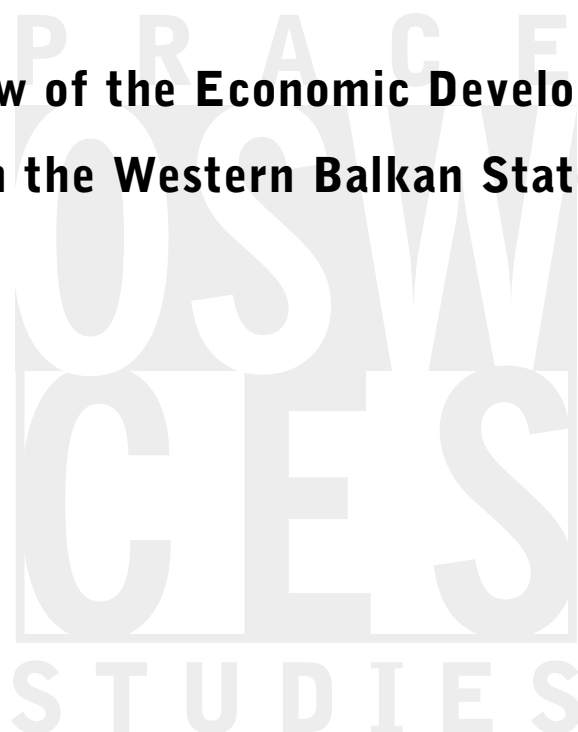


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**Review of the Economic Development  
in the Western Balkan States**



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# Review of the Economic Development in the Western Balkan States

Paulina Biernacka

## Foreword

Ten years after the end of the armed conflict, the Western Balkans<sup>1</sup> are still being considered as the “land of the unsuccessful policies”. Enormous financial and technical assistance transferred by the International Community has not managed to meet the goals of integrating the region within itself as well as within the European markets. Explanation for this can be found in the consequences of the war and the remnants of the socialist state. The complexity of current institutional/political arrangements combined with the limited willingness of the regional actors to introduce and implement much of the needed reforms have additionally contributed to the current state of affairs.

The economy and politics in the region intertwine to an extent as probably in none of the other post-communist states. Therefore, the paper presents the recent economic performance of the Western Balkan countries in the light of their limited institutional development and lack of efficient regional cooperation. The paper discusses the importance of foreign direct investments’ inflow for the economic growth of the “latecomer” states and presents major drawbacks which limit the influx of the foreign capital to the region. It presents private sector activity and regional cooperation programmes. It discusses the role of the International Community with the main focus on the activities of the European Union. The EU is examined not only as the main aid donor but more importantly as a foreign trade partner. Furthermore, it analyses the impact of the presence of the International Community and their strategies towards the region with the special attention to the EU. Finally, it presents recommendations for the improvement of the economic performance in light of the enhanced political cooperation between the EU and the region.

## The legacies

The Western Balkan region<sup>2</sup> has inherited two different legacies distinguishing it to a great extent from the countries of the Central and Eastern Europe. These are:

– ethnic conflict eruption in the beginning of the transition process in the early 1990s

– “home-grown communism” (except for Albania) which was not directly and by force “imported” from the Soviet Union but was partially developed internally and adjusted to the local conditions and environment<sup>3</sup>.

Besides the difficult constitutional arrangements, these two factors combined with each other have been largely accountable for the present condition of the region and its slow transition capabilities into the fully functioning market economy. The consequences of the military actions such as destruction of infrastructure, trading links, governance and education system, displacement of people, and creation of black market are apparent and still existing. However, the key features of region’s present economic and political governance can be associated with the region’s socialist past. The heritage of the Yugoslavia’s political construction has shown to be extremely resilient to any attempts of reforms. The two core elements of the communist system such as the institution of self-management connected with social ownership and deficit of corporate political and economic governance accountability have harmfully induced the current endeavours to restructure the economies of the Western Balkan states<sup>4</sup>. The implementation of two disciplining mechanism in business and politics such as the possibility of bankruptcy for inefficient state companies and real prospects of electoral political defeat are not fully implemented till the present day. The consequences of such conditions connected with the remnants of war are reflected in the region’s economic performance.

## Recent economic performance<sup>5</sup>

By 2003, none of the Western Balkan states, except for Albania<sup>6</sup>, has managed to regain the level of the real GDP of 1989. In 2001, the region reached only 74% of its pre-transition level<sup>7</sup> (see Table 1).

Even though, since the year 2000, there has been an average annual growth of 4.5%, it has to be taken into account that the starting point was extremely low<sup>8</sup>. The continued growth has been a positive sign for the Western Balkans, yet its disproportion across the discussed countries has shown that the region can be viewed as extremely segmented in terms of economic development.

The economic backwardness of the region is illustrated by the Table 2. The level of real GDP *per capita* reached in 2003 a regional average of 2400 euro, stretching from 700 euro in Serbian province of Kosovo to 5400 euro in Croatia<sup>9</sup>. In comparison to the EU average, GDP *per capita* for Serbia/Montenegro and Macedonia represents currently 8% and stands at 23% for Croatia. Even if in the forthcoming ten years a doubling of *per capita* income would take place, then still the overall performance would be estimated at the 16% of the current EU average<sup>10</sup>.

One of the few encouraging indicators is inflation, which through the policies of external anchors (fixed exchange currency rates) has been put under control. However, the unemployment rate exposes structural problems existing in the region. Even though, many people reported to be without a job are involved in a casual labour in an informal sector, many of them are long-time unemployed with no scenario of finding gainful employment again.

The chronically high unemployment rates combined with low job creation level are reflected in high poverty rates<sup>11</sup>. Additionally, policies of privatisation implemented in most of the discussed countries have contributed to the already high unemployment indicators<sup>12</sup>. Therefore, all states of the Western Balkans have been faced with a dangerous phenomenon of brain drain. Wide-ranging lack of economic stability has resulted in high immigration rates to the EU countries and USA. Most of the refugees and job seekers,

whose large proportion is highly qualified, as well as school-age population after completing university education abroad, will probably never return. The exodus started already during the war but it escalated greatly after the end of the armed conflict when only in the period between 1996–1998 the total number of emigrants from Bosnia and Herzegovina (BiH) was estimated at 42 thousand people. The United Nations Development Programme research from 2000 has shown that 62% of the Bosnia and Herzegovina's youth would like to leave the country<sup>13</sup>. In case of Albania, considered to be one of the poorest countries in Europe, a sixth of country's population (including one third of country's intelligentsia) was seeking employment abroad as of 2001. Only 5% of researchers, lecturers and students currently enrolled in foreign universities in Italy, Greece, Canada, and Germany are estimated to return to their home country<sup>14</sup>. Serbia and Montenegro are among states with the highest "permit to stay" application rate in EU.

The loss of the human resources has started to decline in 2003 with region's three countries appearing in the top 40 nationalities seeking asylum in industrialised states against four in 2002. According to the EU "it may reflect an increasing sense of stability and economic opportunity"<sup>15</sup>. However, the migration process is still taking place. This might have extremely harmful effects for the Western Balkans if proper governmental policies encouraging the return of skilled workers are not implemented. Migrants' return would increase the productivity and stimulate human capital formation. Through knowledge and technology transfer their return would boost economic development. Accumulate savings could be brought back to the countries of migrants' origin and invested once the disincentives are removed<sup>16</sup>. However, currently most of the financial means, which are being transferred back to the Western Balkan states are used by migrants' families for everyday consumption purposes, and rarely for investments.

Table 1. Economic growth in the Western Balkans, 1989–2003

Estimated real GDP 2003 (year 1989 = 100)	
Albania	123.00
Croatia	91.00
BiH	n.a.
Serbia and Montenegro (excluding Kosovo)	49.90
Macedonia	81.40

Source: Altmann Franz-Lothar, Regional economic problems and prospects, in Batt Judy (ed.), *The Western Balkans: Moving on, Chaillot Paper*, No 70, Institute for Security Studies, Paris, October 2004, p. 70.

Table 2. Main macroeconomic indicators in US \$

	Real GDP growth (%) 2003	Nominal GDP <i>per capita</i> (in euro, 2002)	Inflation (%) end of 2003	Unemployment rate (%) 2003
Albania	6.0	1,764.9	2.8	15.8
BiH	3.2	1,857.3	0.4	40.6
Croatia	4.8	6,408.6	1.5	14.8
Macedonia	3.3	2,357.3	2.4	31.9
Serbia and Montenegro	1.2	2,506.6	8.0	28.9

Source: Altmann Franz-Lothar, Regional economic problems and prospects, in Batt Judy (ed.), *The Western Balkans: Moving on, Chaillot Paper*, No 70, Institute for Security Studies, Paris, October 2004, p. 71; Sanfley Peter, Falcetti Elisabetta, Taci Anita, Tepic Sladjana, *Spotlight on South-Eastern Europe, An overview of private sector activity and investment*, European Bank for Reconstruction and Development, 2004, p. 6.

## Private sector activity

In 2002, the average share of private sector in the GDP was at the level of 58% in the region as a whole. However, there are considerable differences within the region. Albania private sector is contributing to 75% of the GDP while in BiH and Serbia and Montenegro private sector businesses share amounts to 45%. Significant number of private firms in the region have been established as new private subsidiaries, affiliates of formerly state owned enterprises or as new private joint ventures. The smallest proportion of private sector firms that have a background in privatisation exists in Albania, what after taking into consideration the private sector share in GDP, proves low degree of efficiency of privatised firms. On the other hand privatisation played a more significant role for private sector development in BiH and Serbia and Montenegro, which only in recent years started to privatise their state owned companies<sup>17</sup>.

## Foreign trade

The changes, which took place in the region in the 1990s, have led to the loss of markets in the other former socialist countries and in liberalisation of trade with the industrialised world<sup>18</sup>. In 2003, the overall trade deficit amounted to 25% of GDP, ranging from 17% in Macedonia to almost 40% in BiH (see Table 4)<sup>19</sup>.

Between the years 2000–2003 total imports into the Western Balkan states (Kosovo excluded) rose from 18.7 billion euro to 25.4 billion euro, while in the same period exports increased from 9.8 billion euro to 11.1 billion euro<sup>20</sup>.

Important to note is the fact that large amount of foreign trade, especially cross-border trade, is not included in the official statistics. The grey economy spheres<sup>21</sup> such as non-registered criminal economic activities are for obvious reasons not incorporated in the official data and are difficult to estimate<sup>22</sup>.

Table 3. Origin of private sector firms, 2002 (%)

	Privatised state-owned enterprises	Newly established enterprises	Private subsidiary of former state-owned enterprise	Joint venture	Other private firms
Albania	8.78	84.46	0.00	3.38	3.38
BiH	25.79	67.92	2.52	3.77	0.00
Croatia	16.89	70.95	2.03	4.05	6.08
Macedonia	14.11	80.37	3.68	1.84	0.00
Serbia and Montenegro	13.07	82.91	0.50	2.31	1.01

Source: Building Market Institution in South Eastern Europe, *ibid.*, p. 93.

Table 4. Exports/Imports of goods and services as a % GDP, 2003

	Exports of goods as % of GDP	Imports of goods as a % of GDP	Exports of services as % of GDP	Imports of services as % of GDP	Trade deficit (% of the GDP)
Albania	7.3	29.2	11.8	13.1	-22.8
BiH	21.2	76.9	6.9	4.2	-36.6
Croatia	22.2	50.1	30.4	10.5	-27.2
Macedonia	29.1	47.4	7.0	7.0	-17.2
Serbia and Montenegro	13.6	40.2	5.5	3.9	-25.1

Source: Poeschl Josef, Trade-Offs and Ways Out, Solioz Christophe/Vogel Tobias K. (eds.), Dayton and Beyond: perspectives on the Future of Bosnia and Herzegovina, Nomos Verlagsgesellschaft, 2004, p. 134; Altmann Franz-Lothar, *ibid.*, p. 6.

The European Union became the largest trading partner for the Western Balkans. It presently receives about 60% of the region's exports. The largest importers are Italy, Germany, Austria, France, and Greece taking some 90% of the Western Balkan states' overall exports to the EU<sup>23</sup>. There are three main product groups which are being exported to the EU and other world markets:

- textiles and clothing (mainly from Albania)
- heavy manufacturing (especially transportation equipment and metal processing from BiH, Croatia, Macedonia, Serbia and Montenegro)
- wood products and furniture (mainly BiH)<sup>24</sup>.

In September 2000, the EU has introduced exceptional trade measures<sup>25</sup> to the countries participating in Stabilisation and Association Process (SAP)<sup>26</sup>. They provide for duty and quota free access of products originating in the SAP countries into the European Union. Only few exceptions apply, notably concerning baby-beef, certain fishery products, and wine. These regulations have been far more generous than the ones offered to the Central and Eastern Europe countries which were faced with various EU imports duties and quotas restrictions for the period between four and five years after the entrance in force of the Association Agreements<sup>27</sup>. As a consequence, exports to the EU have increased by 40% between 1999 and 2002, however the overall level still remains extremely low at 5 billion euro.

Thus, these exceptional trade measures have not managed to significantly increase export volume from the Western Balkan states (see Table 5).

The explanation can be found in the EU product certification requirement, which means that the exported products must comply with the EU standards. The EU imposes technical standards requirements to all of its trading partners. It has established broad legislation in the area of product standardisation and conformity assessment procedure, with an aim to provide proper consumer protection throughout the territory of the European Union member states (Harmonised Standards Legislation). These various EU directives have also created very effective barriers to trade for the third parties due to the fact that imposed technical requirements increase the production costs and impose new expenditures relating to the process of obtaining certificates<sup>28</sup>. Thus, in practise the European market is extremely difficult to access for the regions' exporters. Therefore, lack of domestic product diversification combined with lost trading networks, insufficient information<sup>29</sup> and visa requirements for the Western Balkan' citizens (limits the possibility of business meetings abroad) has not restricted the growth of exports to an extent as the EU certification requirements.

Yet, the EU trade measures are very favourable to the foreign investors placing its production facilities in the region. They allow them to take advantage of lower labour costs and of duty free exports to the EU market once all of the EU requirements in this area are fulfilled. Therefore, an environment for the significant inflows of the foreign direct investments (FDI) has been created.

Table 5. Volume and market share of Western Balkans exports to the EU in 1999 and 2002

	Exports (euro/Million)		Change (%) 2002/1999	Share of EU imports (%)	
	1999	2002		1999	2002
Albania	228	330	44	0.030	0.035
BiH	358	624	75	0.047	0.066
Croatia	1892	2357	25	0.251	0.250
Macedonia	591	552	-7	0.078	0.058
Serbia and Montenegro	563	1287	129	0.075	0.136
Western Balkans	3663	5159	42	0.481	0.545

Source: The Stabilisation and Association Report for South East Europe, *ibid.*, p. 30.



## Foreign Direct Investments (FDI)

FDI inflows are considered as a very good proxy for a country's integration with the international economic networks. Foreigners bring access to global markets, knowledge and management, skills and techniques. They often supply transfer of technologies and train local executives. More importantly, they provide capital – their own or generated from foreign banks and investors. They play an essential role in the strengthening of the private sector in the host country, emergence of the market economy behaviour, and elimination of distortions inherited from the centrally planned systems<sup>30</sup>.

The backward or “latecomer” states can take the advantage of the technology transfers secured by the foreign capital willing to profit from the lower labour costs, thus with time catch up with the core regions. The intensified trade, which follows as a consequence, combined with the gradual upgrading of the country in the export roles, eventually leads to an improvement of trade deficit and overall economic performance. Nevertheless,

some preconditions are needed to achieve success: functioning state institutions and an efficient government. They are the ones responsible for the closing of the gap between *is* and *could be*<sup>31</sup>.

An increase in the FDI inflow is extremely important for the South Eastern Europe countries. It could have an influence on the catching-up process and increase of international competitiveness. The promise of the prospective membership in the European structures, stated at the Thessalonica European Council in 2003, should have been an encouragement for the inflow of foreign capital as judged by the example of the Central and Eastern Europe (CEE) states. The EU decision to open negotiation process in 1997 with five CEE countries led to an increase of the inflow of foreign capital to the most successful applicants<sup>32</sup>.

Table 6. Inflow of Foreign Direct Investments (Million \$)

	2001	2003
Albania	759	1,029
BiH	519	1,014
Croatia	6,597	8,756
Macedonia	919	962
Serbia and Montenegro	1,484	2,538

Source: Altmann Franz-Lothar, *ibid.*, p. 74.

Table 7. Investors in the SEE countries (% of FDI stocks), 2002

Albania	BiH	Croatia	Macedonia	SGC
Italy 47.9	Croatia 13.6	Austria 22.9	Hungary 38.0	Data not available
Greece 34.2	Kuwait 12.8	Germany 22.6	Greece 24.7	
Macedonia 2.2	Slovenia 10.9	US 15.6	Cyprus 8.2	
Turkey 2.0	Germany 10.2	UK 10.3	Germany 5.0	
Germany 1.3	Austria 10.1	Luxembourg 5.6	Liechtenstein 4.6	

Source: Sanfley Peter, Falcetti Elisabetta, Taci Anita, Tepic Sladjana, *ibid.*, p. 34.

FDI inflows, with the exception of Croatia, proved to be low in the region (see Table 7) however, with the tendency to increase, which might be associated with rise of the political stability in the region. The volume and the composition of the FDI have been mainly linked to the large-scale privatisation in heavy industry, telecommunications, and banking sector. The presence of greenfield investments has been limited and focused on low-technology, labour-intensive, and export-orientated industries such as textiles, leather, and clothing, which regrettably do not significantly contribute to the economies' upgrading.

Leading investors in the region are companies of the EU origin and as in the case of the BiH of the Arabic root<sup>33</sup>. The strong presence of the EU origin companies is connected with the above-mentioned EU exceptional trade measures, which allow for duty free exports to the EU market.

Table 8 illustrates the distribution of FDI by sector, demonstrating the concentration on manufacturing. This suggests that foreign companies

tend to use region's comparative advantage such as proximity to the European markets and low labour costs.

Important to mention is the negligible presence of intra-regional investments in the SEE what hinders the possibility of creating greater economic space in the region of ex-Yugoslavia and Albania. The reasons behind still not sufficient inflow of the FDI can be found not only in the weak economic situation of the region but also in the governance indicators, which would explain the success of Croatia in attracting the highest level of foreign capital. Thus, governmental policies and strengthening of reform implementation prove to be the key figure in the economy's development. There is a positive association between institutional development and inflow of FDI. The Western Balkan countries characterised by weak business framework combined with low domestic government effectiveness are considered to be less attractive for potential investors. Uncertain property rights and contracts, poor governance indicators combined with underdeveloped infrastructure and high level of corruption create an

Table 8. Distribution of FDI by sector, 2002 (%)

	Industry and Transport	Telecommunications	Financial intermediaries	Trade	Property	Agriculture	Tourism	Construction	Other
Albania	42.3	-	-	27.2	-	-	-	6.2	24.3
BiH	55.5	0.9	16.5	6.2	-	-	0.7	-	20.2
Croatia	36.4	26.3	22.9	5.7	1.8	0.3	4.2	1.1	1.3
Macedonia	25.1	45.5	23.7	3.0			0.5	0.2	2.0
Serbia and Montenegro	Data not available								

Source: Sanfley Peter, Falcetti Elisabetta, Taci Anita, Tepic Sladjana, *ibid.*, p. 35.

Table 9. Business Entry. Data for year 2003

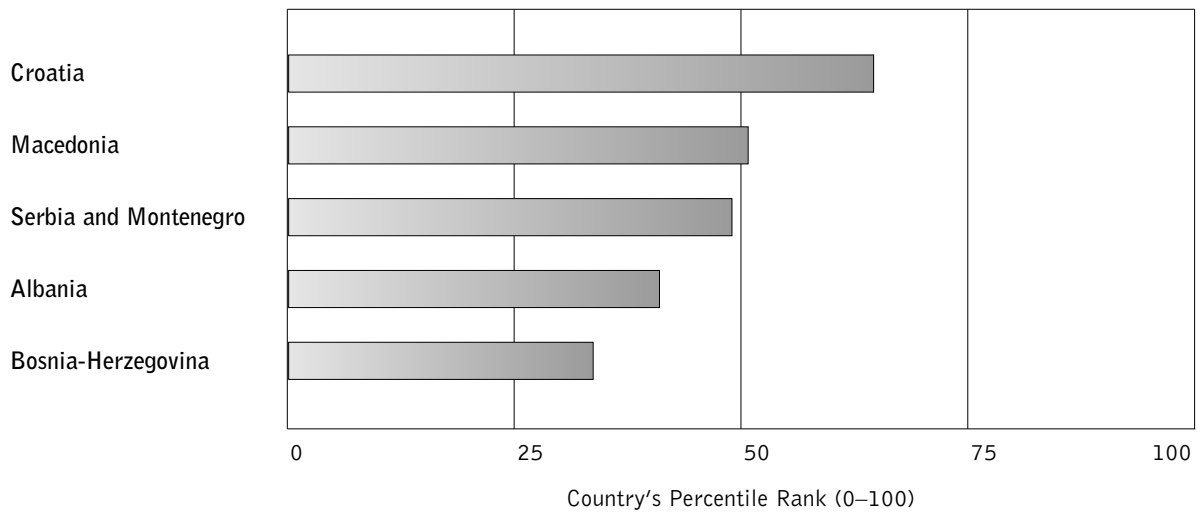
	Number of procedures	Duration (business days)	Local costs (US \$)
Albania	11	62	718.98
BiH	12	74	663.73
Croatia	13	51	798.01
Macedonia	Data not available		
Serbia and Montenegro	16	71	200.11

Source: Building Market Institution in South Eastern Europe, *ibid.*, p. 39.

unfriendly investors climate. The administrative barriers to entry combined with so called “bribe tax” (see Table 9 and Figure 5) regarded by many as major impediment for the investment do not scare away the investors to an extend as anticompetitive practices of other domestic businesses (subsidised in many cases by the states), high taxes rates, and low rate of business dispute settlements.

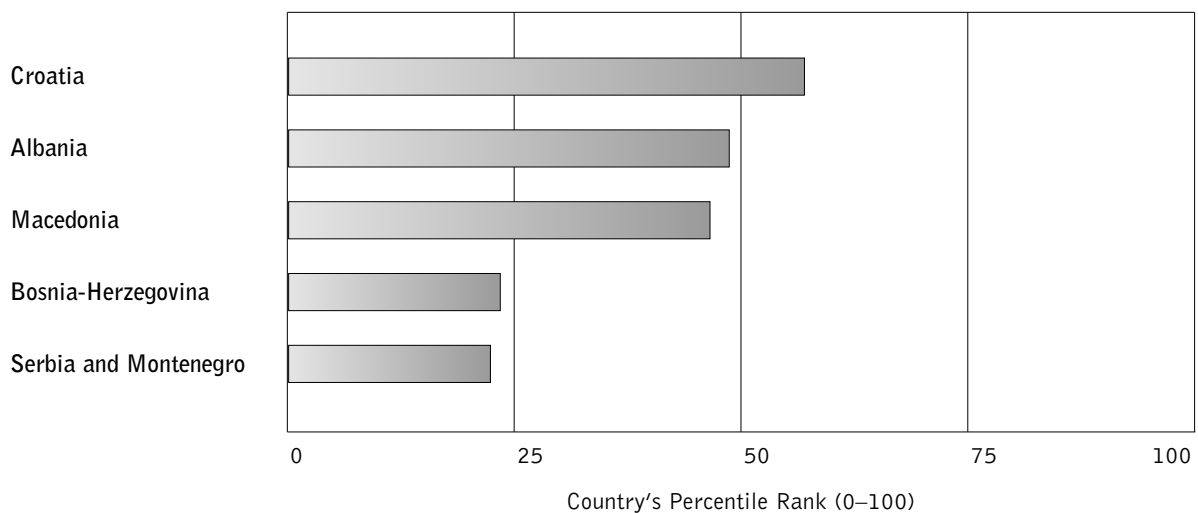
Additional obstructions in the SEE region to the existing market’s obstacles are barriers to exit, which should be depleted in order to create economic space for new businesses. This would allow to redirect productive assets from inefficient enterprises to new entrants thus enable them to expand and diversify their production. However, this requires hard budget constrains, which in most of the cases is not implemented<sup>34</sup>.

Figure 1. Government Effectiveness (Eastern Europe & Baltic region, 2004)



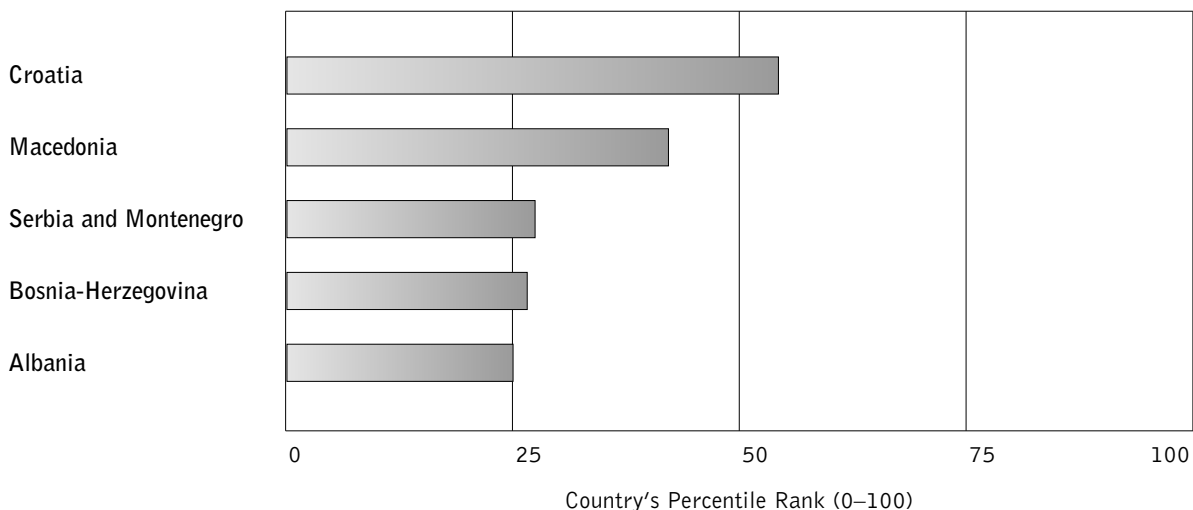
Source: D. Kaufmann, A. Kraay, and M. Mastruzzi 2005: Governance Matters IV: Governance Indicators for 1996–2004 (<http://www.worldbank.org/wbi/governance/pubs/govmatters.html>)

Figure 2. Regulatory Quality (Eastern Europe & Baltics region, 2004)



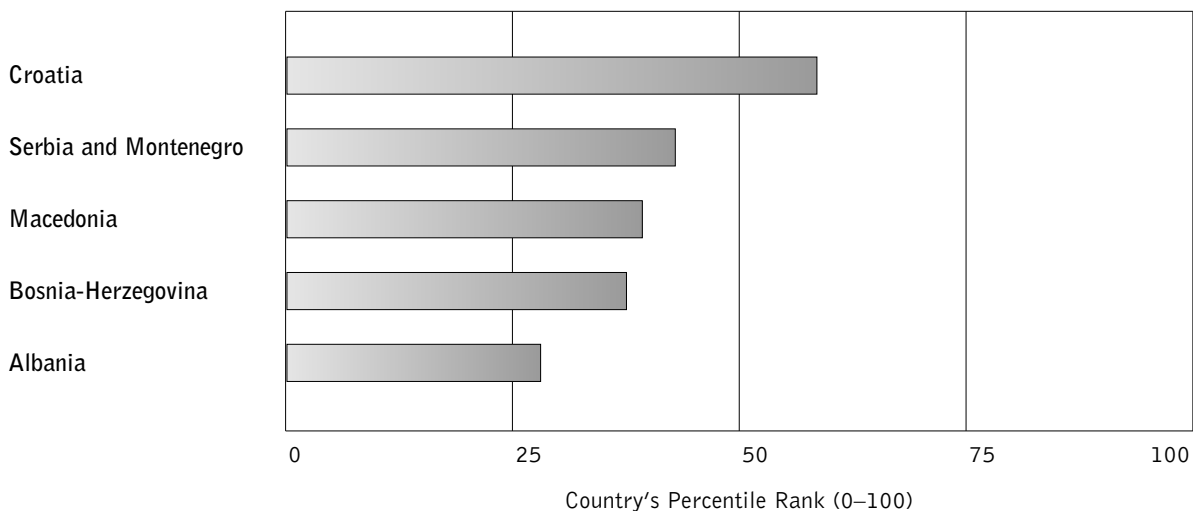
Source: D. Kaufmann, A. Kraay, and M. Mastruzzi 2005: Governance Matters IV: Governance Indicators for 1996–2004 (<http://www.worldbank.org/wbi/governance/pubs/govmatters.html>)

Figure 3. Rule of Law (Eastern Europe & Baltics region, 2004)



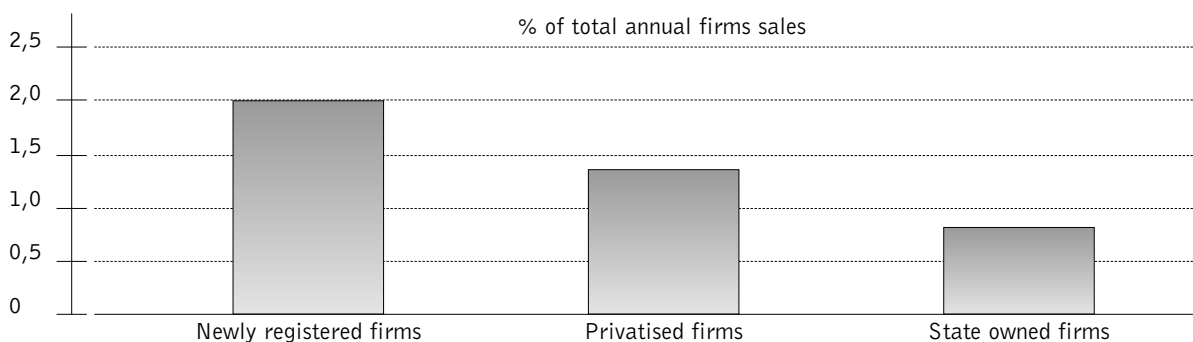
Source: D. Kaufmann, A. Kraay, and M. Mastruzzi 2005: Governance Matters IV: Governance Indicators for 1996–2004 (<http://www.worldbank.org/wbi/governance/pubs/govmatters.html>)

Figure 4. Control of Corruption (Eastern Europe & Baltics region, 2004)



Source: D. Kaufmann, A. Kraay, and M. Mastruzzi 2005: Governance Matters IV: Governance Indicators for 1996–2004 (<http://www.worldbank.org/wbi/governance/pubs/govmatters.html>)

Figure 5. Average Bribe Tax Paid in South Eastern Europe by Firms, 2002, % of firms' sales revenues



Bribe tax is understood here as an illegal forced payments required to obtain necessary business licensing and permits by firms. As it can be seen from the Figure 5, newly established businesses are most burdened with bribe tax while the state companies seem to enjoy "preferential" treatment in this area.

Source: Building Market Institution in South Eastern Europe, *ibid.*, pp. 130–132.

## Main drawbacks to the increase of the FDI inflow

Overall it can be stated that the implementation process of the needed reforms is accompanied by the low degree of their effectiveness and enforcement combined with the slow development of the key market institutions. The main obstacle include:

– **Weak interenterprise competition.** Even though most of the countries have introduced policies aimed at removing administrative barriers to entry and exit, in many cases they fail to operate by discriminating between different types of investors. There is wide spread neglect of the existing competition laws.

– **State subsidies.** State-owned companies receive the greatest amount of subsidies as a % of sales revenues, followed by privatised firms and newly established businesses (except for Macedonia where the privatised firms are the most favoured). The biggest recipients of the subsidies are enterprises active in services and infrastructure sectors while trade, mining, hotel and restaurant sectors are receiving the least of the governmental attention in this area.

– **Insufficient Financial Transparency, Protection of Ownership Rights, and Accountability.** Introduction and implementation of the independent financial audits for enterprises is still lagging behind. The system of checks and balances on managerial performance remains weak, what contributes to the low level of accountability.

– **Institutions for Resolutions of Business Disputes.** Albeit the existence of the legal frameworks, which protect property, rights in the Western Balkans, the functioning of the institutions responsible for their implementation is poor. The region suffers from the lack of qualified staff and weak enforcement mechanisms, not to mention the high costs and time length of such procedures (i.e. in Albania the costs are 1.5 times the claimed amount, while in BiH, Serbia and Montenegro, and Macedonia total attorneys' and court fees range from 40 to 80% of the claimed value).

– **Non-competitive Market Structures and Business Conduct.** The degree of restructuring of state-owned companies remains insufficient in terms of effectiveness and efficiency. Many of them hold market dominant position and operate unchecked by the market structures.

– **Poor quality of infrastructure services.** There is a persisting problem with power shortages (average 11 days per year), water cut-offs (average 9 days per year) and suspension of telecommunication services (average 5 days per year) what increases the costs of business conduct. There is still limited access for the private investors to the regulated utility and services although the privatisation efforts in this area have already started<sup>35</sup>.

– **Corruption.** The high level of corruption is present in all of the Western Balkan States (see graphs on governance). According to the World Bank, the degree of administrative corruption and state capture understood as unofficial private payments, gifts, or private benefits to public official in order to gain advantages in drafting of laws,

Table 10. Exports to the SEE market (million of \$)

	1993	1994	1995	1996	1997	1998	1999	2000	2001
Croatia	252	416	455	619	732	719	612	537	617
BiH	13	4	9	61	31	149	113	75	118
Albania	15	7	10	8	10	4	5	3	4
Serbia and Montenegro	0	0	0	0	0	1	0	0	1
Macedonia, FYR	74	58	57	85	94	87	83	84	96

Source: Antonis, Adam, *ibid.*, p. 25

regulations, etc. is one of the highest among all of post-communist states<sup>36</sup>. It does not only negatively influences the economic activity of the domestic actors in the region but reduces quantity and quality of FDI inflow. The above graphs on governance data presenting the highest degree of corruption control in Croatia prove this case. Foreign firms are less likely to engage in corrupt forms of influence on governmental bodies than their domestic counterparts<sup>37</sup>.

Most of the drawbacks can be successfully eliminated by the governmental policies, which should be successfully and visibly enforced. Some initiatives in this area have already started to take place. They include joint statement of the Western Balkans, Romanian, and Bulgarian Ministers of Economy issued at the first ministerial conference of the Stability Pact<sup>38</sup> held in July 2002 in Vienna. The ministers adopted the Declaration on "Attracting Investment to South East Europe: Common Principles and Best Practices" which related to the importance of the national treatment of the foreign investors and confirmed that the existing exceptions should be precisely formulated with a view of their elimination<sup>39</sup>. During the second conference ministerial conference held in June 2003, the Ministers have agreed to establish regional network of foreign investors' councils with an aim to develop business climate and to create a platform where the concrete proposal for the business environment improvement could be formulated. Additionally, they obliged their respective governments to remove in the upcoming years the existing obstacles hampering the investments in the following areas: reduction of

licensing and approval procedures; simplifying acquisition of real estates for the productive purposes; establishing more transparent laws, regulations and procedures; simplifying residence permit procedure for key personnel for investments; reducing unnecessary reporting requirements for the investors; and removing existing obstacles in the service sector. Furthermore, in June 2003, during the European Council in Thessaloniki, the Western Balkan countries endorsed the European Charter for Small Enterprises as an effort to reinforce business development and good practice in wider Europe<sup>40</sup>. What will be the outcome of these initiatives is still to observe however, the setting for the improvement of business conduct in the region has been created. The increase of the FDI depends largely on the willingness of the domestic governmental institutions to introduce the above-presented agenda.

## Regional cooperation and the role of the International Community

The ability to create regional cooperation is considered by the EU as a mean to demonstrate that the SEE states are capable of sustaining economic relations among each other and with the rest of the Europe. Yet, the countries of the South and Eastern Europe have failed to follow the path of the Central and Eastern Europe states, which created the Central Eastern European Trade Agreement (CEFTA) and the Baltic Free Trade Agreement Regional (BFTA).

Table 11. MoU Bilateral Free Trade Agreements (March 2003)

	Albania	BiH	Bulgaria	Croatia	Macedonia, FYR	Romania
BiH	Initialled					
Bulgaria	Initialled	Initialled				
Croatia	Signed	In Operation	CEFTA			
Macedonia, FYR	In Operation	In Operation	In Operation	In Operation		
Romania	Signed	Initialled	CEFTA	In Operation	Signed	
Serbia and Montenegro	Initialled	In Operation	Initialled	Signed	In Operation	Initialled

Source: Antonis, Adam, *ibid.*, p. 26

The cooperation between the SEE countries has been rather disappointing in the last decade (see Table 10). It is still hindered by the remnant of the war, such as restrictive trade regimes, each with their own tariffs schedule, and border controls<sup>41</sup>. However, more importantly, it has shown deficit of political will of the local institutions and state bodies. It is the international bodies such as the European Union, which are the main actors behind the attempts to integrate the region, and not the local politicians. The domestic players are mainly involved in following Brussels' instructions. Their present contribution to the regional integration process is insufficient for its successful execution.

The local politicians tend to believe that the treatment of the whole region as a trading block could postpone the ultimate goal of joining the EU. If the SEE would be treated as a one group, progress might move at a slower pace adjusted to the least developed country. All states are interested in increasing bilateral relations with the EU however, are reluctant to consider multilateral approaches. Regrettably, cooperation with less developed countries is considered as potentially harmful as it might minimise the chances to integrate with the EU<sup>42</sup>.

## The role of the EU in the regional development process

During the second half of 1990s various initiatives were undertaken by the International Community in order to assist the SEE countries to revitalize the regional cooperation within the Western Balkan region. However, projects such as the Conference on the Good Neighbourliness, Stability, Security and Cooperation in SEE (CSEE), the Royaumont Process, the South East European Cooperation Initiative (SECI) did not lead to any substantial results not only due to the fact that they have been imposed from outside but more importantly because most of the programs were not comprehensive enough.

The most recent initiative "The Stability Pact" has been introduced in June 1999 by the European Union and the World Bank together with the SEE countries governments and has been considered as one of the most successful EU programmes to

date. One of the aims of the Stability Pact has been the implementation of trade liberalization between the SEE countries. It has envisaged two-stage process. During the first stage the participating countries were to eliminate the administrative barriers to trade, put standstill on any measures to restrict trade, and reduce trade barriers towards each other. During the second phase, the countries were to enter into the World Trade Organization and establish a free trade area in the region, thus create the market up to 55 million consumers. The Stability Pact has additionally established the Working Table on Trade Liberalization and Facilitation, which has been given the responsibility for regional economic cooperation<sup>43</sup>.

Yet, instead of quick creation of free trade area, the participating countries decided to sign on June 21, 2001 the Memorandum of Understanding<sup>44</sup> (MoU), which has established a network of limited bilateral relations<sup>45</sup>. This complicated "two-sided" approach was influenced by the lack of political consensus between the SEE states on the formation of free trade area and economic differences in the level of development of each of the countries. The MoU set a target date of December 2002 to finish the work on all the agreements. In March 2003, out of 21 potential agreements eight were operational (see Table 11). In case of the agreements, which are still not in force, tariffs on many items have been already lowered or abolished. However, poor coordination procedures of these agreements, which introduced different products preferences and rules of origin for participating parties has been hindering the creation of effective free trade in the SEE area<sup>46</sup>.

## Criticism of International Community

The proximity of the Western Balkan to the EU countries and danger of the another conflict eruption on the borders of the Western Europe caused an excessive inflow of assistance policies to the states of ex-Yugoslavia and Albania. As a consequence the countries of the region have become a "trial zone" for policies of the International Community. The major actors being active in the area of the economic reconstruction of the region has been the Office of the High Represen-

tative (present only in Bosnia and Herzegovina), the World Bank, the European Bank for Reconstruction and Development, the International Monetary Fund, and various institutions of the European Union. The impact of their presence has been widely discussed among the region however with shadow of criticism. Various studies has shown that certain policies of the international organisations are sometimes self excluding and based on competition among each other and not on cooperation. There have been policy coordination problems. There is still no clear division of responsibilities between the international organisation especially in the field of bank restructuring where the EU, the EBRD, the World Bank and the IMF are all involved. Yet, the general criticism has been focused on the lack of consistency of the International Community and treatment of these countries as transition rather than developing states. The issues such as de-industrialization, institutional degradation, and corruption eruption have not been treated as vital<sup>47</sup>.

Yet, the biggest criticism has been directed toward the role and activities of the European Union, which for nearly five years after the end of the armed conflict failed to develop comprehensive strategy towards the newly established states in the region. The EU early policies directed at the Western Balkan states were criticised for the lack of unified strategy. Differential treatment of the individual SEE states and implementation of more or less favourable policies towards some of the states with respect to others, have had a direct impact on their economic performance and transition process<sup>48</sup>.

It was only since the Stability Pact has been implemented and the Stabilisation and Associate Process have been introduced, the EU has managed to rebuild its role as an important “player”. Nevertheless, the critics of the EU’s approach have been paying attention to lack of commitment from the Western Europe. Even the enormous financial aid programme for the Western Balkan states “CARDS” which was launched in 2001 and is to run to 2006 with a budget of 4.65 billion<sup>49</sup> euro has not managed to stop the criticism. The promise of the prospective EU membership stated to Western Balkan states at the Thessalonica European Council in 2003 has been put on hold with no specified timeframe for further actions. All countries, except for Croatia, which will pro-

bably join the EU before 2010, have no clear road map for the future steps towards the EU membership. Of course the EU has put down the requirements, which needs to be fulfilled before the countries can apply for a candidate country status however, it has also noted on many occasions the financial burden connected with the already upcoming enlargement (Bulgaria, Romania). Moreover, as a part of the EU strategy, each country should go first through the Stabilisation and Association Process which is to be followed by the accession process determined by individual capacity to join the EU. At the same time the EU addresses the structural economic problems of the region by treating these states as one body<sup>50</sup>. Thus, the current picture of the Western Balkan countries, of which many are still not self-sufficient, as a part of the EU remains to be blurred. There have been several policy recommendations for the EU in regards to the discussed region, which should be taken into consideration. Among many, the one proposed by the European Stability Initiative (ESI) deserves attention as it tries to unite the region with the EU in the most effective way. The ESI experts believe that the EU should treat the Western Balkan states as it did Turkey in the period 2001–2004. From 2001 Turkey was dealt with as an accession country, even though the official decision to start negotiations was made in 2004. Treating the Western Balkan states as pre-accession countries without the obligations to open negotiations until they are fit to do so, would resolve a number of tensions within the present EU strategy:

- it would prevent the region from falling into further backwardness. Allowing them to access to the pre-accession financial aid would let them to develop institutional tools needed for intensified regional development. At the same time it would assure them with technical and financial assistance.

- It would eliminate new divisions within the region. Current status of Croatia as a candidate country creates further partition of the region.

- It would strengthen reform process and governance capacity in the region as it would give incentives to the domestic governmental bodies to carry out regional development programmes and mobilise domestic resources through the principle of co-financing<sup>51</sup>.



An additional issue, which needs to be raised towards the EU and International Community is the effect of their presence on the institutional development of the Western Balkan states. Especially in countries with weak constitutional framework such as Bosnia and Herzegovina and Serbia and Montenegro, the International Community has unfortunately contributed to state weaknesses.

Their presence has trapped these countries in a vicious cycle of limited institutional development. The International Community, which in practise is a parallel governmental structure not accountable to the constitution, has in many cases took over responsibility of the state in providing many basic public services which the local government was either not capable or not willing to provide<sup>52</sup>. Moreover, as in the case of Bosnia and Herzegovina, where the Office of the High Representative has the ultimate power to remove politicians from their office, the governmental bodies are reluctant to take any decisions. Therefore, the proposal of the ESI which would enhance the development of the institutional framework and strengthen the role of the central governments, perhaps would result in reduction of International Community presence and allow these countries to create effective states by taking over the responsibility.

## End remarks

The economic development of the Western Balkan states' is without a doubt connected with the armed conflict of the 1990s, socialist past, complicated constitutional arrangements in some of the states, limited presence of strong institutions and deficit of good governance. These drawbacks are all reflected in the economic indicators and growth rates. Nevertheless, these obstacles need to be removed by the Western Balkan countries themselves. The solutions to these problems cannot be imposed from the outside as they will have little chance for success. Yet, the future of the region in economic as well as in political terms is currently influenced by the policies of the international actors, which are active in the region. The EU has an enormous responsibility to guide these states into the full EU membership. Without this clear perspective, the Western

Balkans will stay in its economic backwardness regardless of the financial assistance programmes transferred to the region. There is a big difference in being regarded as the future member and "maybe one day" member. The future members have the incentives to implement reforms, "maybe one day members" are disappointed and reluctant to change.

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- <sup>1</sup> For the purpose of this paper the following countries are considered as the Western Balkans: Croatia, Former Yugoslav Republic of Macedonia, Serbia and Montenegro, Bosnia and Herzegovina (BiH), and Albania.
- <sup>2</sup> Also known as the South Eastern Europe region (SEE).
- <sup>3</sup> Economies in Transition/Eastern Europe and former Soviet Union Regional Overview, *The Economist Intelligence Unit*, March 2003, p. 23.
- <sup>4</sup> Governance and Democracy in Bosnia and Herzegovina, Post-Industrial Society and the Authoritarian Temptation, European Stability Initiative, 2004, p. 3.
- <sup>5</sup> The reliability of the statistics from the Western Balkan region remains low and numbers should be interpreted cautiously. Depending on the data available, the economic indicators are presented in this paper either in US dollars or euro.
- <sup>6</sup> It must be noted that Albania has started from much lower level than the other countries in the region.
- <sup>7</sup> Building Market Institution in South Eastern Europe, Comparative Prospects for Investment and Private Sector Development, The International Bank for Reconstruction and Development/The World Bank, 2004, p.xxi.
- <sup>8</sup> Altmann Franz-Lothar, Regional economic problems and prospects, in Batt Judy (ed.), *The Western Balkans: Moving on, Chailot Paper*, No 70, Institute for Security Studies, Paris, October 2004, pp. 69–70.
- <sup>9</sup> The average GDP *per capita* in Central and Eastern Europe totals to 6000 euros. The Stabilisation and Association Report for South East Europe, Third Annual Report, Commission of the European Communities, Brussels, 30.03.2004, p. 16.
- <sup>10</sup> Altmann Franz-Lothar, *ibid.*, pp. 69–70.
- <sup>11</sup> Building Market Institution in South Eastern Europe, *ibid.*, p. 89.
- <sup>12</sup> Sanfley Peter, *ibid.*, p. 7.
- <sup>13</sup> Causevic, Fikret. “Employment and Privatisation”. Papic, Zarko. (eds). “International Support Policies to South-East European Countries, Lessons (Not) Learned in BiH”, Mueller: Sarajevo, 2002, p. 18.
- <sup>14</sup> Horvat Verdan, Brain Drain. Threat to Successful Transition in South East Europe?, *Southeast European Politics*, Vol. V, No. 1, June 2004, p. 77.
- <sup>15</sup> The Stabilisation and Association Report for South East Europe, *ibid.*, p. 17.
- <sup>16</sup> Horvat Verdan, *ibid.*, p. 81.
- <sup>17</sup> Building Market Institution in South Eastern Europe, *ibid.*, p. 92.
- <sup>18</sup> *Ibid.*, p. 12.
- <sup>19</sup> The Stabilisation and Association Report for South East Europe, *ibid.*, p. 18.
- <sup>20</sup> Altmann Franz-Lothar, *ibid.*, pp. 71–73.
- <sup>21</sup> Basis for the development of grey economy can be found in the armed conflict in the territory of ex-Yugoslavia, the Greek embargo towards Macedonia, weak custom administration, and difficulties in institution building process. *Ibid.*
- <sup>22</sup> For more on the certain aspects of regional illegal trade in the Western Balkans see: Cross Border Trafficking in South Eastern Europe – assessing trafficking activities in the South Adriatic region, SEESAC/South Eastern Europe Clearinghouse for the Control of Small Arms and Light Weapons, 2003.
- <sup>23</sup> The Stabilisation and Association Report for South East Europe, *ibid.*, p. 32.
- <sup>24</sup> Building Market Institution in South Eastern Europe, *ibid.*, p. 12.
- <sup>25</sup> Council Regulation (EC) 2007/2000 of September 18, 2000, amended by Council Regulation (EC) no. 2563/2000 and 2487/2001.
- <sup>26</sup> For more on Stabilisation and Association Process see the EU Commission External Relations website: [http://europa.eu.int/comm/external\\_relations](http://europa.eu.int/comm/external_relations)
- <sup>27</sup> In the case of Poland, which signed the Association Agreement in 1992 (entered in force in 1994), EU agreed on the full trade liberalisation only from 01/01/1998.
- <sup>28</sup> For more information regarding the EU requirements in this area see: “Guide to the Implementation of Directives Based on New Approach and Global Approach” published by the European Commission, available at: <http://europa.eu.int/comm/enterprise/newapproach/legislation/guide/legislation.htm>
- <sup>29</sup> The awareness of the existing trade measures still remains at the low level in the region. In addition, the limited willingness of the local governmental bodies to provide its citizens with necessary trading information does not contribute to the possible export growth. The Stabilisation and Association Report for South East Europe, *ibid.*, p. 33.
- <sup>30</sup> “World Investment Directory: Central and Eastern Europe”, Volume III, United Nations, 2003, p.10, United Nations Conference on Trade and Development, <http://www.unctad.org>
- <sup>31</sup> Landes David, Does it Pay to be Late?, Jean Batou (eds.). “Between Development and Underdevelopment”. Geneva: Publications du Centre D’Histoire Economique Internationale de L’Universite de Geneve, 1991, pp. 43. For more about the importance of the functioning State institutions on the economic development of a country see: Mancur, Olson Jr., Big Bills Left on the Sidewalk: Why some Nations are Rich, and Others Poor. *Journal of Economic Perspectives*, No. 2, Vol. 10, Spring 1999.
- <sup>32</sup> Zakharov, Vladimir. Kusic, Sinisa. “The Role of FDI in EU Accession Process: The Case of Western Balkans”. European Trade Study Group (ETSG), Paper presented during the ETSG Conference, 11–13.09.2003, Madrid, p. 3, The ETSG website, <http://www.etsg.org/ETSG2002/papers/adam.pdf>
- <sup>33</sup> There are clear indicators that the placement of the investments is connected with the ethnical division of the country (as in the case of the Arabic countries’ investments only in the Federation of Bosnia and Herzegovina inhabited by the Muslim population), what might not always correspond to the best resources allocation.
- <sup>34</sup> Building Market Institution in South Eastern Europe, *ibid.*, p. xxv.
- <sup>35</sup> Building Market Institution in South Eastern Europe, *ibid.*, p. xxii-xxxix.
- <sup>36</sup> Grey Cheryl, Hellman Joel, Ryterman Randi, Anticorruption in Transition 2, Corruption in Enterprise-State Interactions in Europe and Central Asia 1999–2002, The International Bank for Reconstruction and Development/The World Bank, 2004, p. 24.
- <sup>37</sup> Hellman S. Joel, Jones Geraint, Kaufmann Daniel, Far From Home: Do Foreign Investors Import Higher Standards of

Governance in Transition Economies, World Bank Institute, p. 4 [www.worldbank.org/governance/pdf/fafromhome.pdf](http://www.worldbank.org/governance/pdf/fafromhome.pdf)

<sup>38</sup> For more about Stability Pact see section “The role of the EU in the regional development process”.

<sup>39</sup> National Treatment of International Investment in South East European Countries: Measures providing Exceptions, Organisation for Economic Co-Operation and Development, 2003, p. 11.

<sup>40</sup> Building Market Institution in South Eastern Europe, *ibid.*, p. 41–42.

<sup>41</sup> Antonis, Adam, Kosma, S. Thodora, Mchugh, Jimmy. “Trade Liberalization Strategies: What Could South Eastern Europe Learn From CEFTA and BFTA” European Trade Study Group (ETSG), Paper presented during the ETSG Conference, 11–13.09.2003, Madrid, p. 3, The ETSG website, <http://www.etsg.org/ETSG2002/papers/adam.pdf>

<sup>42</sup> Choromides Constantinos, The Challenges and Prospects of South Eastern Europe Towards regional and European Integration: An Approach for Development, Peace, and Security in South Eastern Europe, Peace and Conflict Development, Issue 5, July 2004, p. 10–11, [www.peacestudiesjournal.org.uk](http://www.peacestudiesjournal.org.uk)

<sup>43</sup> More about Stability Pact: see the Official website of Special Co-Coordinator of the Stability Pact for South Eastern Europe, <http://www.stabilitypact.org>

<sup>44</sup> Signed by Albania, BiH, Bulgaria, Croatia, Macedonia, Romania, Serbia and Montenegro, and Moldova.

<sup>45</sup> Antonis, Adam, *ibid.*, p. 7.

<sup>46</sup> Michalopoulos, Constantine., *ibid.*, p. 12.

<sup>47</sup> Welfens Paul J.J., Stabilizing and Integrating the Balkans, Springer Verlag, Berlin 2001, p. 59–104.

<sup>48</sup> Uvalic, Milica, Regional Cooperation and Economic Integration in South-Eastern Europe, Economic and Social Research Council, 2000, p. 8, <http://www.one-europe.ac.uk/events/2000/conference/Uvalicpaper.pdf>

<sup>49</sup> Bechev Dimitar, Andreev Svetlozar, Top-Down vs. Bottom-Up of the Institution Building Strategies in the Western Balkans, South East European Programme, Occasional Paper no. 3/05, p. 14.

<sup>50</sup> The Road to Thessalonica: Cohesion and the Western Balkans, European Stability Initiative, Berlin, March 12, 2003, p. 9.

<sup>51</sup> *Ibid.*, pp. 9–10.

<sup>52</sup> The Balkans in Europe’s Future, International Commission on the Balkans, Center for Liberal Studies, Sofia, p. 16.

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