -4.2 | -3.8 | -2.8 |
| | Defence expenditure | 1.1 | . | . |
| Bosnia and Herzegovina | Revenues | 44.4 | 46.8 | 46.5 |
| | Expenditures | 57.5 | 56.2 | 52.6 |
| | Overall balance | -13.2 | -9.4 | -6.1 |
| | Interest payments | 1.2 | 1.1 | 1.1 |
| | Primary balance | -12.0 | -8.3 | -5.0 |
| | | | | |
| Federation BiH | Revenues | 45.9 | 44.1 | 44.3 |
| | Expenditures | 47.6 | 46.3 | 43.7 |
| | Overall balance | -1.7 | -2.2 | 0.6 |
| | Defence expenditure | 4.1 | 5.1 | 3.4 |
| Republika Srpska | Revenues | 48.1 | 55.4 | 54.4 |
| | Expenditures | 56.2 | 56.2 | 53.4 |
| | Overall balance | -8.1 | -0.8 | -1.0 |
| | Defence expenditure | 2.1 | 2.9 | 2.9 |
| Bulgaria | Revenues | 37.7 | 36.0 | 35.6 |
| | Expenditures | 38.6 | 36.7 | 36.3 |
| | Overall balance | -0.9 | -0.7 | -0.7 |
| | Interest payments | 3.7 | 2.2 | 2.4 |
| | Primary balance | 2.8 | 1.5 | 1.7 |
| | Defence expenditure | 3.2 | 3.4 | 3.3 |
| Croatia | Revenues | 44.7 | 45.4 | 45.0 |
| | Expenditures | 51.5 | 51.5 | 50.0 |
| | Overall balance | -6.8 | -6.1 | -5.0 |
| | Interest payments | 2.2 | 2.3 | 2.5 |
| | Primary balance | -4.6 | -3.8 | -2.5 |
| Macedonia | Revenues | 34.4 | 35.9 | 32.9 |
| | Expenditures | 41.6 | 41.7 | 35.3 |
| | Overall balance | -7.2 | -5.8 | -2.5 |
| | Interest payments | 1.9 | 1.5 | 1.2 |
| | Primary balance | -5.3 | -4.3 | -1.3 |
| | Defence expenditure | 10.3 | 5.9 | . |
| Romania | Revenues | 30.5 | 30.2 | 30.4 |
| | Expenditures | 33.7 | 33.1 | 33.1 |
| | Overall balance | -3.2 | -2.9 | -2.7 |
| | Interest payments | 3.9 | 3.2 | 2.9 |
| | Primary balance | 0.7 | 0.3 | 0.2 |
| Serbia and Montenegro | Revenues | 38.9 | 42.5 | 40.5 |
| | Expenditures | 40.2 | 47.5 | 45.1 |
| | Overall balance | -1.3 | -5.0 | -4.5 |
| | Interest payments | 0.7 | 1.0 | 1.1 |
| | Primary balance | -0.6 | -4.0 | -3.4 |
| | | | | |
| Serbia | Revenues | 35.9 | 40.0 | 38.0 |
| | Expenditures | 36.8 | 44.7 | 42.1 |
| | Overall balance | -1.0 | -4.7 | -4.1 |
| | Interest payments | 0.7 | 0.9 | 1.0 |
| | Primary balance | -0.3 | -3.8 | -3.1 |
| Montenegro | Revenues | 38.0 | 36.5 | 36.9 |
| | Expenditures | 42.3 | 40.6 | 42.5 |
| | Overall balance | -4.7 | -4.0 | -5.6 |
| | Interest payments | 0.1 | 1.2 | 1.3 |
| | Primary balance | -4.6 | -3.0 | -4.3 |

Notes: *) Projections. For Serbia as percentage of the GDP of Serbia and Montenegro. For the entities in B&H revenues with grants.

Sources: IMF and national statistics.