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**The Kosovo Crisis
and the Balkans:
Background,
Consequences,
Costs and
Prospects**

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The analysis of economic developments in the Balkan region has been an important topic of research in the Vienna Institute's activities throughout the years. The most recent publications in this field are:

J. Pöschl: Bosnia and Herzegovina: New Hope for Economic and Political Progress. *WIIW Current Analyses and Country Profiles* No. 11, May 1998

V. Gligorov and H. Vidovic (eds.): The Economies of the Successor States of Former Yugoslavia. *WIIW Research Report* No. 250, October 1998

V. Gligorov and N. Sundström: The Costs of the Kosovo Crisis. *WIIW Current Analyses and Country Profiles* No. 12, April 1999

Short country surveys and forecasts based on data for the first quarter 1999, all published in *WIIW Research Report* No. 257, June 1999:

- Bulgaria: War in Yugoslavia adds to mounting economic strain
- Croatia: Entering recession
- Macedonia: Stability under threat
- Romania: Overcoming the payments crisis, but remaining in depression
- FR Yugoslavia: At the dead end

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General Introduction

The four papers collected here treat the economic development of Yugoslavia (Serbia and Montenegro) and of the so-called Western Balkans, the issues of regional trade and investments in the Balkans and some of the political and economic aspects of the Kosovo crisis. Mostly the developments in the second half of the nineties are covered, though there are some references to the economic history of the Balkans and of South-East Europe.

In 'The Economy of the Federal Republic of Yugoslavia' the peculiar economic system of that country is described and an account of its performance is given. The key feature of the Yugoslav economic policy in the nineties was the strategy designed to avoid transition or transformation. Because of the lack of reforms and because of the wars in Croatia and Bosnia and Herzegovina, the economic performance of Yugoslavia was characterized by low growth and persistent macroeconomic imbalances.

In 'Trade and Investment in the Balkans' it is argued that the regional integration is rather low, while the integration with the European Union is quite significant. This fact has repercussions for the regional policy of the European Union especially in view of the increased awareness that a more ambitious and a more comprehensive policy towards the region should be adopted.

In 'Patterns of Divergence in the Western Balkans' the recent development of the countries of the so-called Western Balkans (Croatia, Bosnia and Herzegovina, Yugoslavia, Macedonia and Albania) is put into the context of the longer-term Balkan development. Relying on the idea of Gerschenkron's about the agents of the economic spur in backward countries or regions, it is argued that neither the local entrepreneurs, nor the banks, nor the states could play that role and that perhaps the only alternative left is to rely on the foreign entrepreneurs to provide for the major impetus to investment and growth in the region. In view of that, the paper provides an overview of privatization programmes and possibilities in the region, country by country (except for Albania).

Finally, in 'The Kosovo Crisis: Consequences, Costs and Prospects' a brief treatment of the political and economic consequences of the war in Kosovo on the affected countries is presented. The key point made is that the existing political and security arrangement can support the reconstruction of Kosovo but not the reconstruction of Yugoslavia as a whole but in all probability cannot support the recovery either of Kosovo nor of the region as a whole.

Vladimir Gligorov

The Economy of the Federal Republic of Yugoslavia *

1 Introduction

The economic development of the Federal Republic of Yugoslavia can be characterized as almost catastrophic. Gross social product (GSP) at the end of 1997 was less than 50% of that in 1989, industrial production just above 40%. The rate of registered unemployment was close to 26%. Average yearly inflation was about 22%. The trade deficit reached over USD 2.4 bn in 1997 (more than 15% of the officially estimated GSP). More importantly, the country is still not accepted as a full member of the international community and has done little to transform its economy from a socialist to a market one. Indeed, one can characterize its strategy as that of *side-stepping the transformation*. How this came to be the case will not be discussed extensively here, though some background information will be provided in the next section.¹⁾ More will be said about the current situation and about the choices and dilemmas that the Yugoslav government is facing.

A general characterization of the current, 1998, situation can look as follows: Expectations of speedy improvement following the suspension (in December 1995) of the EU- and UN-imposed sanctions (imposed in May 1992 and May 1993 respectively) have been disappointed. The government has been reluctant to undertake the necessary reforms and this has led to a steady rise in tensions amidst worsening economic circumstances. Indeed, after the November 1996 general elections, a deep political crisis erupted with mass demonstrations lasting almost three months. Political tensions and conflicts have continued to characterize public life in anticipation and in the aftermath of the presidential and parliamentary elections in Serbia that took place in the second half of 1997. As a consequence of the lax monetary policy followed by the central bank in order to ensure the desired election results, inflation has started to rise again and the growing disequilibria had to be corrected through a devaluation of the national currency. During this whole period and especially now the country has been facing the following general economic policy dilemma: *hyperinflation or transformational recession or both*. Indeed, more generally considered, everything is at stake: (i) the constitution, (ii) international relations, (iii) privatization, (iv) stabilization, (v) liberalization, (vi) restructuring, and (vii) social welfare. These issues will be discussed in turn after some background facts have been reviewed.

* Written in April 1998.

¹ For more on that see V. Gligorov, *Why Do Countries Break Up? The Case of Yugoslavia*, Uppsala: Acta Universitatis Upsaliensis, 1994.

2 Some background information

The Federal Republic of Yugoslavia emerged from the break-up of the Socialist Federal Republic of Yugoslavia in 1991 and 1992. The latter was a federation of Slovenia, Croatia, Bosnia & Herzegovina, Macedonia, Serbia, and Montenegro. After the former four states had proclaimed their independence, the latter two (Serbia and Montenegro) formed a federation in 1992. The economic and political developments of the new state in the last five years were dominated by the wars in Croatia and Bosnia & Herzegovina, by the international isolation due to the imposition of sanctions by the EU and the UN, and by the internal political tensions due to the unsolved problem with the Kosovo province (a province in Serbia mainly populated by ethnic Albanians) and due to the lack of democratization. The legacy of the wars is the large number of refugees from Croatia and Bosnia & Herzegovina (more than half a million) living in Yugoslavia, the loss of ethnic territories in Croatia, and the creation of the Serbian Republic in Bosnia & Herzegovina that has special relations with Serbia and Yugoslavia.²⁾ The legacy of the sanctions is a devastated and distorted economy still facing the most fundamental dilemmas of post-socialist transformation. Finally, the lack of democratization and the persistence of near-apartheid in Kosovo put pressure on the political options in Yugoslavia. These developments contribute to the persistent external and internal problems that Yugoslavia is facing.

The major political developments in Yugoslavia are unlike those that are to be found in most of the transition economies. The fundamental political preferences were arrived at in the mid-1980s, while the former country was still in existence, and combined four main elements:³⁾

- the preponderance of the Serbian interest over that of the former federation and of the new federation (nationalism);
- the strategic reliance on the alliance with Russia (anti-westernization);
- the reliance on political continuity (authoritarianism);
- the policy of economic inertia (non-reformism).

These political preferences have guided Yugoslavia's political behaviour. They are still dominating the political scene especially in Serbia. A process of erosion as well as of disillusion is going on, but a change in the main outlook is yet to happen.

The economic developments have been determined by the decision not to reform. Indeed, as the economy of former Yugoslavia was more open and more market-

² The 'Agreement on the special parallel relations between the Federal Republic of Yugoslavia and the Republika Srpska' was signed 28 February 1997 and then ratified in the parliaments of Yugoslavia and Republika Srpska. It is yet to be ratified by the parliament of Bosnia & Herzegovina as required by the agreement.

³ For more on that see V. Gligorov, 'Fears and Passions: The Prospects of Former Yugoslavia', in Z. Bogetiè (ed.), *The Cost of War in Former Yugoslavia*, Paris: Peace and Crises Management Foundation, 1996: 82-94.

oriented than most other socialist economies, the economic policy and institutional development pursued by the Yugoslav government can be seen as moving into a retrograde direction. The main features can be summarized thus:

- elimination of local autonomy in the provinces, counties and towns (centralization);
- reintroduction of state ownership and intervention (nationalization);
- reliance on managed trade and prices (anti-liberalization);
- reliance on inflationary taxation and redistribution of resources (anti-stabilization);
- reliance on the coloured and black markets (corruption).

These economic policies have not been changed yet. They have contributed significantly to the overall economic and social developments in Yugoslavia. Indeed, the country has been facing the same policy and institutional dilemmas for almost a decade now. Remarkably, with all the very negative economic developments, support for reform is yet to appear, take root and gain strength.

It is difficult to give a brief characterization of the overall political and economic developments in the past decade or so in Yugoslavia (Serbia and Montenegro). Some of the most basic political events and outcomes can be summarized by simply pointing out the fact that the same parties and the same individuals have been in power since the mid-eighties. Yugoslavia is the one clear case of political continuity in the post-socialist world. This continuity was secured by the mass political support for the political and economic strategy outlined above. This has legitimized the Communist-turned Socialist Party and its leader Mr. Slobodan Milosevic, who now holds the post of the president of Yugoslavia. He and his Socialist Party have succeeded in winning in a number of elections since 1990. Their support has been eroding over the years, but has yet to be seriously challenged.

The main economic developments are summarized in Table 1.⁴⁾ Another way to represent the economic developments in Yugoslavia is by way of Figure 1. It is noticeable that Yugoslavia went through two episodes of hyperinflation (in 1989 and 1993), developed extraordinary budget deficits during the years of the most intense war in Bosnia & Herzegovina (1992 and 1993), ran persistent current account deficits and experienced a huge fall in the GSP. Indeed, with budget and current account deficits growing, the fragile GSP recovery and price stability are under combined recessionary and inflationary pressures practically all the time.

⁴ All figures in this and the subsequent tables are from official statistical sources, unless otherwise stated.

Table 1

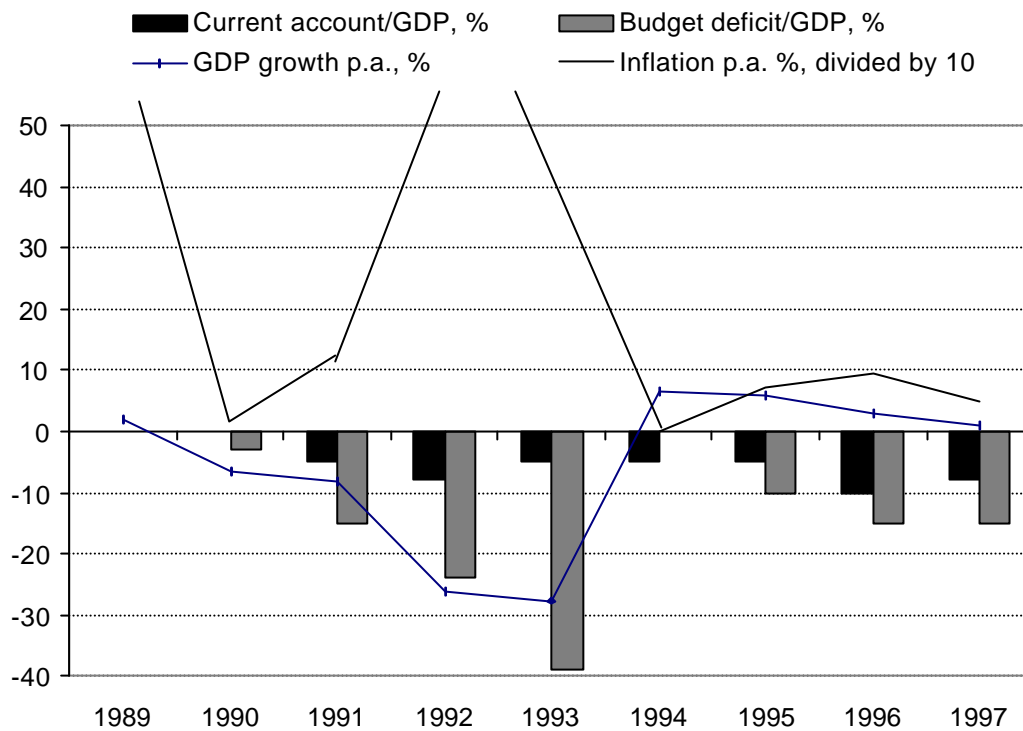
FR Yugoslavia: Selected economic indicators

	1990	1991	1992	1993	1994	1995	1996	1997 ¹⁾	1998	1999 forecast
Population, th pers., mid-year	10529	10409	10448	10482	10516	10547	10577	10597	.	.
Gross domestic product, USD mn	26590	24660	18140	13340	14570	15910	16340	18500	13700	14100
annual change in % (real) ²⁾	-7.9	-11.6	-27.9	-30.8	2.5	6.1	5.8	7.4	3	3
GDP/capita (USD at exchange rate)	2530	2370	1740	1270	1390	1510	1545	1455	.	.
Gross industrial production										
annual change in % (real)	-12	-18	-22	-37.3	1.3	3.8	7.5	9.5	3	3
Gross agricultural production										
annual change in % (real)	-6.9	9.3	-17.7	-3.7	5.9	4.0	1.3	5.0	3	3
Goods transport, th t-kms ³⁾	105.9	89.7	55.8	11.1	2.6	.	.	.	.	.
annual change in % ³⁾	-0.5	-15.3	-37.8	-80.0	-77.0	18	96	8	.	.
Gross fixed investment										
annual change in % (real)	.	-14.7	-29.9	-37.6	-12	-3.7	.	.	.	.
Construction output total										
annual change in % (real)	12	-10	-44	-43	46.9	1.1	5.3	14.0	.	.
Dwellings completed, units	44978	30496	25162	19405	17442	14337	13000	16030	.	.
annual change in %	-5.6	-32.2	-17.5	-22.9	-10.1	-17.8	-9.3	23.3	.	.
Employment total, th pers., average ⁴⁾	2707	2625	2536	2464	2413	2379	2367	2328	.	.
annual change in %	-3.0	-3.0	-3.4	-2.8	-2.1	-1.4	-0.5	-1.6	-5	.
Employees in industry, th pers., average	1067	992	940	915	894	870	852	820	.	.
annual change in %	-2.1	-7.0	-5.2	-2.7	-2.3	-2.7	-2.1	-3.8	.	.
Unemployed reg., th, period average	663.5	714.2	747.5	738.7	726.0	775.5	819.4	814.1	.	.
Unemployment rate in %, period av ⁵⁾	19.7	21.4	22.8	23.1	23.1	24.6	25.7	25.9	28	30
Average net monthly wages, YUN			119	45	140	291	545	803	.	.
annual change in % (real, net)	-22	-5	-49	.	329	16.4	-2.2	21.2	.	.
Retail trade turnover, YUN mn ⁶⁾					8481	14661	27896	.	.	.
annual change in % (real)	0.9	-1.5	-44.5	-35.9	70.1	4.5	7.5	2.0	.	.
Consumer prices, % p.a. ⁷⁾	580	122	8926	.	3	78.6	91.5	21.6	50	50
Producer prices in industry, % p.a.	468	124	8993	.	8	57.7	90.1	19.5	.	.
General government budget, YUN mn										
Revenues	.	.	.	.	9959	17974	35412	47787	.	.
Expenditures	.	.	.	.	9959	17974	35412	47787	.	.
Deficit (-) / surplus (+) ⁸⁾	0	0	0	0	.	.
Money supply, YUN mn, end of period										
M1, Money	.	.	.	.	2435	3256	5495	9148	.	.
M2, Money + quasi money	.	.	.	.	9832	27261	31513	39845	.	.
Discount rate % p.a., end of period	.	.	.	.	10	90.2	68.15	33.74	.	.
Current account, USD mn	-512	-536	-935	.	.	-500	-1317	-1400	-1000	-1000
Gross reserves of NB excl. gold USD mn	.	5460	2680	1980	200	300	300	300	.	.
Gross external debt, USD mn	.	.	.	.	9000	9000	9000	10500	.	.
Exports total, fob, USD mn	5816	4704	2539	.	.	.	1842	2368	.	.
annual change in %	.	-19.1	-46.0	.	.	.	.	28.6	.	.
Imports total, cif, USD mn	7460	5548	3859	.	.	.	4102	4799	.	.
annual change in %	.	-25.6	-30.4	.	.	.	.	17.0	.	.
Average exchange rate YUN/USD, official					1.5	2.4	4.97	5.72	12	18
Average exchange rate YUN/DEM, official					1.0	1.38	3.30	3.30	7	10

Notes: 1) Preliminary. - 2) Based on GMP in dinar. - 3) According to official incomplete reporting units, from 1995 excl. air transport. - 4) Employees total plus own-account workers. - 5) Ratio of unemployed to employed plus unemployed persons. - 6) Excluding catering. - 7) Costs of living index. In 1993 there was a hyperinflation, the inflation figure for 1994 is from March to December. - 8) Official data, that don't report budget deficit.

Source: WIIW Database incorporating national and international statistics.

Figure 1



So, the Yugoslav economy has had a rather turbulent past and has inherited significant fiscal and balance of payments disequilibria. Together with the institutional problems and constraints, these pretty vividly describe the enormous reform tasks that the country is facing and the serious political and social problems that those will bring.

3 State without borders

The break-up of the former Yugoslavia has left present-day Yugoslavia (Serbia and Montenegro) with key constitutional issues unresolved. They have been aggravated by the fact that the current constitutions of Serbia, Montenegro and Yugoslavia (not to mention the underground constitution of Kosovo) have been passed at different times and not amended afterwards to take care of the often glaring inconsistencies. Thus, to mention the issue of constitutional commitment first, the Serbian 1990 constitution (written when Serbia was still a part of former Yugoslavia) gives precedence to the Serbian laws over those of the federation, while the Montenegrin constitution, passed after the creation of the new state in 1992, gives precedence to the federal laws 'in the areas in which legal powers have been delegated to the federation'. Thus, constitutionally, Serbia can opt out, while Montenegro cannot. In fact, as the Serbian constitution refers to the non-existent former Yugoslav federation and does not refer in

any way to the new Yugoslav federation, it can be safely said that Serbia, unlike Montenegro, has no constitutional commitment whatsoever to the new federation.

The most fundamental constitutional ambiguity is the issue of territories. The current, 1992, Yugoslav constitution defines the state as a federation comprising Serbia and Montenegro. In addition, the current, 1990, Serbian constitution provides for two autonomous provinces, Vojvodina and Kosovo & Metohija (previously, Kosovo). Both constitutions provide for a possibility of other states and territories joining either Serbia or Yugoslavia. This rump state was created with the intention to serve as a nucleus of either new Yugoslavia or of greater Serbia. As a consequence, Yugoslavia's borders are perceived as subject to change. At the moment, it is still uncertain whether Yugoslavia (or Serbia) intend to take in eventually the Serbian Republic in Bosnia & Herzegovina.

However, Yugoslavia's internal borders are also clouded in uncertainty. The federation between Serbia and Montenegro is in many ways unstable, both states being highly independent from each other, and the federal institutions, except for the army, being essentially powerless (the federal parliament meets infrequently and the federal government has few responsibilities and even less instruments to implement them while the central bank is almost completely dependent on the will of the Yugoslav president). This has raised criticisms that the federation is rather a dysfunctional one and has fuelled fears of the possibility of it falling apart.

More importantly, there is the Kosovo problem. This province has proclaimed independence and has a shadow president of the Republic of Kosovo and a shadow government. The province's predominantly Albanian population (about 90%) does not take part in Serbian and Yugoslav elections and little communication exists between their representatives and those of the Yugoslav and Serbian governments. The Kosovo shadow government has been determined to achieve its goal, the creation of an independent state, through peaceful means and the province has remained mainly quiet despite the reportedly harsh police rule. However, recently, from spring 1996 onwards, there have been incidents of violent clashes in which a growing number of people have been killed. The general uncertainty has increased after the 1997 collapse of the political regime in Albania and in view of the recent (March 1998) underground parliamentary elections in Kosovo. Efforts have intensified to find a peaceful solution to the problem, but talks and negotiations between the two parties, Yugoslav and Serbian authorities and the Kosovo Albanian leadership, are yet to start.

The second unresolved basic constitutional issue is that of the separation and division of power. Constitutionally, Yugoslavia is both a federation and a democracy. In reality, it is neither. Serbia is in practically everything the senior partner that as a rule does not consult the junior partner, Montenegro, in almost anything. This disequilibrium has been aggravated after the election of Mr. Milosevic to the post of the president of Yugoslavia in

July 1997. His factual power significantly exceeds his constitutional responsibilities. Indeed, as the president of the Socialist Party of Serbia, he rules over Serbia. As the president of Yugoslavia, he controls the federal government, the army and the central bank. This concentration of power in the hands of one man severely distorts the spirit of the Yugoslav constitution which provides for a ceremonial president and for a highly federalized parliament and government that requires the consensus of the two federal units, Serbia and Montenegro, for any more significant decision to be taken. Because of such a huge gap between the *de facto* powers and *de jure* responsibilities, there are serious tensions between the two federal partners and there are widely shared expectations that Mr. Milosevic will attempt to change the current constitution to legalize and legitimize his actual authority.

Whichever way these issues are resolved, it does not seem as if Yugoslavia is a country that has, or can ever hope to have an equilibrium distribution of political and territorial power. On the one hand, the two states that form the Yugoslav federation, Serbia and Montenegro, are extremely unequal in economic and political power (Montenegro has a population of about 600,000, Serbia of about 10 million). This inequality does not lend itself to consistent federalization. Serbia will always feel that it does not make sense to divide the political power equally between so unequal partners, while Montenegro will for that very reason insist on strict equality in rights in the Yugoslav federation. On the other hand, there is hardly any constitutional arrangement, short of separation, that could be supported by the Kosovo Albanians. Due to these two causes of political disequilibrium, support will always exist in Serbia for a strong central authority. The real problem is how it is to be institutionalized, because it will also be fuelling resentment as it always has. The current solution, by which the president of Yugoslavia is that authority, may be actually more than the current distribution of power could stand. The country probably needs the federalist front (i.e. a formal equality of the two federal units and a *de facto* inequality of power and influence) that can be used for satisfying the more fundamental authoritarian preferences that are especially strong in Serbia. Also, the current coexistence of police and underground states in Kosovo may be just as much of domination and independence that both sides can live with. This accommodation could be gradually enlarged (as in the recent agreements on education) in order to preserve stability and to institutionalize somewhat the current *modus vivendi*. Any attempt to find 'the final solution' to the Kosovo problem may be much more than the fragile stability could support. The same is probably true for any attempt to find 'a final constitutional solution' for Yugoslavia as a whole. In other words, the solutions feasible to Yugoslavia are political rather than constitutional. Of course, it is not at all sure that there is still time left for political solutions.

4 Between East and West

The suspension, at the end of 1995, of the UN-imposed sanctions has put the issue of Yugoslavia's international, political and economic, relations on the agenda. Yugoslavia has still been left to face the so-called 'outer wall of sanctions' that ban the country from resuming its relations with the UN and most other international organizations as well as with the international financial institutions. The suspension of these sanctions too was widely expected to come soon after the 1996 and then after the 1997 elections in Serbia and Yugoslavia. That did not happen, however. In fact, due to the adverse developments in Kosovo it is clear that further integration of Yugoslavia will be delayed for an indefinite period of time.

What are the main integration issues that Yugoslavia is facing?

- First, there is the re-integration into the international political organizations. Yugoslavia's membership in the UN has been suspended. It is also not a member of any of the European organizations (for instance, the Council of Europe, the OSCE). In effect, it is a sort of an outcast country almost without precedence in current international political relations.
- Second, there is the issue of re-integration into the international financial and economic organizations. Of those, the most important is normalization of relations with the IMF and the World Bank. The initial obstacle to re-integration, apart from the 'outer wall of sanctions', was the demand by Yugoslavia to be treated as the sole successor to former Yugoslavia. However, this obstacle has been overcome now and Yugoslavia has accepted the division of the assets and liabilities with these institutions according to the quotas adopted by them in late 1992. The following table summarizes these quotas.

Table 2

Republic of Bosnia & Herzegovina	13.20%
Republic of Croatia	28.49%
Republic of Macedonia	5.40%
Republic of Slovenia	16.39%
Federal Republic of Yugoslavia	35.52%

With the application of a 35.52% quota, Yugoslavia owes the IMF about USD 120 mn US dollars (without arrears) and the World Bank about USD 1.2 bn (again without arrears). The re-integration into these institutions is in principle impossible without the debts being cleared. Even if that obstacle were to be surpassed, there would be the problem of drawing on the resources of these institutions because these loans would come with conditions attached that the Yugoslav authorities may not be ready to accept or honour.

- Third, the return of Yugoslavia to the financial markets depends on the clearing of its debts with the London and Paris Clubs of commercial and sovereign creditors. Those amount to about USD 2.5 bn to the London Club of commercial banks and to about USD 5.5 bn to the Paris Club of sovereign creditors (both figures are without the arrears). Negotiations with the Paris Club creditors cannot start because of the ‘outer wall of sanctions’, while those with the London Club broke off in the autumn of 1997 because the Yugoslav side asked for a large write-off (80%) and for a very long period of rescheduling.

The negotiations with the London Club opened up the issue whether Yugoslavia really wants to re-integrate if that means that it would have to honour its financial obligations. The terms it offered were such that they almost implied a negative answer. They could be interpreted as implying that Yugoslavia is interested in returning to the financial markets if its accumulated obligations are practically written off, otherwise not.

The same ambiguity surrounds Yugoslavia’s negotiations with the other successor states about the distribution of the assets and liabilities of the former common state. Though these negotiations are understandably complicated and protracted, the behaviour of the Yugoslav delegation almost implies a preference for the *status quo* over most of the feasible agreements.

The reasons for the lack of enthusiasm on the part of Yugoslavia to re-integrate come down to the following list.

- First, Yugoslavia would rather not honour its financial as well as other economic and political obligations.
- Second, it would rather hold on to the assets of the former Yugoslavia that it controls. Those comprise embassies and other real estate abroad, documents, financial assets of the former common central bank (gold reserves with the BIS in Basle estimated at about USD 600 mn and foreign currency reserves estimated to be between USD 2-4.5 bn depending on what date is taken to represent the dissolution of the common state), and debt owed to former Yugoslavia (by the Soviet Union, i.e. Russia, and by countries like Iraq, Libya and a number of others). The latter may have already been spent thus increasing the overall debt rather than assets.
- Third, Yugoslav leaders show no interest in accelerating the process of transformation that they would certainly have to if Yugoslavia were to re-enter the international financial institutions and the financial market.
- Finally, fourth and most importantly, Yugoslavia has emerged as a country that is not sure where it would want to go. Its economic interests are split between strong trade and monetary dependence on the EU and significant interests in doing business with the East, especially with Russia. Indeed, there is a disequilibrium in

that. Liberalization and integration would strengthen the influence of the EU on the Yugoslav economy, while most of the ministers in the Serbian and Yugoslav governments have significant business interests in trade and financial dealings with Russia.

Because of all that, the current Yugoslav foreign policy follows a strategy of being somewhere between West and East. This strategy is similar to the one that was followed previously by Josip Broz Tito, in very different circumstances, however. The current Yugoslav policy depends on some kind of long-term competition between the EU and Russia emerging in the Balkans. Though this is a highly unrealistic strategy, it coincides with some strong public preferences and with some temporary economic interests.

5 Efficiency and justice

Starting in mid-1995, privatization has become one of the most discussed issues. However, the process itself has not progressed all that much as can be seen from the following tables.

Table 3

Ownership structure of the Yugoslav economy and contribution to GSP

	Structure		Contribution	
	XII/1994	XII/1996	XII/1994	XII/1996
Public	60.6	56.8	40.7	37.1
Mixed	27.9	31.3	25.8	24.1
Co-operative	2.0	1.5	1.3	0.9
Private	9.5	10.5	32.2	37.9

Table 4

Structure of employed according to type of ownership

end of 1996, % of total

	Yugoslavia	Serbia	Montenegro
Social	83.82	84.34	76.44
Private	13.28	13.12	15.53
Mixed	2.90	2.54	8.04

The increase in the contribution of the private sector to the GSP has mainly been due to the collapse of the state sector and especially of industry. Whatever growth of private business has taken place is mainly in small and medium-sized newly opened private

firms, first of all in the services sector. Privatized firms play quite an insignificant part in that.

The whole debate on privatization in Yugoslavia has centred around two issues: efficiency and justice.

From the efficiency point of view, the main argument of the ruling Socialist Party has been that privatization should proceed via the market and should not be mandated to the firms and enterprises. This led to the adoption of the rule of equal rights of all forms of property in the Serbian and then Yugoslav constitutions rather than to the norm of protection of private property that is more often to be found in other transitional states and economies. This constitutional principle has constrained all the privatization laws that have followed. This principle has been argued for on efficiency grounds: those forms of ownership should emerge that could survive the competition in the markets.

However, the public accepted it more on grounds of justice. Most people in Yugoslavia believe that the firms they work in belong to them and not to anybody else. Thus, like in the other former Yugoslavia states, insider privatization is preferable to any other. In a number of laws that were passed in the Yugoslav and Serbian parliaments (most notably in May 1996 in the Yugoslav parliament and in July 1997 in the Serbian parliament) this sense of justice has been recognized and insiders were given preferential treatment to all the other potential investors. However, even in that case, no obligation was legislated and no dates were set. Because of that, these laws have had next to no consequences on the privatization process. In fact, most of the employees see no reason to privatize the firm in which they already have all the rights of the actual owners. Privatization would most probably change the position of the majority for the worse because they would exchange their shared ownership over the whole firm for a private ownership of a possibly very small part of that same firm.

For these two reasons, no progress has been achieved in privatization in Yugoslavia. There are some indications that this may change, but that would require a change in the existing legislation as well as a change in the general feeling about foreign investment participation – because that is where the money could come from, the domestic resources being largely exhausted.

6 Foreign investment

The law on privatization passed by the federal parliament on 14 May 1996 has shown no effects so far. The same is true for the law on privatization in the Serbian parliament in the summer of 1997. This is not altogether related to the foreign investment legislation because the law on foreign investment that was adopted in the spring of 1996

gives some significant possibilities for foreign investment. However, the high level of political and other risks impede larger inflows of foreign capital.

From the legal point of view, there are few restrictions on foreign investment in the majority of sectors of the economy. Also, the share of foreign participation is not legally restricted to any share of firms' capital or equity. In principle, foreigners can own 100% in almost every sector. In addition, repatriation of profits is not restricted and the tax on corporate profits is put at 30%, that is not much higher than in other countries in transition.

However, legal efficiency in Yugoslavia is not very high. Very often, also, there are legal provisions that contradict those in the respective law. Some of these provisions can even be secret and known only to the officials in the respective ministries or other government institutions.

The situation being as it is, experience is more important than the laws. The major foreign investment experience is provided by the sale of the Serbian Telecom in spring 1997. The contract was signed after slightly more than six months of negotiations between the prospective buyers and the state with the mediation of the British investment bank NatWest Markets. The deal was struck with little publicity. Indeed, the public still complains that the contract was never made public. The necessary legal adjustments were speeded up through the Serbian parliament without much discussion. The transfer of 49% ownership of the Telecom to an Italian firm (STET, 29%) and a Greek firm (OTE, 20%) as well as the transfer of the money, actually of the first part amounting to about DEM 1.2 bn, took place in June 1997. The rest, somewhat more than DEM 300 mn, was supposed to be paid in early January 1998. It is unclear at this point when and how that payment was made. Indeed, the use of all of the money is clouded in secrecy. It was to have been paid to the Development Fund that was set up for that purpose. The members of the board of directors included most of the ministers of the Serbian government, including the prime-minister, who are also directors of owners of firms and enterprises dealing mainly in foreign trade. Much of the money was to be used to stimulate exports with low interest foreign currency loans. In addition, much of the money was to be used for clearing of the arrears in pensions and wages (about DEM 700 mn). Some of these arrears were indeed cleared and both wages and pensions were raised significantly in August and September. The reason was that September and, as it proved, the whole autumn was election period. The government practically doubled the money supply in that period to buy these elections. It eventually succeeded.

In that same period the new law on privatization was passed. In that law, the government set aside 75 major firms and companies for sale under a government-led programme of privatization. The common understanding was that the government

intended to proceed with selling off to foreigners state-owned property in the same way and with the same aims as it did with the Serbian Telecom. However, the law was unclear enough for the process not to proceed quickly and the backlash of the Telecom privatization was unfavourable, because the public was unclear about the actual intentions of the government and thus the general uncertainty increased significantly. In any case, the developments in Kosovo at the end of 1997 and the beginning of 1998 worsened the political and every other risk in Yugoslavia so that the planned sales to the foreign investors, that were targeted at a level of about USD 1.5 bn for 1998, look quite unrealistic now.

7 Rationing inflation

Moving to more macroeconomic issues, it is to be noted that the Yugoslav economy is highly unstable. It went through a short-lived hyperinflation in the autumn of 1989. It went through a hyperinflation again in 1993. The latter was one of the worst ever recorded. It ended after a stabilization programme, known as the Avramovic Programme, had been introduced on 24 January 1994. However, stability did not last for too long. Already at the end of 1994 inflation was back and kept going up throughout most of 1995 and 1996. In 1997 the country enjoyed temporary price stability (inflation was running at 1% per month, or about 20% per year), but there are persistent high inflationary risks. Indeed, at the end of 1997 and the beginning of 1998, higher monthly inflation rates were back with the inflation outlook for 1998 being somewhere around 50% for the year.

A more detailed inflation record looks as follows: After the 1993-94 hyperinflation and stabilization, inflation in 1995 was over 70%, 126% in December (over December 1994). In 1996 it was 93.1% on average. The government tried to keep it down by introducing price controls, but that only led to outbursts of higher inflation. The fixed exchange rate – re-introduced in November 1995, after the Yugoslav dinar had been devalued from 1 dinar for 1 German mark to 3.3 dinars for 1 German mark – influences the slowdown of the inflation only to the extent that the currency market (essentially a coloured and black market) believes that the central bank will resist the requests to print money for this or that special interest. After the November 1996 election crisis and after the government decision to print money to buy loyalty in late December 1996 and early January 1997, the central bank introduced a number of restrictive measures in order to bring the supply of money down. As a result, the dinar stabilized at about 4 dinars for 1 German mark and even appreciated to 3.6 dinars for 1 German mark in late March and early April 1997 and stayed there for most of 1997. That brought the 1997 inflation down though it did not remove either the inflationary pressures or the inflationary expectations. To buy the 1997 elections, as already explained, the Yugoslav central bank almost doubled the money supply during the summer and autumn of 1997, which led to an increase in prices in November and December, then to attacks on the currency in

January 1998 and to devaluation on 1 April 1998. At the same time, prices started to move upwards at a pace of about 3-5% per month.

The Yugoslav experience with inflation and hyperinflation is typical of an economy with a repressed banking and financial system that aims to ration price increases and the growth of production. Two main aspects have to be noted here:

- First, because of the long experience with inflation there is a short lag between money, price and output movements. For that reason, the government is using both monetary and non-monetary mechanisms to target the development of the inflation level. The instrument used is that of relying on so-called selective credits and price controls, i.e. rationing. What the government does is to approve of the central bank giving credits for special purposes with a lower discount rate. This increases the money supply and thus the inflation rate. Then the government introduces selective price controls to keep the inflation from increasing even further. Over a period of time, a variety of selective credits with different interest rates will be issued and a maze of price controls will be created. The government then has a choice of partial liberalization and of introduction of comprehensive price controls. From time to time, it relies on both. But this is only for the reason of enabling it to revert more easily to its usual policy of selective favouritism.
- Second, with this policy of 'inflation rationing', the government is capable of extending the period between rising inflation and the eventual eruption of hyperinflation. Both in the 1989 hyperinflation and in the 1993 hyperinflation, the period of rising inflation was rather long, though once the developments got out of hand, the collapse came very quickly. This ability of the government to rely on inflation for such a long time is somewhat of a mystery. The expectations that are supporting these kinds of processes are yet to be identified.

Whatever they turn out to be, the role of the banks and of the financial markets is without doubt crucial. The development of the banking system has been under much scrutiny in the press and in the scholarly publications. This was prompted by a series of scandals that it was hit with in 1993 and 1994. Some of the scandals were with banks that used basically pyramid schemes. Other scandals had to do with political favouritism. But, the determining factor of the situation in which the banks find themselves has to do with the fact of the high level of bad loans in their portfolio and with the very low level of savings because of the default on the foreign currency savings of the population. A more detailed picture of the Yugoslav banking system looks as follows.

There are over 100 banks in Yugoslavia. Most of them are rather small. In fact, the banking sector is quite concentrated, with four or five banks controlling much of the market. Nominally, all of the banks are owned by their shareholders. However, in most

cases, and especially in the case of the largest banks, the shareholders are socially- or state-owned companies. Some banks are in mixed ownership. In some of those, usually small ones, the majority of the shares are privately owned.

The most important *de facto* state-owned banks are Beogradska Banka, Beobanka, Invest Banka, Jugobanka, Vojvodjanska Banka and Montenegro Banka. Of these, by far the most important are Beogradska Banka and Beobanka. In the late 1970s and early 1980s, Slobodan Milosevic, the current president of Yugoslavia, served as a president of Beogradska Banka (which at that time included Beobanka too). Beogradska Banka used to have offices in major financial centres of the world and still has branches or owns banks in Cyprus, London, Vienna, Moscow and in other places. It has been the main instrument of the government's international financial operations that had to be done through rather obscure and probably illegal channels during the time Yugoslavia was under tight international sanctions.

The most important private bank is Karic Banka. It is described as a bank in mixed ownership, but is in fact a family business with significant government connections and with significant foreign capital participation (about 40%). It is mainly involved in foreign trade, investment and in foreign currency transfers for private citizens and companies. It is the only significant private bank to have survived the banking scandals of 1993 and 1994 and to have actually expanded.

The banks are permanently in difficulties and get periodically into crisis. One such crisis was in spring 1995. The whole banking sector faced insolvency. As part of the package of new measures, the so-called Programme 2 of Mr. Avramovic, the then governor of the central bank, their situation was alleviated. Their reserve requirements were lowered, their bad loans were rescheduled, the central bank started issuing short-term bonds to control liquidity through open market operations, the interest rates were partly freed, and the supervision by the central bank was tightened. Eventually, the interest rates were liberalized too. As a result of these measures, the state of the banking sector improved dramatically. By the end of 1995, most of the banks reported profits (though the banking system as a whole reported losses of about USD 100 mn, still significantly less than the year before) and this favourable situation extended into early 1996.

The improvement in the banking sector proved to be only temporary. The banks are still burdened with huge amount of bad loans that in most cases are owed by those who own the banks (the banks are mostly owned by enterprises who are also the main customers of these same banks). This ownership structure is responsible for the specific macroeconomic consequences discussed above. Banks serve as the main channel for 'inflation rationing'. In essence, they extend credits as a form of subsidy. They lend to their owners at interest rates that are negative in real terms. They, of

course, also borrow at negative real interest rates (from the central bank and from the population). Thus, savings are predictably low, while loans are predictably high. Because of that, from time to time, their bad loans have to be taken over by the central bank or have to be wiped out through a hyperinflation. As long as the banks are capable of preserving some equilibrium level of negative real interest rate, they are able to keep the rise in the inflation rate under control. Once it becomes obvious that this is not possible any more, a hyperinflation is used to clean up the balance sheets. Therefore, no improvement in the profitability of the banks can ever be more than temporary. Indeed, every time when the money supply has to be tightened in order to evade the outburst of a hyperinflation, banks experience a crisis. This was the case in early 1997 when a number of banks had to be temporarily or permanently closed. This is again the case now, in spring 1998, when banks are experiencing problems with their liquidity due to the monetary squeeze that has followed the 1 April devaluation. Practically all of the banks experience constant liquidity problems.

The situation in the banking sector also explains, at least partly, the short lag between the changes in the monetary policy, prices and the output growth. As soon as the money supply is tightened, there are no credit subsidies and the production is adjusted accordingly because there are no alternative sources of finance. Firms cannot revert to lower prices to boost their sales, because their prices are already such as not to cover the costs if they are not subsidized. Thus, they reduce their output to minimize losses. Once the uncertainty about the monetary policy is resolved, the production can immediately increase.

This system could work for decades in former Yugoslavia because the country had no difficulties in borrowing money abroad and could also rely on foreign currency savings of its citizens. Thus, the investments were generally financed from foreign credits while the banks made money on their foreign currency deposits. However, this source disappeared when the foreign currency deposits were frozen, i.e. confiscated. In addition, with the imposition of the international sanctions, foreign credits and investment became unavailable. As a consequence, the whole banking system simply went broke. It makes some money on transfers and payments services that it renders its mainly territorially determined customers. Otherwise, it has to go through a thorough programme of restructuring.

The picture provided by Table 5, though in many respects unrealistic (the capital adequacy ratio is certainly not true), is one of a rather strained banking system. It is short of capital and long on big loans exposure. It also has a lot of money tied up in equity investments. Thus, the banking system needs to be re-capitalized and to be cleaned of bad loans and investments. This process of restructuring will take some time and will certainly be quite costly.

One of the main problems the Yugoslav banks are facing is that concerning the so-called old foreign currency savings. Yugoslav banks had accepted foreign currency deposits since the mid-1960s. Most of the people saved in foreign currency. With the break-up of Yugoslavia those accounts were frozen. They appear on the balance sheets of the Yugoslav banks, but, more importantly, they impede the banks in their attempts to attract new foreign currency savings and even Yugoslav dinar savings. The amount of money that was frozen is quite significant. It probably comes out to more than USD 4 bn. At the moment, only very small amounts of money can be withdrawn from these accounts (DEM 1000 per year per account holder and only for specified purposes). This debt will also have to be rescheduled or solved in some other way if the banks are to start to regain their credibility. However, this is not an easy matter. If interest is added to the stock of frozen savings, this may prove to be a very significant debt indeed. On the other hand, if this situation persists, it may prove to be a long-term severe constraint on the whole banking system.

Table 5

Indicators of banks' performance

	30.09.1995	30.12.1995	30.03.1996
Capital adequacy (8% min)	15.12	8.12	8.65
Equity share (20% min)	13.89	7.9	8.21
Deposits (50% max)	24.79	31.62	30.47
Short-term loans/deposits (100% min)	156.26	160.36	161.11
Forex deposits/loans (95%-105%)	93.93	96.05	95.85
Share of big loans (80% max)	255.89	545.56	502.24
Share of direct investments in firms (15% max)	7.54	7.74	8.45
Share of direct investments in banks (51% max)	9.87	8.95	9.11
Equity investments (20% max)	52.44	59.69	58.36

The role of the central bank is also important. In the 1990 reform, the central bank was given a certain independence as it was responsible to the parliament and not to the government. The federal parliament also appointed the governor of the central bank. This system was retained after the new Yugoslavia came into being. However, the bank did not show any practical independence as it played a major role in the policy of high inflation and hyperinflation followed in 1992 and 1993. Its independence was somewhat reasserted in the stabilization year of 1994, but came under attack already in the second half of the same year. In the second half of 1995, the central bank was given new powers as it became responsible for the supervision of the payments system and of the commercial banks. In that period, it tried to eliminate the use of selective credits and to liberalize the interest rates. It also attempted to shore up the foreign currency reserves that were falling to a rather critical level. They stood reportedly at about USD 300 mn at the end of 1995 and 1996 also. This policy was given up in spring 1996. The

bank reverted to the policy of selective credits and of disregard for the foreign currency reserves. The latter have reportedly remained at the same level of USD 300 mn at the end of 1997 from which it is obvious that they do not play any significant role in the banks' foreign financial operations. Thus, the central bank's independence was short-lived and largely formal anyhow.

At the outset of 1997 the banking system was facing new problems and was again in deep crisis. In January 1997 the central bank revoked the licences of six banks, two of them quite important ones (Slavia Banka and JIK Banka).⁵⁾ Indeed, in April 1997 more than 30 banks faced the same problems with their liquidity that had prompted the central bank to come down on the above mentioned banks. Among the troubled banks, the most troubled are the biggest ones. Thus, one can safely say that the whole banking sector in Yugoslavia is facing a serious and continued liquidity crisis.

At the moment, it is not obvious how it is to be resolved. There are apparently two strategies being considered. One is to concentrate the largest banks into two or three and then to introduce a programme of rehabilitation. The other is to go through the same cycle that the sector has gone through repeatedly and was described above, i.e. to print money to increase banks' liquidity. In all probability, some combination of these two measures will be adopted. Whichever way it is done, the re-animation of the banking sector will bring in significant inflationary pressures.

8 Free and other trade

One of the very first measures in most transformation countries was the liberalization of external and internal trade. The opposite was the case in Yugoslavia. This was the outcome of the break-up of the former Yugoslav market and of the EU and UN sanctions that were imposed in 1992 and 1993 respectively. However, the anti-liberalization ideology of the Socialist Party as well as the development of the war economy contributed significantly to the thoroughly illiberal type of trade that had developed. The legal markets are restricted in all kinds of ways and there is a wide variety of coloured markets. As with the monetary and price policies, the trade policy also relies on rationing and repression.

The main legal barriers to trade used are:

- First, regulations that directly restrict or eliminate markets. The two main areas are trade in strategic agricultural products and foreign investment. The government buys wheat, corn, oil, sugar and some other products and then determines who is going to export, and how much. As for foreign direct investment, the recently passed law (May 1996), though it is more liberal than the previous one (as explained

⁵ The courts eventually annulled this decision and the status of these banks is yet to be clarified.

above), still restricts, in one way or another, a number of areas in which the foreign investor cannot hold the majority stake.

- Second, price controls, taxes, bribes and rent-seeking. The main price controlled is the interest rate used in the money market. The prices of utilities as well as those of energy are also government-controlled. Finally, prices of consumer goods are often regulated and sometimes put under the regime of licensing. Rather often, maybe two or three times a year, the government introduces almost complete price controls by requiring the producers and retailers to justify their intention to raise prices and obtain permission from the appropriate ministry.

Taxes are quite high and their structure is not market-oriented. The major tax instruments are sales taxes, income taxes (i.e. taxes on wages and salaries) and social security contributions (again deducted from wages and salaries). Because of that, there are significant incentives for tax evasion. The black market evades the sales tax, unregistered employment evades income taxes and social security contributions. In addition, nominal employment in the state sector secures health and other social benefits without any work and any financial contribution. Probably the worst aspect of the tax system is that it is discretionary. It is left to the governments and even ministers to change the tax rates practically at will and on a case-by-case basis where that is possible. Thus, the tax system bears all the marks of the illiberal trade system: it is prohibitive, it is confiscatory and it is discretionary.

Bribes are pervasive. To get a feeling on how important they are, it is enough to just point out the fact that the black and coloured markets add about 50% to the official GSP. Even if the average level of the bribes paid is 10%, that amounts to more than 3% of the combined GSP or GDP (i.e. somewhere in the vicinity of USD 0.5 bn). However, the official economy is also run through bribes, as there are so many selective credits, price exemptions and trade licences, so that at least the same 10% of GSP might be made in bribes there also, which brings the 'bribe industry' to about USD 1.5 bn.

Part of the bribe money may be classified under rent-seeking. However, a significant part can be added to it. This involves the profits that bribes bring to those who get special treatment. There is no way of knowing what is their level.

Finally, the overall level of tariffs is rather high. The government looks at imports as one of the main sources of public revenues. Because of that, the average level of tariffs is quite high, though it is not known what it is exactly. The tariffs with only a few countries (Macedonia, Russia, China, Ukraine, Belarus, Bulgaria, Slovakia, Romania and Tajikistan) are somewhat lower (up to 25%) while with all the others they are significantly higher and can go over 100%. In addition, there are manipulative charges and extra charges that add about 10% to the base tariff rate. These extra charges are not set by law and can be changed practically at any moment. In addition, the

government can charge tariffs that are lower than those set by law, i.e. it can grant tax exemptions. This is essentially a model type of regulation that characterizes the Yugoslav legal system.

Given that the government and the ruling party are so much involved in illiberal trade and given that the economy is adapted to the black markets, there is quite a small constituency for liberalization and even the one that exists is only partly committed to it. The banking organization does favour the liberalization of the money markets, i.e. the policy of market-determined interest rates, but does not favour the widespread restructuring that those would bring about. In other words, the banking sector likes to lend at positive real interest rates, but would also like to be able to borrow at negative real interest rates. The same is true for firms, which prefer that their prices are not regulated, but are not ready to accept that the prices they pay are market-determined. Finally, there is no support for the liberalization of the labour market, as the level of unemployment could explode.

The effects of this system of illiberal trade can be seen in the area of foreign trade especially. In 1996 the trade deficit was about USD 2.3 bn. A somewhat higher trade deficit was recorded in 1997. More or less the same foreign trade picture is developing in 1998 too.

Table 6

Exports and imports

USD mn, 1996

	Exports	Imports	Ex plus Im	Balance
Total	1842	4102	5944	-2260
Italy	181	435	616	-254
Germany	146	524	670	-378
Macedonia	212	213	425	-1
Russia	156	225	381	-69
France	55	134	189	-79
USA	33	119	152	-86
Slovenia	29	56	85	-27
Ukraine	15	55	70	-40
Austria	25	120	195	-95
Greece	100	130	230	-30
Republika Srpska	380	229	609	151

If one subtracts the trade with Republika Srpska, which is mostly done in dinars and not in foreign currency, the trade deficit increases. On the other hand, the trade of Republika Srpska gets recorded in the Yugoslav trade in one way or another because it mainly goes via the Yugoslav territory. So, the overall trade balance is not possible to

determine. The exports-imports ratio comes to around 45%. It is, however, not possible to tell how much trade is not reported and how much is even not registered. The other positions in the balance of payments are also unknown. Foreign currency transfers are probably rather substantial. Also, some of the foreign currency earnings never enter the country and are not recorded. Thus, it is difficult to know how the trade deficit is financed.

It is, however, obvious that Yugoslavia is a rather closed economy. Taking the above figures and assuming that the Yugoslav GDP was somewhere around USD 16 bn in 1997, the share of foreign trade in GDP is less than 40%. If the trade with Republika Srpska is taken out (because it is not obvious what it means), the level of openness of the Yugoslav economy comes down to about 30%. Whichever way it is looked at, the Yugoslav economy is near autarky for a small economy that it is.

Yugoslavia's main foreign trade partners are Germany and Italy and EU countries in general. The growth of this trade was constrained by the sanctions and by the fact that the EU has no trade agreements with Yugoslavia. Even the general regime of preferential trade that was re-introduced in May 1997 was discontinued at the end of 1997 due to the EU's dissatisfaction with the political and human rights developments in Yugoslavia. The liberalization of trade with the EU seems rather unrealistic at this moment.

9 Involuntary restructuring

The major structural developments in the Yugoslav economy can be seen from the following table:

Table 7

Structure of GSP

1994 prices

	1990	1996
Industry	41.3	39.7
Agriculture	10.2	19
Construction	7.9	5.8
Transport	16.9	9.7
Trade	13.3	15.9
<i>Other</i>	10.4	11.7

The output development of the Yugoslav economy, apart from its huge fall, is characterized by:

- (i) an increase in the share of agriculture,
- (ii) the destruction of whole industries,
- (iii) a distorted industrial and economic structure characteristic of a closed economy.

Ad (i)

Agriculture has been hit hard in this period too. Its output development can be seen from Table 8. The average fall in agricultural output for the 1991-95 period is only 0.9%, however. This compares to a much larger fall in industrial production. Also, the fall in employment in agriculture has been about 10%, while in industry it has been about 16%. It has, of course, to be taken into account that most of the people working in agriculture are self-employed and not registered. Thus, whichever way it is taken, the share of agriculture in the GSP has certainly increased.

Table 8

Agriculture, output change in % and major products in 000 tons

	1991	1992	1993	1994	1995
Output	10	-18	-3	6	3
Wheat	4109	2101	3049	3249	2970
Maize	7818	4513	4002	4724	5705
Sugar beet	4719	2764	1292	2238	1701
Sunflower	376	359	389	294	296
Soya	115.2	89.6	76.9	83.3	110
Plums	365	374	519	430	222
Grapes	596	394	397	464	428

In 1996, agriculture was facing a new crisis. Overall agricultural production fell by 1% officially and by 3% more realistically. The development of some of the main products can be seen from Table 9. In 1997 agricultural production recorded much better results. However, the structural problems in agriculture will take some time to be solved. There are no plans, as of now, to privatize the large and monopolistic socially owned agrokombinats while the government is not ready to liberalize the market for land, to introduce the necessary credit facilities or to liberalize the markets for agricultural products. Indeed, given the predominant attitudes towards the agricultural policy, the reform in this sector cannot be expected to be adopted and implemented any time soon.

Table 9

Production of major products and livestock

000 tons

	1991	1996
Wheat	4109	1507
Maize	7818	5094
Sugar beat	4719	2342
Potatoes	918	976
Meat	561	545
Milk	1825	1937
Cattle	2098	1926
Pigs	4354	4446
Sheep	3044	2656
Horses	95	93
Poultry	30212	26457

Ad (ii)

Some industries have been practically wiped out. Of those that have sustained their level of production, that of production of electricity and oil stand out. Practically all the rest have production levels that are very much lower than those in 1989. From this, one can also conclude that the growth of industrial production that has been recorded for the last three years has been due mainly to the stability of the production of electricity and of oil as well as to the low level of practically all of the other industries. In fact, the still low growth rates in 1995 and 1996, 1997 notwithstanding, alert to the fact that industry in general has a hard time recovering and is obviously facing severe constraints. These are the following:

- (a) loss of markets in former Yugoslavia and in other countries;
- (b) lack of spare parts and of investments;
- (c) lack of working capital.

These three types of constraint cannot be removed without trade liberalization and without some significant restructuring. Thus, with all this fall, the Yugoslav industry is still to go through the transformational recession as has been emphasized several times in this study already.

Table 10 gives a rather detailed picture of the output developments in the major industrial branches:

Table 10

Indices of industrial production in FR Yugoslavia

	1994/93	1995/94	1-6 96/1-6 95	1-6 96/1-6 89
Manufacturing - total	101.3	103.8	102.1	36.7
Electric power generation	103.5	105.2	103.5	90.6
Coal extraction	101.1	103.8	95.6	83.1
Crude oil extraction	90.8	102.7	87.8	87.6
Oil refinery	93.2	106.7	84.6	18.8
Production of iron ores		59.1	122.2	41.7
Iron and steel	78.5	120.6	256.1	25.4
Production of non-ferrous metals' ores	103.0	122.1	132.9	46.9
Processing of non-ferrous metals' ores	109.9	118.7	123	42.2
Production of non-metallic ores	109.5	78.4	114	26.6
Processing of non-metallic ores	98.0	108.7	128.5	26.7
Metal processing and electrical manufacturing ind.	90.7	101.2	94.8	13.9
Metal working industry	82.4	102.8	94.8	17.5
Manufacturing of machinery	72.6	99.8	82.6	6.7
Manufacturing of means of transportation	92.7	95.8	101.1	5.9
Shipbuilding	116.8	27.2	191.0	9.8
Manufacturing of electr. machinery and apparatus	118.7	108.0	94.4	17.3
Manufacturing of chemicals	113.5	98.9	135.0	22.9
Processing of chemicals	115.4	114.8	121.6	54.0
Extraction of stone and sand	110.7	111.9	111.2	36.6
Manufacturing of building materials	119.2	106.9	121.6	48.5
Manufacturing sawmill products and wood boards	92.2	108.8	92.4	42.1
Manufacturing of finished wood products	90.9	102.7	85.7	31.1
Paper manufacturing and processing	102.6	110.2	97.6	32.0
Manufacturing of yarns and fabrics	100.1	90.9	90.5	27.5
Manufacturing of finished textile products	107.2	82.7	89.4	20.2
Manufacturing of leather and fur products	98.3	98.1	101.4	28.7
Manufacturing of footwear and leather small goods	78.1	72.9	95.3	16.9
Rubber processing	138.4	98.3	134.4	23.6
Manufacturing of food products	101.6	110.4	98.0	62.0
Manufacturing of beverages	109.3	104.1	99.5	85.7
Manufacturing of animal feeds	86.9	105.2	82.5	44.1
Tobacco manufacturing and processing	95.7	93.3	88.4	72.8
Printing industry		104.7	109.6	42.6
Raw materials recycling		99.5	81.8	10.4
Manufacturing of miscellaneous products	100.4	53.4	109.2	32.8

Ad (iii)

Yugoslavia has emerged as an economy that produces raw materials, energy and food. It is a production structure typical of an underdeveloped and closed economy. Table 11 summarizes these developments as well as some of the major facts from the previous two tables.

Much of the rest of the economy has been lying idle for five or so years and it is difficult to estimate what can be done with it. In all probability, in most cases, it will not be able to continue with the same production programme. How much of it can be restructured, and to what purposes, is impossible to say. It is, however, quite possible that the de-industrialization that Yugoslavia has gone through will have long-term consequences.

Table 11

Industry and agriculture, indices of physical volume					
1989=100					
	1990	1993	1994	1995	1996
Industry, total	88	35	36	37	40
energy	98	74	75	79	80
basic industries	94	26	27	33	48
non-metals	85	30	33	35	44
metals and electrical industry	71	15	14	14	15
chemicals and paper	89	29	34	38	46
wood products	80	41	38	39	37
textiles, leather and rubber	86	26	27	23	25
food and tobacco	102	58	61	66	67
other industries	97	39	40	37	42
Agriculture, total	102	81	86	90	90
farm crops	124	79	91	102	91
cereals	148	90	102	112	88
industrial crops	103	72	76	60	78
fruits	80	86	71	59	100
viniculture	181	120	141	131	151
livestock production	87	81	84	89	89
cattle	88	84	87	89	89
pig	87	81	85	93	96

Note: For agriculture 1991.

10 Poor, relatively speaking

Though the output has been increasing from 1994 onwards, employment has been decreasing. Indeed, once the necessary reforms are undertaken, unemployment may reach catastrophic levels. Wages and pensions are low and are not paid regularly, the number of poor people is increasing fast (though it is not altogether easy to say how reliable the statistics on incomes and welfare really are), the number of people leaving the country is also increasing, as is the number of refugees coming into the country (there are more than 500,000 refugees in Yugoslavia that will mostly settle there though they cannot expect to be granted citizenship automatically). This has created the

curious situation where everybody feels that there is somebody even worse off than he or she is, so that though there is a pervasive feeling of helplessness, there is no feeling of general desperation. Still the general welfare is constantly going down, with the government being unable to do very much about it.

As for the registered unemployment, it has been increasing, though not dramatically. In 1991, 714,000 were registered as unemployed, while in 1995 the number was 778,000. In June 1996, it increased to over 800,000 but stayed there for most of 1997. The rate of unemployment has thus passed the 25% mark at the end of 1997. At the same time the number of people employed or seeking employment is rather small (as a share of the total population) and an unspecified (possibly rather high) number of those employed is on indeterminate pay leave (the share of over-employment is customarily put at 40% of the overall number of employed). Thus, unemployment may eventually reach an extremely high level.

Table 12

	Employment				
	in 000				
	1991	1992	1993	1994	1995
Total	2,438.30	2,328.40	2243.4	2170.2	2113.3
Industry and mining	991.8	940.2	915.5	891.5	869.3
Agriculture	115.1	109.1	106.8	104	98.9
Forestry	14	12.6	12.5	12.4	11.8
Water management	5.6	5.3	5	4.6	4.4
Construction	184.5	171.1	157.6	147.6	137.1
Transport	161.6	158.1	150.8	146.1	144.1
Commerce	240	237.7	225.7	211.9	194.1
Catering and tourism	68.4	61.6	57.1	53.6	52.3
Crafts	46.7	42.8	40.3	37.6	36.4
Public utilities and housing	50.6	52	50.3	48	49.7
Financial services	86.1	86.2	85.5	81	75.9
Education and culture	191	181.7	178	174.7	176.6
Public health and welfare	178	175.6	170.8	167.1	172.7
Administration	105	94.3	90.9	90.1	90.1

The public finance developments also testify to an economy highly dependent on the state. The 1996 and 1997 federal budget was passed on the assumption that output would grow by some 12.5% (the Serbian budget relied on GSP growth of 20%). Actual growth was nowhere near that level, and the economy had to be satisfied with a rather modest increase in production (of about 6% and 7%) in comparison with the planned one. This means that the government must be running a very significant budget deficit though it always reports balanced budgets. This is because the government does not honour its obligations to the social security funds (pensions, health etc.) as well as towards agriculture and the employees in social services (education) and even to the

army. On average, the government owes about one fourth of all these obligation, which gives about 10% of GSP in budget deficits. These deficits have been growing in 1998 and it is possible that they will reach rather high levels due to the fact that no revenues from foreign investments are currently expected and no other sources of revenues can be found, while some of the expenditures are growing more than planned (the expenditures on the Yugoslav army due to the worsening security situation in Kosovo and on the border with Albania).

In 1994 public revenues were 53% of GSP. In 1995 they decreased due to the increase in the inflation rate and to increased tax evasion. Their share in GSP was about 47%. The 1995 and 1996 situation is summarized in Table 13. In 1997 the share of government revenues were reportedly at a level of 55% of GSP. If the 10% deficit that was also reported is added, the share of public expenditures comes to about 65% of GSP.

Table 13

Public revenues			
% share of GSP indices of growth			
	1995	1996	1996/1995
Total public revenues	47.9	44.1	96
Budgets	26.6	25.6	104.5
Taxes on	18.1	15.9	87.2
Sales and excise	9.6	9	101.3
Income	7.9	6.2	167.9
Other	0.6	0.6	112.2
Customs	1.8	2.2	154.8
Other budget revenues	6.7	7.5	137.3
Social security	20.8	18.1	85.5
Other public revenues	0.5	0.4	86

With the increase in inflation, taxes and contributions lag and tax evasion increases. The government then has difficulties in meeting its obligations in education, pensions and health. This leads to strikes, of which those of the teachers regularly begin with the new school season. In 1997, however, schools and universities have been striking on and off for most of the school year and in spring 1997 the hospitals also went on strike. In fact, strikes are a fact of everyday life in Yugoslavia.

About 30% of the population is considered poor (has an income below the poverty line). About 700,000 are very poor, with an income that is lower than half of the poverty line. In May of 1996, 60% of those employed in industry received wages that were 46% below

the average (USD 58) while 152,000 workers in the textile industry received a USD 48 wage per month on average.

Thus, Yugoslavia is a poor country, with high unemployment, with high over-employment, a high level of public expenditures that it cannot sustain, with a lot of poor people and a significant number of very poor people.

11 Regional differences

The regional development of Yugoslavia has not been studied all that well. This is now somewhat more difficult because data are not readily available. While most of the data are broken down to Serbia and Montenegro, this is less frequently the case with Vojvodina and Kosovo, the two Serbian provinces. The economic developments in Kosovo are especially difficult to follow because of the dual political system that exists there. Therefore, most of the figures that refer to Kosovo represent only the official part, which is probably just a fraction of what actually goes on there. The data for Vojvodina are more readily available, but often do not refer to the indicators that are of special interest. Two characteristics can be singled out that differ significantly over regions:

- first, Montenegro, Vojvodina and Kosovo lost more in terms of GSP and industrial production than Serbia proper (i.e. Serbia without Kosovo and Vojvodina);
- second, these regions responded more favourably to the lifting of the sanctions than did Serbia proper.

In the first half of 1996 as well as in 1996 as a whole, all of the regions recorded faster growth than Serbia proper (Montenegro's industrial production grew 50.4% in the first half of 1996). In addition, Kosovo recorded growth in exports (mainly from raw material extraction). However, these regions face significant constraints, different for each of them.

Kosovo is constrained by political uncertainty and instability. This is reflected in the lack of workers. Though the unemployment rate in Kosovo is almost 100% among the Albanians, the mining industry, which is the most important there, is chronically short of workers. The current worsening of the security situation in Kosovo bodes ill for the economic development in this province. Though it is not likely that a full-scale civil war will erupt in Kosovo, a low-level violence and terrorism with the persistent police rule will sap the economic development there for quite a while.

Vojvodina is constrained by the Serbian policy towards agriculture. Because of the distribution of land ownership (the existence of large state farms), because of the price controls on strategic agricultural products (i.e. grain, sunflower, sugar), and because of the unfavourable tax system, Vojvodina's main sector is having a hard time. The

situation in 1996 may have been one of the worst in many years, with the production of wheat being exceptionally low. This was not repeated in 1997, but the systemic problems with agricultural production have not been on the agenda of either the Yugoslav or the Serbian governments.

Montenegro is constrained by the above-average increase in the trade deficit. Montenegro's economy is rather dependent on imports, while its most promising sector, tourism, is rather dependent on foreign investments. In addition, the economic and political collapse in Albania hit Montenegro's large black market and smuggling activities quite severely. The government of Montenegro has become increasingly aware that the international isolation of Yugoslavia may become a permanent economic condition in which case this state cannot hope to revitalize either its tourist or its trading sectors. Indeed, in 1997 Montenegro fared worse than Serbia and this trend is continuing in 1998 too. This is the consequence of its higher-than-average dependence on foreign trade both within and without Yugoslavia. As the borders of Albania and Croatia are mostly closed (Montenegro borders on Albania, Croatia and Bosnia & Herzegovina), Montenegro depends on the trade with Serbia. However, due to political tensions between the two states, there is some kind of blockade of Montenegro on the part of Serbia. The current government of Montenegro plans to move towards reforms, but the extent of public support for such a change in economic policy is unclear. Much depends on the May 1998 parliamentary elections. If the current government coalition does not win, or does not win decisively, a prolonged period of political instability and uncertainty may be facing this small state.

These regional differences will work for constant problems in the formulation and implementation of Yugoslav economic policy. The interest of most of the regions is in the opening up of the economy. However, their influence on the economic policy agenda is bound to be rather insignificant. The agenda has been set by Serbia proper, which has had other priorities. Indeed, as the developments in the last year or so show, the so-called Serbia proper has less pronounced interests in trade liberalization and in an increase in economic relations with the world. This, of course, strains the internal political and economic relations in Yugoslavia as a whole.

12 Prospects

There are no easy solutions to Yugoslavia's problems. The country has been accumulating problems for too long for quick solutions to be feasible. In 1998 most of these problems have reached the crisis level. This is so particularly in the following areas: international relations, constitutional tensions, macroeconomic stability and social conflicts.

Yugoslavia is further from integration than at any time since the suspension of sanctions at the end of 1995. Relations with the EU are strained: Yugoslavia has no contractual relations with the EU and is facing the possibility of re-introduction of some sanctions (the UN has already imposed a ban on the sale of weapons and other military and special police-related equipment to Yugoslavia). In addition, rather than normalizing its relations with its neighbours, Yugoslavia has strained its relations with Albania and is yet to agree on the borders with Macedonia. Finally, Yugoslavia's relations with the USA are at the lowest level since the signing of the Dayton agreement in the autumn of 1995. As a consequence of the latter, the prospects for the 'outer wall of sanctions' to be removed are rather distant. With those in place, the agreements with the IMF and the World Bank, even if Yugoslavia were to be ready for those, are out of the question. And the latter leads to the impossibility of the normalization of financial relations with the commercial and sovereign creditors. As a final consequence, that leaves Yugoslavia outside of the international financial markets and institutions, making it next to impossible for it to engage in any long-term financial strategy and investment planning.

At the beginning of 1998 Yugoslavia faces two fundamental constitutional problems. The first is with Kosovo. The current police rule there and the suspension of the autonomy of that province seem less and less sustainable. This situation has led to an increase in political tensions and in terrorist activities. Though some progress has been achieved recently with the agreement on the normalization of the education system that enables the return of the Albanian students to schools and the university there, no progress has been achieved in the start of political negotiations between the representatives of the government and of the Kosovo Albanians. Finally, recent terrorist activities and the police and military interventions especially in the border area with Albania threaten the stability of Serbia and Yugoslavia and indeed of the whole region. Though a full-scale civil or Balkan war is not to be expected to erupt, long-term instability and insecurity is quite likely.

In addition to the Kosovo problem, there are tensions between Serbia and Montenegro due to the disagreements over the level of centralization of Yugoslavia, the speed of the reforms and the relations with the international community. The really fundamental conflict is that over the level of centralization. With the election of Mr. Slobodan Milosevic to the post of the president of Yugoslavia, the issue of the role of the federal institutions has become crucial. The current constitution of Yugoslavia provides for a largely ceremonial post of the president of Yugoslavia. He or she is to be elected by the federal parliament, is to serve a four-year term, and cannot be re-elected. Mr. Milosevic has already indicated that he will seek to amend the constitution so that the Yugoslav president would be elected by the people, will have a longer term (possibly seven years like in France), and could be re-elected. Those changes are unacceptable to the current president and government in Montenegro. This may change after the end-May elections in this state. If the pro-Milosevic opposition wins or if there is a divided parliament, it will

be more difficult for Montenegro to oppose these changes. As secessionism does not commend the support of the majority of the population in Montenegro, the relations between these two states will remain strained and problematic for the foreseeable future.

The current president and government of Montenegro have also declared their support for rapid and comprehensive reforms. They plan a speedy and comprehensive privatization with significant foreign investment participation. It is, however, not clear at this point how determined they are and what their actual possibilities are given the firm grip that Serbia has over the federal institutions. Obviously, a clear and decisive victory in the upcoming parliamentary elections would be helpful, but how realistic this is to expect is currently unclear. In any case, no breakthrough can be expected as long as the situation in Serbia and in the federal institutions remains as it is.

The macroeconomic situation is precarious as it has been for a number of years. The two main problems are the trade (and current account) deficit and the budget deficit. Both, current account and budget deficits, together make up at least 20% of GSP. As foreign borrowing is very difficult and as tax evasion is quite widespread, the government has to resort to periodic devaluation and inflationary taxation. Both create problems with the macroeconomic adjustments that are never easy and always bring in a significant risk of hyperinflation erupting or of recession setting in or of both. At the beginning of 1998 Yugoslavia is facing one such problem of macroeconomic adjustment after the 1 April devaluation. Given the worsening of the international position of Yugoslavia, it is to be expected that the adjustment will be more difficult and more costly than it would have otherwise been. The likely prospect is a significant increase in inflation (to about 50% on a yearly level) and a significant slowdown in growth (to around 3% of GSP).

The crisis in Kosovo increases inter-ethnic conflicts, but can serve as a cap on social conflicts among the Serbian population. This may help the process of macroeconomic adjustment that will certainly mean lower real wages and higher unemployment. However, this cannot last forever. In the second half of the year, new social conflicts over the wages and pensions can be expected. At this moment it is difficult to forecast the political consequences of these developments. The opposition in Serbia is all but non-existent. In addition, the two most populist parties, the Socialist Party and the Serbian Radical Party, have formed a coalition government and so the social pressure will have no readily available political channel to push its demands through. The democratic opposition is weak and is not united. If, in addition, there is no clear outcome in Montenegro, as it looks likely, the constituency for change, reform, international integration and reform will be very narrow indeed.

Trade and investment in the Balkans *

The break-up of former Yugoslavia has had serious and long-term consequences. Seven years or so after the fact, it is appropriate to take at least partial stock of the costs and benefits of the disintegration and to look at the existing situation in the context of the developments in the regions that former Yugoslavia belonged to and in the context of Europe as a whole. This is because the break-up, though still not over for a large part of the former country, has already led to a new reality, both for the new countries and for the regions that they are parts of. In addition, the normalization in this whole area as well as in every successor state separately depends, at last partly, on their regional and global integration. In this chapter, Balkan integration in terms of trade and finance will be looked at more closely. Links or lack of links with some other regions and possible alternative regional integration will also be briefly referred to.

The roughest indication of the costs of the break-up of former Yugoslavia, given the way it happened, is to be found in the figures contained in Table 1.⁶ Of course, not all the changes in the GDP, industrial production and the rise in unemployment can be attributed to the costs of break-up. Still, those must have been the dominant ones. These are not to be taken as opportunity costs, as they often are, because the costs of alternative outcomes can only be estimated hypothetically.

Table 1

Successor states of former Yugoslavia: Key indicators, 1997

	Slovenia	Croatia	B&H	Yugoslavia	Macedonia
GDP, 1989=100	99	76	40	50.3	69
Industrial production, 1989=100	73.2	54.7	20	43.8	44.8
Unemployment	14.8	17.6	50	25.6	31

Note: Figures for Bosnia and Herzegovina (B&H) are very crude estimates.

Source: WIIW.

The problem to be addressed here has to do with the consequences for foreign trade and investment of the break-up of former Yugoslavia for successor countries as well as for the Balkan region as a whole. In addition, some consideration will be given to the role of regional integration in general for the difference in the economic performance of particular states in the Balkans.

While most of the transition countries have liberalized their economies, the Balkan region has continued to be full of barriers and restrictions – some imposed, some self-

* Written in July 1998.

⁶ For some general considerations see Gligorov (1994); for more specific discussion see Gligorov (1996a).

imposed and some inherited. The consequence has been that the region has continued to experience trade and other real and policy-induced shocks. It has also motivated most, though not all, of the states in the region to consider advancing either on the path of regional or on that of European integration or on neither. As further EU integration has been conditioned on further regional integration for many of the Balkan countries by the European Union,⁷ the level and development of regional trade and economic integration in general has become an important institutional and policy issue.

What region(s)?

In the Balkans, for the purposes of this paper, the following countries are included: Slovenia, Croatia, Bosnia and Herzegovina, Yugoslavia (Serbia and Montenegro), Albania, Macedonia, Romania, Bulgaria, Greece and Turkey.⁸ The criteria for inclusion are mainly geography and partly history. Both are usually taken to be important for economic integration because of increasing returns that are connected with geography and path-dependency that is the domain of history.⁹ In other words, geographical proximity should lead to *trade creation* in the region while history should induce *trade diversion* to the region. If, on the contrary, trade integration is low, these trade enhancing factors can be taken not to be present or it can be assumed that there are specific trade impeding factors that outweigh the benefits from regional trade. In addition, if it is observed that the level of trade in the region is falling or is volatile, the region can be taken to be *trade averting* or that it is not a region at all in terms of trade and economic integration.

Similar considerations apply to flows of foreign investments. A high and growing level of foreign trade is usually accompanied by a similarly high level of investment. Also, flows of investment often tend to be regionally distributed in a way similar to the distribution of trade. Thus, trade creation should be, in principle, followed by investment creation, and trade destruction by a lack of investment opportunities. Finally, security concerns affect investments even more than they affect trade, so that a low level of foreign investment, especially that which is regional, will be, *ceteris paribus*, a sign of high security and political risks. Given that security risks are a form of an externality, connected again with history and geography, a high level of these types of risks will also indicate a high level of regional disintegration.

⁷ In 1996 the EU adopted the principles of its so-called regional approach which applies to a changing set of Balkan countries and currently includes Croatia, Bosnia and Herzegovina, Yugoslavia, Macedonia and Albania. The key principle is that the advance in the contractual relations with the EU for these countries depends on the progress in their bilateral and regional co-operation. More on that in Gligorov (1996b).

⁸ Some countries raise strong objections to being included in the Balkans. Some, like Slovenia and Croatia, prefer to be treated as Central European countries on geographical and historical grounds also. However, regions are not exclusive, so a country can participate in more than one region as is pointed out in this paper. For more on this see Gligorov (1997).

⁹ However, nothing changes if practically any subset of these countries is taken to represent the Balkans.

Many of the Balkan countries can be considered belonging to other regions too. Indeed, the Balkans are a region of overlapping regions, so to speak. This is also the consequence of history and geography. Thus, many Balkan countries belong to Central Europe, though, similar to the Balkans, this region does not seem to have an altogether large economic significance now. Similar considerations apply to the Mediterranean region and to the Black Sea region. Indeed, regionalism in today's Europe seems to be acquiring a different meaning than the one inherited both from its history and its geography. These broader questions will only be alluded to in this paper.

Given such definitions of the Balkans and of regional integration, the first question to ask is, 'Are the Balkans an economic region?' (and the same applies to all the other regions). There are two aspects to this question: 'Are the Balkans an economic region now?', and 'Are they going to be an economic region in the future?'¹⁰ The answers to these questions are more or less negative. They are not to be taken, however, as either the explanation of or the justification for the lack of trade and other liberalization in the Balkans.¹¹

The current level of regional integration can be illustrated by the level of intra-regional trade. Table 2 shows how important the Balkan countries are to each other as trading partners.

¹⁰ The issue of the past is not treated here except indirectly through the persistence of trade links between the former Yugoslavia states. However, the Balkans were not an economic region even then because, though former Yugoslavia was of course economically integrated, the Balkans were divided.

¹¹ At the moment the institutionalization of trade in the region and with the EU is rather complex. Greece is an EU member. Turkey has a free trade agreement with the EU. Slovenia, Romania and Bulgaria have association agreements with the EU. Albania and Macedonia have co-operation agreements with the EU. Croatia, Bosnia and Herzegovina and Yugoslavia (Serbia and Montenegro) do not have agreements with the EU. Slovenia and Romania are members of CEFTA (Bulgaria will join from 1 January 1999). A number of Balkan states have bilateral free trade agreements. Slovenia and Croatia have signed a free trade agreement while Slovenia, Croatia and Yugoslavia already have free trade agreements with Bosnia and Herzegovina. All of them have free trade agreements with Macedonia.

Table 2

Balkan countries: Trade with the countries of the region, 1997

per cent of total

	Slovenia		Croatia		B&H		Yugoslavia		Albania		Macedonia		Romania		Bulgaria		Greece		Turkey		
	EX	IM	EX	IM	EX	IM	EX	IM	EX	IM	EX	IM	EX	IM	EX	IM	EX	IM	EX	IM	
Slovenia	.	.	10	5	3.5	0	1.34	0.5	0	0	1.8	0.6	0	0	0	0	0	0	0	0	0.5
Croatia	12.1	8.3	.	.	15.5	1.5	0	0	0	0	1.9	0.5	0	0	0	0	0	0	0	0	0
B&H	7.2	13.3	33.4	30	.	.	43.2	18.8	0	0	0	0	1.8	0	0	0	0	0	0	0	1.5
Yugoslavia	1.6	1.6	2.5	0.5	18.9	5.9	.	.	0	0	9.3	6	1.7	1.7	1.4	1.8	4.3	4.2	0	1.5	
Albania	1.3	1.5	4.2	0	0	0	0	0	.	.	2.6	2.1	0	0	0	2.7	20.5	26.6	0.9	4.4	
Macedonia	4.7	7.8	3.1	3.9	1.7	0	22.8	11.6	2.5	0	.	.	0	0	2.7	5.6	8.1	7.3	1.9	2.8	
Romania	0	0	0	0	0	0	0	0	0	0	0	0	.	.	0.7	0.5	2.1	1.7	4.2	3.1	
Bulgaria	0	0	0	0	0	0	2.5	0.8	0.5	0	2	0.5	1.3	1.2	.	.	8.3	4.2	9	2.1	
Greece	0	0	0	0	0	0	0	0	1.7	0	0	0	1.9	0.7	2	1.5	.	.	4.4	1.2	
Turkey	0	0	0	0	0	0	0	0	0	0	0	0	1.4	0.8	0.7	0.8	1.1	0.9	.	.	

Source: WIIW database, national statistics and IMF direction of trade statistics.*

*) Trade with Bosnia and Herzegovina recorded in the Yugoslav statistics must have been left out from the IMF direction of trade statistics especially when it comes to exports. The actual figures can be found in Tables 3 and 4 below. Here the exports to Yugoslavia recorded there have been added when calculating the relevant share, but not in other cases.

Certain facts seem obvious at a glance:

- (i) For many Balkan countries the other Balkan countries are not important trading partners. In Table 2 a lot of zeros, or near zeros, can be observed. They do not always represent an absolute absence of trade but rather levels that are so low (much lower than 1%) that they are not worth mentioning. From this it follows that currently the Balkans are not a trade-creating region. Geographical proximity does not lead to increasing returns to intra-regional trade.
- (ii) For some Balkan countries the other Balkan countries are not trading partners at all. For instance, Slovenia and Croatia trade with each other and with Macedonia and sell to Bosnia and Herzegovina. The other Balkan countries do not seem to exist for them in terms of trade. Here historical factors play a significant role both in the persistence of some trade between the former Yugoslavia states and in its absence as well as in low trade integration with other Balkan countries due to political and economic divisions in the previous, cold war, period.

Table 3

Balkan countries: Trade with selected countries, 1997

per cent of total

	Germany		Italy		Russia	
	Exports	Imports	Exports	Imports	Exports	Imports
Slovenia	39.4	20.7	14.9	16.7	3.9	2.7
Croatia	17.9	20.2	18.8	18.7	3.9	5
B&H	17	14.8	21.5	12.7	2.3	0.6
Yugoslavia	9.2	13.4	11.5	10	7.5	9.5
Albania	6.9	4.2	49.4	46.5	0	0
Macedonia	16.2	13.4	3.6	5.5	2.1	3.9
Romania	16.8	16.4	19.5	15.8	3	12
Bulgaria	9.5	11.5	11.7	7.1	28.1	37.2
Greece	18.6	13.9	13.9	18.1	1.9	0.9
Turkey	20	16.5	5.3	9.2	7.8	4.4

Source: WIIW database, national statistics and IMF direction of trade statistics.

- (iii) For almost no Balkan country is another Balkan country the main trading partner.¹² This can be seen from Table 3 where the trade shares with Germany, Italy and Russia are shown and can be compared to those in Table 2. A similar picture emerges if regional, e.g., trade with the EU and within the Balkans, rather than trade with individual countries is compared. Though the region as a whole plays a more

¹² Bosnia and Herzegovina is a notable exception. The only possible other exception may be Macedonia in 1997 for which Yugoslavia has emerged as one of the most important trading partners. However, this may prove to be a temporary development due to the volatility of foreign trade links that will be commented on below.

important role for some countries, trade with the EU is by far more important for every single Balkan country (except, as already noted, for Bosnia and Herzegovina and perhaps for Macedonia).

- (iv) In the Balkans, no Balkan country is really 'Balkan'. However, some are 'more Balkan' than the others. For instance, Macedonia, Yugoslavia, and especially Bosnia and Herzegovina, trade more in the Balkans than do most of the other countries. Some of it is a consequence of involuntary trade diversion as will be discussed below.

These considerations suggest that, given the current level of regional integration as reflected in the trade flows, the Balkans as an economic region is practically non-existent. Intra-regional trade flows are low and most of the trade is conducted with the non-Balkan countries. The region neither creates trade nor does it divert trade from other regions to intra-regional trade. Indeed, it tends to induce trade aversion both in the sense of keeping the overall trade level low and in the sense of diverting the trade out of the region through constant policy shocks that tend to induce a high level of uncertainty and thus volatility.¹³

For comparative purposes, the trade integration of some Balkan countries with CEFTA can be assessed. The history of CEFTA, however, is not so long as to support generalizations. This is especially true for CEFTA members from the Balkans. Slovenia has been a member for a few years now, but its trade with this region cannot increase all that much because Slovenia's trade is so much EU-oriented. Romania, on the other hand, is a recent CEFTA member and no significant trade shifts have been observed on account of that yet. Similar patterns have been observed for trade patterns of the other CEFTA members. Thus, what goes for the Balkans, goes for CEFTA too, though for different reasons. Basically, trade liberalization is not enough to bring in trade diversion in the presence of a very strong attractor like the EU is. As for the Balkans, however, in many cases even the basic elements of trade liberalization are lacking. One has to realize that this is an area in which the regional regime of doing business is the one that can be characterized as that of illiberal trade.

Involuntary trade

An illiberal trade regime can be described in another way as that trade that is done out of necessity, i.e., in some sense, involuntarily. One indicator of such a trade is that there is not much of it going on. Apart from low levels, trade is quite volatile in the Balkans. This is true for all the Balkan countries, though again for some more than for

¹³ More on this in Gligorov (1996c).

Table 4

Bosnia and Herzegovina: Trade with selected countries

USD million

	1993	1994	1995	1996	1997
Exports					
Total	85.2	35.9	51	175.4	372.8
Germany	13.8	8.1	11.5	27.5	63.4
Italy	7.3	2.8	14.8	45.4	8.3
Greece	3.1	2.3	1.1	1.3	1.4
Turkey	0	0	0.1	2.3	1.2
Bulgaria	.	.	.	.	0.3
Russia	9.9	5.8	0.4	0.1	8.6
Croatia	12.7	3.3	7.1	57.7	124.4
Slovenia	.	4.6	7.3	13.8	26.8
Macedonia	.	.	0.7	0.8	0.9
Romania	13.8	.	.	0.4	6.8
Yugoslavia ²⁾	.	.	.	229	283
Imports					
Total	424.1	650	941	1932.1	2377
Germany	38.3	63.6	85.7	249.4	351
Italy	23.4	30.1	76.6	235.9	301
Greece	17.3	0.5	0.2	0.2	0.2
Turkey	0	1	5.8	24.4	35.1
Bulgaria	.	0	0.1	3	3.5
Russia	39	127.9	98	27.2	14.5
Croatia	207.8	248	414.9	603.5	713.6
Slovenia	.	74.8	129.5	289.5	317.3
Macedonia	.	.	0.8	0.8	1
Romania	8	0.6	0.8	2.6	11.8
Yugoslavia ¹⁾	.	.	.	380	447

Note: 1) The trade figures that appear in the Yugoslav national statistics are, in all probability, not integrated into the IMF direction of trade statistics so that total figures for Bosnia and Herzegovina most probably have to be augmented for the trade with Yugoslavia figures (only partly for 1997).

Source: National statistics and IMF direction of trade statistics.

the others. The countries that are 'more Balkan' have more volatile trade. That shows that the volatility is generated in the region or that it is caused by the developments in the region. This being the case, the Balkans can be seen as a trade-averting region and one of trade destruction rather than creation. The fundamental reason for this is that of

security. The Balkans have gone through a series of security shocks, not all of those connected with the break-up of former Yugoslavia, that have induced large political and economic consequences. However, apart from security shocks, there are those that relate to the lack of tradition and commitment to free trade. Finally, there are those that follow from the prevalent nationalism in the region which co-exists or reinforces, or both, the significant level of authoritarianism found in many if not most Balkan countries.

The worst case in every respect is of course that of Bosnia and Herzegovina. Table 4 summarizes the quite dramatic foreign trade developments from 1993 until 1997.

The three obvious features of this table are:

- (i) low initial, after break-up, level and steep growth of imports afterwards,
- (ii) a huge trade deficit, which is not surprising, and
- (iii) a large share of Croatia, Yugoslavia and Slovenia, the three main trading partners of Bosnia and Herzegovina, in its imports (and in its exports when Yugoslavia and increasingly Croatia are concerned).

For a different, but also typical story, Table 5 shows the development of the Macedonian trade with its Balkan partners in the last several years.¹⁴

Table 5

Macedonia: Trade with selected countries of the region

USD million

	1992	1993	1994	1995	1996	1997
Exports						
Total	1199	1055	1086	1204	1147	1201
Albania	21.2	35.7	28	24.7	32.6	30
Bulgaria	63.5	82.7	240	255	38.2	32
Yugoslavia	70	51	40	85	246	274
Greece	38.7	49.6	12.7	14.2	102.4	97
Turkey	17.5	43.8	35.4	38.6	18.2	23
Imports						
Total	1205	1199	1484	1718	1627	1740
Albania	3.9	7.3	8.2	8.2	5.1	4
Bulgaria	173	131	242.6	256	107.4	98
Yugoslavia	9	63	101	161	166	202
Greece	49	52.2	23.5	29.1	77.4	127
Turkey	32.5	34.3	47.7	55.1	44.3	49

Source: WIIW database, national statistics and IMF direction of trade statistics.

¹⁴ Macedonia is probably the 'most Balkan' of the Balkan countries (apart from Bosnia and Herzegovina), at least as far as trade is concerned.

The period chosen is that after the break-up of former Yugoslavia that Macedonia was a part of. The level of Macedonia's overall foreign trade had already been significantly lowered at that time. Still, the volatility of the trade with the major Balkan partners is quite significant. The volatility has been influenced by the following major factors that can be generalized to the foreign trade developments in the other Balkan countries too though they may not be so pronounced.

- (i) Security-related shocks that consist of sanctions and embargoes, border closures, high political and legal risks, and high transaction costs of all kinds (those are to be seen in the volatility of the trade with Yugoslavia and Greece and with Albania in 1997).
- (ii) Macroeconomic shocks due to high inflation, economic crisis or an outright economic collapse (this is especially characteristic of the volatility of trade with Bulgaria).
- (iii) Trade regime and policy shocks due to introduction of tariff and non-tariff barriers as well as to erratic trade liberalization measures (this is again especially characteristic of the trade with Yugoslavia and Greece).

These observations can be applied to other cases as well. For instance, the Yugoslav (Serbia and Montenegro) foreign trade shows similar patterns. The trade developments in this country are difficult to analyse because figures have been released for the last two years only (i.e. 1996 and 1997). The most recent previous official figures are those from 1992. However, some analyses point to the following development of the Yugoslav foreign trade:

Table 6

Yugoslavia: Exports and imports as % of 1990

	1991	1992	1993	1994	1995	1996	1997
Exports	80	40	12	10.8	11	21	28
Imports	75	50	14.8	22	45	48.2	54

Note: Only trade with non-former Yugoslavia states included.

Source: MAP (1997).

If trade with former Yugoslavia states is included, it turns out that the value of 1997 exports was just about 15% of that in 1990 and the value of imports just 27%. On the other hand, looking at the most recent foreign trade figures, it can be seen that Yugoslavia is experiencing the same trade volatility as Macedonia. There is:

- (i) a fast increase in the volume of foreign trade of more than 25% in 1997 due to the removal of the trade sanctions and due to the introduction of a free trade agreement

- with Macedonia (but a stagnation in 1998 due to macroeconomic instability, renewed sanctions and security concerns);
- (ii) a significant shift in trade with Germany and the other EU countries growing in volume and in share (until 1998), and
 - (iii) trade concentration that is a consequence of essentially involuntary trade diversion which is characteristic of the fact that Bosnia and Herzegovina, i.e. the Serbian entity there, is either the second (in 1996) or the fourth (1997) or the third (in the first eight months of 1998) most significant trading partner of Yugoslavia.

Some shocks are more important than others. In the case of Romania and Bulgaria, the foreign trade developments are volatile, but the volatility is mostly caused by the changes in the trade regimes and policies as well as in macroeconomic developments rather than by security concerns and involuntary trade diversions. The sequence there is one of a significant trade shift due to liberalization of trade with the EU which is accompanied by an increase in overall trade with this region and then trade volatility due to macroeconomic instability and lack of vigorous reform programmes.

The figures in Table 7 show:

- volatility of total foreign trade, mainly due to macroeconomic developments (periods of high inflation are accompanied by foreign trade fall);
- a low level of bilateral trade with the tendency of further fall or at best stagnation (low levels of mutual trade were characteristic of the pre-transition period also and the trade shift that has occurred has mainly led to trade integration with the EU and not regionally).

Table 7

Bulgaria and Romania: Total and mutual foreign trade growth

	1993	1994	1995	1996	1997
Bulgaria, growth total					
Exports	-5.1	7.1	34.4	-8.7	0.5
Imports	6.5	-12	35.2	-10.3	-3.7
Share with Romania					
Exports	2.47	1.59	1.78	1.54	1.34
imports	2.13	1.91	1.08	1.39	1.18
Romania, growth total					
exports	12.1	25.7	28.6	2.2	4.3
imports	4.2	9	44.5	11.3	-1.4
Share with Bulgaria					
exports	2.1	1.57	0.9	0.88	0.68
imports	1.09	0.91	0.75	0.64	0.51

Source: WIW.

In this category, the extreme case is Albania. There trade liberalization led to a surge primarily in imports. However, due to a complete economic collapse in 1997, Albania's trade with many Balkan countries experienced a drop as did its overall foreign trade. That is an additional indication that the opening up of Albania, which was previously probably the most closed country in Europe, in terms of trade and travel, has led to only a small increase in its trade in the region (with the exception of Greece) and to a much larger increase in trade outside of the region. The picture may look somewhat different if all of the black market trade over the Yugoslav border were to be included. Indeed, that activity has continued even after the economic collapse in Albania, or because of that collapse (as a curiosity, the large-scale smuggling of scraped iron from looted Albanian factories has been going into Montenegro to be used as a raw material in the Nikšić steel-mill) though it might have stopped or practically disappeared in view of the current developments in Kosovo. Table 8 gives some indication of the recent official trade developments in Albania. To see how explosive these developments are, it has to be taken into account that Albania's exports and imports in the 1980s were about USD 250 mn on average.

Table 8

Albania: Exports and imports

USD million

	1993	1994	1995	1996	1997
Exports	123.3	157	220.9	297.1	141.3
Imports	603.6	701.8	975	1283.1	619.7

Source: IMF direction of trade statistics.

Finally, due to trade barriers and to political and legal uncertainties, there is a significant level of smuggling activity going on in the Balkans. There are no reliable estimates on either the volumes or the volatility of this trade. However, the indirect evidence points to a significant level of persistent black market trade across borders in the Balkans. In the balance of payments statistics large positions for errors and omissions are found. In addition, trade figures reported by different countries are different, with the difference being sometimes very large. The smuggling activity as the regular trade activity is not directed to the Balkan region primarily. It is, in fact, fair to assume that its distribution is pretty much the same as that of the overall trade.

As a different example, trade between Croatia and Slovenia can be considered. That trade shows an especially interesting pattern of development. As these two states have had high levels of trade before the break-up of Yugoslavia and as they have not introduced too many barriers to bilateral trade after the break-up of the common state and have indeed recently signed a free trade agreement, it is interesting to note that the

share of their mutual trade is all the time diminishing. Both countries are less and less important to each other irrespective of geography, history and trade regime.

It is quite clear that there is a process of disintegration going on between Slovenia and Croatia, though it may have reached or is close to reaching the equilibrium point given the proximity and the foreign trade habits. Still, one problem that may push for further trade restructuring is the fact that Croatia runs a trade deficit with Slovenia and finds it increasingly difficult to sell there. In case this is perceived as a problem, bilateral trade may decline further.

All in all, it can be concluded that involuntary trade is the dominant form of regional trade in the Balkans and that voluntary trade, where such a regime exists, diverts trade out of the region rather than creating intra-regional trade.

Table 9

Croatia and Slovenia: Total growth and mutual share of foreign trade

	1993	1994	1995	1996	1997
Croatia, growth total					
Exports	-15.1	9.1	8.7	-2.6	-7.6
Imports	4.6	12.1	43.6	3.7	16.9
Share with Slovenia					
Exports	18.23	13.05	13.12	13.55	12.12
Imports	6.56	6.75	7.65	7.87	7.79
Slovenia, growth total					
Exports	-9	12.2	21.8	-0.1	0.8
Imports	5.9	12.4	30	-0.7	-0.7
Share with Croatia					
Exports	12.14	10.8	10.72	10.29	10
Imports	9.16	6.82	6.06	6.27	4.97

Source: WIIW.

Trade and output

The openness of the Balkan economies varies, as can be seen from Table 10. Slovenia is a very open economy. It also shows a certain stability in its foreign trade performance. Other Balkan economies are much less open and some are quite closed. Also, measuring the level of openness in current US dollars is not satisfactory because it leads to high volatility in the volume of GDP which then translates into sharp changes in the level of openness. However, no other measure is really satisfactory. Also, openness is strongly correlated with the largeness of an economy as well as with its level of development. Larger and more developed economies often tend to be more

closed than smaller and less developed economies. As the countries in the Balkans vary in their size and level of development, comparisons are altogether difficult to make.

It is also not clear how important the fact of low openness to foreign trade is for growth and development in the Balkans. As already noted, the countries in the region gravitate towards out-of-Balkan markets. In addition, more developed countries in the Balkans are either small (Slovenia) or not all that open to trade. For the latter, the trade figures for Greece and Turkey are interesting to look at. The Greek economy is not an open one. The same is true for Turkey. In addition, both countries run significant trade deficits. One can conclude that Greece and Turkey have a lot of things to buy but mainly in the developed countries while they do not have all that much to sell. In other words, bordering on Greece or Turkey – or being in the same region as they are – is not the same as bordering on Germany, Italy or Austria.

Table 10

Openness (exports & imports/GDP) in the Balkans

	1992	1993	1994	1995	1996
Slovenia	102.4	99.7	98.2	95	93.5
Croatia	91	73.5	66.2	67.2	64.8
B&H	.	.	.	.	.
Yugoslavia	35.3	.	.	.	36
Albania	85.7	49.5	53.6	60.4	35.6
Macedonia	80	93	81	71	60
Romania	53.6	43.3	44.1	50.1	55
Bulgaria	97.5	78.4	80.9	85.2	103.3
Greece	32.9	31.8	30	32.2	29.7
Turkey	24.7	26.4	31.9	33.9	36

Note: B&H's GDP is either unknown or not reliable enough.

Source: WIIW database and national statistics.

History plays a part, though a diminishing one, in the existing trade patterns too. Thus, Macedonia figures as a trading partner of Slovenia and Croatia though Bulgaria and Romania do not, or not to that extent. This is the case in the opposite direction too. Bulgaria and Romania do not figure as significant trading partners in most of the states of former Yugoslavia. This suggests that there are trade re-orientations that are ongoing or are yet to come. The latter comment relates to the trade between Slovenia and Croatia, as already pointed out, that is still quite significant and important for both countries. The trade has gone down from the levels characteristic of the late 1980s but has perhaps stabilized in recent years. In addition, Croatia and Slovenia have recently signed a free trade agreement that, however, has so far failed to boost their bilateral trade. Thus, at the moment, it is difficult to say whether there is any long-term prospect

for high levels of trade between these two countries. Slovenia tends to run increasing trade surpluses with the Balkan economies with which it trades while Croatia tends to run trade deficits, except with Bosnia and Herzegovina, and may actually shift its imports from Slovenia to the EU.

Bosnia and Herzegovina is a special case. After the Dayton peace agreement, there has been some revitalization of economic activity. However, the foreign trade figures are not very reliable. Looking at this country from the trade statistics of the neighbouring countries, one finds that a number of former Yugoslavia states are exporting to Bosnia and Herzegovina, though they are not importing all that much. The largest trade in volume is that between Croatia and Bosnia and Herzegovina, and that between Yugoslavia (Serbia and Montenegro) and the Republic of Srpska. Thus, in 1996 the latter trade was USD 609 mn or more than 10% of the total Yugoslav foreign trade. Indeed, the Republic of Srpska was the second most important trading partner of Yugoslavia. In 1997 the level of Yugoslav trade with Bosnia and Herzegovina (which now includes the Republic of Srpska) has remained significant. Bosnia and Herzegovina appears as an importer of goods from Slovenia, and that can hardly be explained in any other way but as an effect of path-dependency, i.e. of the history of belonging to the same state in the very recent past.

Finally, the low level of trade integration is related to the generally low level of output and income in the Balkans. Indeed, the comparison of GDP levels in the Balkans given in Table 11 leads to one striking observation.

Table 11

Balkan countries: GDP in 1996

	in USD bn	GDP per capita
Slovenia	20	9500
Croatia	18	4000
Bosnia and Herzegovina	2	800
Yugoslavia	16	1500
Albania	3	800
Macedonia	4	2000
Romania	35	1500
Bulgaria	10	1200
Greece	123	12000

Note: Rough and rounded figures.

Source: WIIV.

Greece has a larger GDP than all the other Balkan countries combined (except Turkey). However, Greece exports only slightly more than Slovenia and not much more than

some larger Balkan economies. Thus, the largest economy in the region cannot act as the centre of gravity or an attractor of foreign trade in the region. As a consequence, it is not to be expected that there is much scope for an increase in regional trade and it is not to be expected that regional trade can exert a decisive influence on the growth of output in the region.

The flow of foreign investment

If one looks only at the so-called post-socialist countries in the Balkans, the inflow of foreign investment can be characterized as rather low. This is true for more or less all the countries, though for different reasons. The reasons can be classified as follows:

- security
- sanctions
- instability
- legality
- protectionism.

Security is a very significant consideration for most countries in the region because of all the military and other conflicts that are going on there. The level of risk is fluctuating, as is the region affected. But, for a rather large area, it has remained constant. This, of course, translates into country risks which are considerable for all these countries, except for Slovenia.

Sanctions have had serious effects, and will continue to have these effects in an obvious manner. There are sanctions imposed by the outside world, but also those that are imposed bilaterally in the region itself. The most important sanctions in the former category are those that were imposed on Yugoslavia (Serbia and Montenegro) by the EU and the UN, some of which were lifted at the end of 1995 (after the Dayton agreement), but some remained (the so-called outer wall of sanctions as well as the recent decision by the USA and the EU not to allow state-sponsored or helped investments into Yugoslavia). The most important example of the second kind are the sanctions imposed on Macedonia by Greece from early 1995 to late 1996. However, there are also undeclared sanctions on imports of Slovenian goods to Yugoslavia and a number of other trade barriers of a similar kind that vary from time to time and from country to country.

Macroeconomic instability has been a serious problem for a number of countries, like Romania and Bulgaria. But this is true more generally, though in many cases this cause plays a secondary role the others being so much more important.

The low level of *legality* has also contributed to the high risk of foreign investments in the whole area. This is a problem in all the post-socialist countries in the region, with the exception of Slovenia.

Finally, some countries have also followed a path of *protectionism* in one way or another, though often for different reasons. This is the case of Slovenia, which has been very cautious with foreign direct investments and has maintained policies that put barriers to foreign investments both short- and long-term. Short-term investments are discouraged by a deposit requirement (a foreign investor is required to put a deposit on a 'custody account' with a Slovenian bank, the amount of which is some share of the value of the intended loan or investment). Foreign direct investment has been discouraged because Slovenia opted for insider privatization and because the government has been reluctant to sell state companies and banks to foreigners. Table 12 summarizes the FDI developments in Southeast Europe.

Table 12

FDI in South Eastern Europe, USD mn, stock, end of period

	1992	1993	1994	1995	1996	1997
Albania	157	205	205	300	291	329
Bulgaria	65	192	412	517	831	1252
Romania	544	761	1272	1595	2209	3401
Croatia	.	96	209	311	844	1192
Macedonia	29	46	56	64	44	75
Slovenia	1044	954	1331	1745	1934	2400

Source: WIIW.

Table 13 shows the FDI share of some EU countries. The countries from the region, with some exceptions, do not play a significant role in investment flows. Exceptions are Greek investments in Bulgaria (about 5% of total FDI there in 1996-97 on average) and Turkish investments in Romania (about 4% on average the last couple of years). Another exception is Greek participation in the acquisition of 20% of the Serbian Telecom in mid-1997. Other Greek investments in Serbia have been reported but their extent is not clear. In any case, all these intra-regional investments are small in comparison to out-of-region investments, though overall levels are low, as already pointed out.

Table 13

FDI by Germany, Austria and Italy, % share¹⁵, end-1997

	Germany	Austria	Italy
Slovenia	34.3	14.1	7.4
Bulgaria	20.9	4.4	.
Romania	11.8	3.8	8.5
Croatia	9.2	16.3	2.9

Source: WIIW.

In any case, FDI flows are not very significant and do not represent, as of yet, a significant factor in the developments of this region.

The issue of causality

Looking at the trade and investment levels and patterns in the Balkans leads to the conclusion that this is not an economic region. Given the current regional initiatives, it would be important to determine whether the Balkans are potentially an economic region. Though there is no obvious way to answer this question, one way to approach it is to determine whether the lack of regional integration is the consequence of the low level of trade or whether it is the other way around. In other words, it would be necessary to ascertain what are the causes that have determined the existing low level of regional integration.

By just looking at the present situation, the Balkans do not fulfil the conditions for regional integration for the following reasons:¹⁶

- (i) Though there are quite developed regions at the periphery of the Balkans (Slovenia, Istria), most of the region is quite underdeveloped (apart from Greece). If the region were to converge to the growth characteristic of the region, it would remain underdeveloped in the future too.
- (ii) The most important trading and investment partners of the Balkan countries are those in the EU. In addition, no country in the Balkans constitutes an optimal currency area. In fact, when one says money in the Balkans one means German marks.¹⁷ The significance of this is that no local currency in the Balkans can play the role of an anchor currency and can serve as a vehicle of integration.

¹⁵ For Bulgaria, the second most important investor is Belgium with a 20.1% share (third most important is Netherlands with 7.4%). For Romania, second most important is Netherlands with 10.3% share and many countries (including South Korea are more important than Austria). For Croatia, third most important investor is EBRD and a number of other countries are more important than the neighbouring Italy.

¹⁶ Those refer loosely to the conditions set out in Rosenstein-Rodden's classic (1943).

¹⁷ Bulgaria used to be an exception but this is changing because with the introduction of the currency board regime, it chose the German mark as a shadow currency for its peg.

(iii) Together with the lack of monetary closeness there is also the lack of financial closeness in terms of a working payment system or a working banking system. Also, foreign direct investment that would be internal to the Balkans is not existent at the moment. Greece plays a larger role than the other countries, but there is practically no chance for it to take the place of Germany especially because much of foreign investment in the Balkans relates to outward processing industries mostly oriented towards Germany and the EU.

If the current situation is anything to go by, the causality does not run from the low levels of trade and investments to the low level of integration, but the low level of integration – due to inherited divisions, general underdevelopment and overall security problems – is what causes the low levels of trade in the Balkans and what prevents the development of regional integration.

Looking into the future, it is difficult to see this being changed. Though geography gives one impression, economics suggests another. It may be more realistic to hope for a general liberalization of trade to take place in the Balkans than to hope for some regional integration developing. In fact, the growth engine for the Balkans will remain in the EU, so it is probably more realistic to look at the ways how to integrate the Balkans with the EU than to condition this integration on the antecedent integration in the Balkans or on the inclusion of the Balkan countries in other regional integrations.

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Patterns of Divergence in the Western Balkans*

Introduction

The name Western Balkans is used by the European Union (EU) to refer to the region that includes Croatia, Bosnia and Herzegovina, Yugoslavia (Serbia and Montenegro), Macedonia and Albania. These countries are grouped in order to separate them from the other Central and East European countries not only in terms of geography, but also in terms of policy. The EU has adopted a regional approach in relations with these countries. The basic principle of this approach is that these countries cannot hope to have closer relations with the EU than they are ready to have with each other. Though this principle incites a lot of debate in political circles in the Western Balkans, it is a rather clear statement that security issues stand in the way of EU integration. In other words, as long as the countries in the Western Balkans generate security concerns and problems, they cannot improve their relations with the EU.

More abstractly, the principle represents a regional approach to security issues. In the same way the EU itself has been attempting through integration to solve what used to be international problems for its members, it is trying to do regionally, i.e. in the Balkans, through regional integration. This integration should proceed before or parallel to the region's integration into the EU. This 'security approach' to this region relies on the assumption that the economic interests for integration will be stronger than the security concerns. The approach assumes also that there are also local or regional economic interests, in terms of trade, investment and possibly even common economic policy and development.

These interests are hard to make out in the Balkans, however. The region is disintegrated and mostly depends on trade with and finance from countries that are outside of the region, i.e., from the EU. Therefore, the regional approach of the EU amounts to the suggestion that the countries in the Western Balkans should trade-in their local conflicts for the benefits of economic and political integration with the EU. This incentive has been shown to be weak, however. It is often the case that a change in political preferences cannot be realistically expected if there are no direct economic interests. This transforms the regional approach by the EU into a long-term delay in Balkan integration.

In the context of the general theme of the seminar, the example of the Western Balkans presents the possibility of backwardness¹⁸ appearing and persisting amidst the process

* This article was prepared for the WIIW Spring Seminar in March 1999. It provides background information on the environment of the Kosovo crisis. For detailed information on this issue also *WIIW Current Analysis No. 12*, 'The Costs of the Kosovo Crisis'.

¹⁸ In the sense of Gerschenkron [1962].

of European integration. To deal with this, in this paper, I want to put the short-term developments in these Balkan countries in the context of the longer period of disintegration and divergence. I will start with an overview of the current situation, introduce some historical reflections, analyse some current developments, look at more urgent policy problems, especially as they relate to issues of privatization, and conclude with some conjectures about the prospects.

Some stylized facts

The following tables give a summary of the current economic situation in the countries in the Western Balkans. Much of what I will have to say will be an analysis of these tables.

Table 1

Western Balkans: some indicators						
('normal values', based on recent experiences)						
	GDP growth	Inflation	Trade deficit	CA deficit	Unemployment	Budget deficit
Croatia	2-3%	4-6%	20%	7-9%	20%	3-5%
B&H	15%	3-5%	50%	30%	40%	20%
Yugoslavia	2-3%	20-50%	15%	10%	30%	10%
Macedonia	3-5%	3-5%	10%	8-10%	32%	2-3%
Albania	7-8%	8-10%	20%	10%	20%	10%

Table 2

Western Balkans: more indicators			
('normal values', based on recent experiences)			
	GDP per capita in USD	Openness	EU trade share
Croatia	4500	65%	65%
B&H	750	90%	40%
Yugoslavia	1500	40%	45%
Macedonia	1800	90%	45%
Albania	700	50%	90%

The figures represent estimates of the 'normal values' for these countries given the recent economic experience. Figures for deficits are shares in GDP. Openness is exports plus imports of goods as a share of GDP. The EU share is the share of EU trade in total trade. Other figures are standard. The common characteristics are as follows:

1. Low growth. The high growth rates in Bosnia and Albania are the consequence of very low levels. Even they are unstable, as evidenced from the recent experience of Albania. In Bosnia, growth is essentially due to the inflow of aid.
2. Relatively low inflation, except in Yugoslavia. In any case, inflation is not an immediate problem in the Western Balkans.
3. *Unemployment is high* or very high or catastrophic. If anything, it will get worse in the medium run.
4. *The trade deficit is large as is the current account (CA) deficit.* This raises the key issue of external finance that I will deal with in more detail.
5. *The economies are small or very small and open or very open.* The exception in terms of openness is Yugoslavia, but this is due to the sanctions and is thus temporary.
6. There are *serious fiscal problems*. Exceptions are Croatia and Macedonia. However, if bad loans and enterprise arrears are taken into account, the situation in these two countries is also difficult. I will give some estimates as to how large these para-fiscal deficits may be.

A view from the past

The general picture is one of backwardness. It is always illuminating to try to see large divergences in historical terms. In that way it can be seen whether there are some persistent factors that explain the present-day state of affairs. As the story of former Yugoslavia has been told quite a number of times,¹⁹ I will go somewhat further in history to see whether the region was diverging from other countries and regions as it does now. Table 3 gives some indication of the income levels at the beginning of the twentieth century.²⁰

Table 3

National product per capita in 1910, USD (1970 value)

Germany	958	Dalmatia	650
Austria	810	Bosnia	546
Czech lands	819	Croatia	542
Hungary	616	Serbia	462
Italy	546	Transylvania	542
Greece	455	Russia	398

Other estimates exist.²¹ They differ, sometimes significantly, depending on what variables are taken as proxies for income and depending on the units those are

¹⁹ For instance in Gligorov [1996].

²⁰ Taken from Palairat [1997].

²¹ For newest estimates and for a comparison with the earlier ones see Good [1998].

expressed in, but most estimates show the same patterns and differences as the ones in Table 3. Balkan countries and areas were backward, but the internal divergence and the distance from the Western and Central European countries was not so great. The distance from Germany or Austria was at most three to four to one, not five or ten or twenty to one as it is now. Looking still further into the past, it can be concluded that even the difference that can be observed in Table 3 was a product of diverging economic developments in the nineteenth century. While the differences increased over the whole century, they started to diminish in the late nineteenth and early twentieth century.²² There were three factors that contributed to that.

First, the regions in Austro-Hungary started to converge after serfdom was abolished there and internal tariff barriers were removed. Larger markets and free movement of labour contributed to economic convergence.

Second, the modernization of the infrastructure, especially of railway connections, facilitated by the somewhat improved security situation in the region, contributed to market integration and to the spread of industrialization throughout the region.

Third, in the newly independent countries (Serbia and Montenegro in the group of countries considered here), the state was relied on to raise the level of education and to make other social services (e.g., health) available to the larger population. Though in other areas the new states were not necessarily successful, they were not altogether unsuccessful in providing education and health services.

As a consequence, there was an increase in the level of foreign trade and in the financial and other services that could be instrumental to trade and investment.²³ The trade patterns show an enduring characteristic: Most of the trade was conducted with the more developed countries in Western and Central Europe. The intra-regional trade was small and not very dynamic. The same is true for financing and investment. Both credits and direct investments came from the West and not from within the region.

In the new states, budgets were used and misused. In the regions that were not independent, fiscal centralization outside of the regions, in Vienna or Budapest, was predictably one of the major causes of political conflicts.

All in all, the situation at the beginning of the twentieth century seems to underline:

- (i) the trade and finance dependence of the region on the more developed parts of Europe,

²² See Good [1998] and Palairat [1997].

²³ See Lampe and Jackson [1982].

- (ii) the beneficial influence of market and even political integration for growth and convergence, and
- (iii) the enduring problems with fiscal independence and with the misuse of that independence once acquired.

Given these considerations as well as the experience with the development during the twentieth century as a whole, it can be argued that market and institutional integration with Western Europe has been beneficial for the Western Balkans while disintegration and isolation has been harmful.

An historical example

One interesting historical example is Bosnia. The situation in today's Bosnia and Herzegovina is somewhat similar to the one prevailing after 1878 when Bosnia was put under the protectorate of Austro-Hungary. Without going into details, the development can be summarized as follows:

First, there was a significant economic development and growth due to large investments especially in the mines and in infrastructure. Most of these investments were public. This is certainly true for railroad construction.

Second, there was a marked rise in GDP per capita and in incomes. As can be seen from Table 3, Bosnia was slightly ahead of Croatia and Serbia in the period just before World War I. However, there was little or no progress in other human capital indicators, like education, skill-development, health or in the availability of social services.²⁴ It is not even clear that there was a perceptible increase in the rule of law. Indeed, the main complaint at the time was that the rule of law was either non-existent or was laxly interpreted.

Third, there was no political legitimacy to the whole process. Austro-Hungary had problems of its own, but it also tried to adapt to local political preferences and that proved as a way to aggravate the whole situation rather than anything else.

The problems facing the reconstruction and recovery of Bosnia and Herzegovina today are more or less the same. The process of economic growth has to be combined with the process of state- and nation-building. There is no indication that even reconstruction is proceeding quickly and smoothly, but the state- and nation-building is not proceeding at all.

²⁴ See Palairat [1997] for details.

This same problems can be found in the Western Balkans as a whole. Certainly, similar problems are facing the EU in Kosovo, but also in Serbia as a whole, in Albania, in Macedonia and even in Croatia. The regional approach outlined in the introduction assumes that there are states or nations in the Western Balkans that can co-operate regionally and then integrate into the EU. This is not the case now in the same way in which it was not the case in Bosnia in the second half of the last century.

Current state

Looking more closely at the current state of affairs, and given that a significant breakthrough in the overall security in the region cannot be expected in the short run, the development of some of the key constraints on the economic recovery of more or less all of these countries that can be expected are quite disturbing. The key constraints are: (i) external disequilibria, (ii) internal disequilibria, and (iii) low level of integration. I will discuss them in turn.

Trade and finance²⁵

The trade deficits are large and persistent. The current accounts are also negative, but there are some differences. In some countries the balance of services trade is positive or strongly positive while in others it is negative. In all countries transfers play a significant role and tend to be positive or strongly positive.

All of the countries in the region have balance-of-payments problems. Those pervade both their current accounts as well as their capital accounts. Looking at the development of the merchandise trade balance (see Table 1), it is clear that a long-term deficit can be expected. In most cases, current account deficits are smaller than the trade deficits. Trade in services helps, though not everywhere. On the other hand, transfers are everywhere significant. Indeed, one can say that the whole region does not export all that much and relies to a very large extent on tourism (on the coast) and on transfers (everywhere). This structure of the current account is characteristic of a backward country (though not necessarily only of a backward country). In the whole region, exports of goods are quite low. This is partly a reflection of the depressed level of production, but it is also a reflection of the fact that not all that much is being produced that can be exported.

The capital accounts show similar signs of backwardness. Grants, aid, and credits with low interest rates, i.e., credits for development, dominate. In addition, there are trade credits that help to finance the trade deficits. However, investments are low (both direct and portfolio). The reliance on aid and credits has short-term advantages, but will prove

²⁵ More on this whole subject in Gligorov [1998].

to be a problem in the longer run because of the increase in foreign debt and because the debt service will be increasingly a problem for the budget.

Fiscal problems

In most cases, the states are bankrupt. Croatia and Macedonia are exceptions, but this is because the losses in the banking and in the enterprise sector are not covered which leads to soaring liquidity problems. There are deficits in the social funds too, which are partly covered from the budget and are partly defaulted on in one way or another. If comprehensive financial restructuring were to be undertaken, budget deficits would become quite significant in Croatia and Macedonia too, at least temporarily.

In the remaining three countries, budget deficits are persistent and unsustainable. With growth being unconvincing and volatile, the fiscal situation will not improve. This being the case, outbursts of higher inflation cannot be excluded, though all these countries have recent memories of hyperinflation and most citizens are hedging against this possibility by contracting and saving in foreign currency. As a consequence, social welfare is bound to continue to decline with predictable consequences for social inequality.

In any case, budgets cannot be expected to provide an impetus to the economic developments because there is hardly any money for public investment (an exception was Croatia, but increasing problems with the debt service and with the social funds make it hard to allocate significant amounts of money to public investments in reconstruction and development).

Unemployment

There are two issues to be mentioned that are related to employment and unemployment:

First, official figures of registered unemployment are quite high, but even labour force surveys show high or very high levels of unemployment. More importantly, unemployment will continue to increase for some time in all countries. This is because there is no sharp turnaround in growth to be expected and because there is still quite a lot to be done in the area of enterprise restructuring.

Second, people employed in the black market are of course facing levels of uncertainty that are not conducive to either stability or productivity. It is often said that the black market is a big employer, but it is not often said what type of employment it is that one can get through the black market. Therefore, that type of employment is both socially

unattractive and costly, because it is subsidized through tax evasion. The extent of black market activity is not really known, but it is quite substantial throughout the region.

Integration

The Western Balkans, except for Albania, is the only region that has decreased its level of integration with the EU. Former Yugoslavia had a co-operation agreement with the European Community. The successor countries have no contractual agreements with the EU, except for Macedonia, which has signed a co-operation agreement. Albania also has a co-operation agreement with the EU. Yugoslavia is indeed under sanctions. The above-described regional approach of the EU is indeed designed to address the problem of integration of this whole region with the EU.

Some policy issues

Given the trade and current account deficits, the key policy issue is how to finance those. Two factors influence the policy choices.

The first is the availability of the foreign financial markets. For most countries in this group, the financial markets are closed. Croatia is an exception, but even in that case it is only a matter of time when Croatia will drop out if there is no significant change in the attitude towards the trade deficit.

The second is the level of foreign debt and its structure. Yugoslavia and Bosnia are either in moratorium or cannot be expected to service their debts. Croatia, Albania and Macedonia are coming close to the situation when their foreign debt will become a problem.

These constraints push for greater reliance on foreign direct investment. Indeed, the key policy issue in the whole region is that of attracting FDI in order to sustain the external position. There are a number of problems connected to privatization that will be discussed in more detail below.

Fiscal deficits present serious problems that will be difficult to solve. The way that they are treated now is unsustainable. However, there are huge problems with fiscal reforms beyond the introduction of the VAT, that helps with fiscal revenues. Especially difficult is the situation with the social funds and it is hard to see how those are to be reformed.

Monetary policy options are limited. Given the high level of currency substitution and indexation, the scope for monetary policy is quite restricted. Because of that, fixed exchange rates are practically unavoidable. This, however, puts the decisive stress on

market flexibility, which is not really present because, among other reasons, of the internal regional disintegration and because of the lack of integration with the EU market.

Privatization

The process of privatization in Croatia, Bosnia and Herzegovina, Yugoslavia (Serbia and Montenegro) and Macedonia has been influenced by the initial conditions, i.e., the legacy of self-management, but has also depended significantly on the policy preferences and choices in every particular state. Because of the latter, the progress in privatization has been uneven with some countries having made some advances while some other countries remaining at the very beginning of that process. However, in all these countries the process of privatization will take quite a long time to be completed.

In what follows, the present situation will be described country by country, then the effects will be assessed and finally the possible future developments will be discussed. In the conclusions, a summary of the most promising business opportunities can be found.

Croatia: from nationalization to privatization

Privatization in Croatia has been largely determined by two laws: one on the Transformation of Socially Owned Property from April 1991 and the other on Privatization from March 1996. The aims of the 1991 law were twofold: (i) to identify the owners, and (ii) to nationalize.

(1) Aim (i) was achieved through insider privatization. Employees in socially owned firms were given a deadline (June 1992) to submit their privatization programmes or their equity would be transferred to the Development Fund. Most of the firms (about 80% of 2650 firms) chose the method by which employees and managers took over their firms with large discounts (up to 40%). The rest went to the Development Fund, renamed Privatization Fund at the end of 1992, which together with the outright nationalization of utilities, banks and some large companies (for instance INA) achieved aim (ii).

(2) The new Law on Privatization from March 1996 applies mostly to nationalized property. It is to be partly sold, partly distributed via vouchers to soldiers and veterans and partly sold at a discount.

As for the firms to be sold, the most important are those that are considered to be strategically important for Croatia. There were initially seven such firms:

- INA, the oil company,

- the electricity company (which is responsible for the generation and distribution of electric power),
- national radio and TV,
- the state railway company,
- state Mail and Telecom,
- the roads and forests company.

A number of others have been added. In particular, the largest state-owned bank Privredna banka Zagreb and two smaller state-owned banks, Splitska banka and Riječka banka, are to be sold this year (that is the plan). Apart from the Telecom and the state electricity company, firms like Rade (durable consumer goods) are slated to be sold this year.

These state companies are to be privatized by the state on a case-by-case basis and basically sold to foreigners.

As for voucher privatization, it involved all Croat nationals affected by the war (mostly veterans and displaced persons) and was concerned with the shares the Privatization Agency holds in the previously socially-owned enterprises. The vouchers have been distributed free of charge and have largely been exchanged for shares in the portfolio of the Privatization Fund.

The shares that could be bought at a discount refer to all those privatized under the previous law the purchase of which can be rescheduled for twenty years. In addition, soldiers who had no chance to participate in the previous privatization, i.e., the one in 1991 and 1992, can now buy shares at a discount.

The Law on Privatization was passed on 1 March 1996. The privatization according to this new law has not advanced all that much except for the voucher privatization. The vouchers have been distributed and the public offerings of state-owned shares in 471 firms which could be exchanged for these vouchers were made; the whole process was completed by the end of last year. The shares are concentrated in seven investment funds the shares of which should become tradable at the Zagreb stock exchange this year.

- (3) The whole process is planned to end in 1999. The end result aimed at by the privatization process should be the following structure of the Croatian economy:
- indigenous private sector mainly in trade, tourism and other services,
 - insider-privatized sector of former socially-owned firms ,
 - shares of state property owned by investment funds and the residual state ownership,

- foreign-owned firms in tourism, utilities, the banking sector, trade and industry consisting mainly of shares of former state-owned companies.

The end result will clearly be influenced by the institutional legacy of self-management, by the consequences of the massive nationalization effected after 1992, and by the circumstances. For the latter, two main characteristics should be mentioned.

First, as part of a declared government strategy of pushing for a capitalist society with a hundred or so rich or very rich families, a number of individuals with close ties to the government were favoured in the establishment of the indigenous private sector. This consists of interconnected firms in trade, financial services in media industries and the like. This sector is practically bankrupting now and is creating huge economic and social problems.

The second influence comes from the high trade and current account deficits and the rising foreign debt that are pushing for larger foreign investment participation than was the case in the past. This year's budget assumes about DEM 1 bn in foreign direct investments. The debt service will be significant next year too, so the same need to sell to foreigners in order to pay the foreign debts will be present. The problem will be whether the firms, the companies and the banks that are planned to be sold will be ready for privatization in such a quick time and what price they will fetch given the worsened investment situation in the emerging markets in general and in Croatia in particular.

In any case, the main investment opportunities in Croatia are going to be those connected with the privatization of the strategic companies listed above. In addition, there are significant opportunities in tourism and in the banking sector. Unrelated to privatization, there will be continuing investment opportunities in the Croatian public debt, i.e., in government bonds. Indeed the Croatian government issued EUR 300 mn in eurobonds in the first quarter of this year (at 375 basis point above the benchmark interest rate) and more will certainly come.

Bosnia and Herzegovina: forced privatization

The process of privatization in Bosnia and Herzegovina is rather complex as could be expected. According to the constitution of Bosnia and Herzegovina, which is a part of the Dayton peace agreement, it is the entities (the Federation of Bosnia and Herzegovina and the Republic of Srpska) that are responsible for privatization. In addition, in the Federation the cantons (ten of them) have significant responsibilities in this area. Finally, privatization in Bosnia and Herzegovina has to deal with a number of problems that are specific to this country.

As far as the legislation goes, both the Federation of Bosnia and Herzegovina (in 1997) and the Republic of Srpska (in mid-1996) have adopted laws on privatization. The strategies of these laws are different however.

In the Federation, the law on privatization is the same for the whole Federation, but privatization is to be administered by the ten cantons. Citizens are to get shares in enterprises in exchange for claims of various kinds that they have on the government. Mostly, those will be frozen foreign currency deposits, accumulated debts in terms of unpaid salaries and pensions, compensations for lost property and vouchers that will be distributed free of charge.

In the Republic of Srpska the so-called social capital was nationalized and is now to be privatized so that 55% will remain in the portfolios of various state funds, 15% will be sold to strategic investors (possibly foreign) while 30% will be exchanged for vouchers. Neither of these two privatization programmes have advanced significantly. They run into all kinds of problems, of which three are the most important.

- (i) Both laws discriminate against citizens who find themselves in the other entity. This leads and will in the future lead to great injustices that will undermine the legitimacy of the whole process.
- (ii) The implementation of privatization depends on the political developments in both entities. As those are complicated and slow, so is the privatization.
- (iii) The capital to be privatized is in many cases non-existent. Thus, most of the ownership rights that the citizens and the employees will acquire will be basically worthless.

The main aim of the privatization in Bosnia and Herzegovina is to somehow put the institutional past behind and to clear the ground for economic reconstruction and development. This is proceeding at a slow pace to say the least. It is at the moment quite difficult to say what the investment opportunities in Bosnia and Herzegovina are. There is not much to invest into anyway, and the political risks are too high.

Yugoslavia (Serbia and Montenegro): façade privatization

Yugoslavia adopted a law on transformation of socially-owned property in May 1996. Montenegro had adopted a programme of privatization before while Serbia adopted a privatization law in summer 1997, which became valid on 1 November 1997. Montenegro adopted a new law on privatization in February 1999. What are the main characteristics of these laws and programmes?

First, the Yugoslav 1996 law has been completely inconsequential so it does not merit discussion.

Second, the privatization programme in Montenegro has proceeded mainly in the following manner: The shares of socially-owned enterprises were transferred to a Development Fund which sells them in public auctions. It was generally agreed that the process was not proceeding all that quickly and that some new legislation should be passed to make especially the foreign participation more attractive. As already mentioned, such a law has just been passed. It introduces the free distribution of voucher to all citizens of Montenegro (worth DEM 5000 per capita). Those can be used to buy shares now in the portfolio of the Development Fund and in other companies. The six most attractive and largest firms and companies are to be sold to strategic investors (among those are a big aluminium producer, a steel-mill, a producer of trucks and some hotels or resorts on the coast).

Third, the Serbian 1997 law has had hardly any significant consequences so far. The socially-owned enterprises eligible for privatization have been divided in two groups.

- (i) In the first are 75 enterprises that can be privatized only with the government's consent. In this disparate group one finds firms that seem destined for sale to foreigners as well as firms that are destined for liquidation. None of these companies have has been sold yet.
- (ii) In the second group are to be found all the other enterprises which can privatize or not privatize at will. These firms can choose from three methods of privatization (sale, capitalization and internal), but the law is obviously biased towards insider privatization because it requires the firms to distribute free shares to their employees and makes it possible for them to buy additional shares at large discounts. This method of privatization ensures that the employees (current and former) will control at least 60% of the shares in the firm's equity. In addition, the privatization can proceed gradually and the shares, if they are bought at a discount, can be paid for over a period of six years. As a consequence, the privatization process can last a decade with the end result of insiders controlling the majority stake in their firms.
- (iii) At this moment more than a thousand firms have completed the process of auditing and of the determination of the value of their capital. About two hundred have already started the process of privatization with the distribution of free shares and with the sale of internal shares at discounts. The capital already determined to be privatized is around DEM 2 bn, but how much money will actually change hands is another matter.

Given the legal and the political situation in Yugoslavia, the most probable advance in privatization can be expected in direct sales similar to that of the Serbian Telecom. The

49% share of that company was sold in late spring 1997 to an Italian (STET) and a Greek (OTE) company for a little over DEM 1.5 bn. This money has been used to finance the budget and trade deficits and to subsidize exports. Similar sales with similar aims in mind can be expected in the future. This is now hard to do due to the new sanctions introduced by the European Union and the USA in mid-1998 that rule out government-related investments, i.e., precisely the investments like the one involving the Serbian Telecom.

The strategic idea behind the Serbian privatization law seems to be to have one economy and two ownership systems. One part of the economy will be self-managed, though the firms will be owned mainly by the employees, while the other will be sold to foreigners with or without the existence of a majority stake of the state. Indeed, given the financial and the foreign debt situation of Yugoslavia, it is to be expected that the circumstances will push for the latter part to grow quite fast if the international position of the country will allow it.

However, it is still early to talk about investment opportunities. Most of those will be found in the 75 firms that the state plans to privatize or restructure or both. But as the intentions of the government are not known, it is difficult to say all that much about this at the moment. Also, the recent incident with the American-owned ICN Galenika (a drugs producing company), which was effectively nationalized without clear explanation and without any compensation, highlights the problems that foreign investors may encounter in Yugoslavia. Domestic privatization has already gone through one huge re-nationalization and hundreds of affected companies are still suing the state trying to revert the decision and to win back their property. Thus, unlike in most other cases, privatization in Yugoslavia is not irreversible.

Macedonia: from self-management to employee and management buy-outs

The law on transformation of socially-owned enterprises was adopted in 1993. The law covers more than 16 hundred firms of various sizes. It offers a number of methods of privatization, the one most popular and most used is that of management buy-outs. This is because the proclaimed aim of privatization was an increase in efficiency rather than distribution of ownership rights.

At the moment, more than 1400 firms have completed their privatization. The rest are in various stages of the privatization process. The remaining firms are going to finish the process by the end of 1999 (most probably). In addition, the privatization of socially-owned firms in agriculture started in 1997. Also, the privatization of the largest bank, Stopanska banka, is contemplated with foreign participation of more than 50% of the bank's equity. Finally, the privatization of the utilities is to start with the sale of the Macedonian Telecom which was planned for 1998 but has been postponed.

The outcome of the privatization in Macedonia, as it looks now, can be summarized thus:

- (1) Most of the more valuable firms (252 by the latest count) have ended up being owned by their management. This does not necessarily increase the efficiency of their performance as in the case of most other types of insider privatization.
- (2) Most of the other firms have ended up being owned by the employees (364). The same efficiency problem appears there as in the other types of insider privatization.
- (3) Privatization has not brought large amounts of money to the budget because the shares were bought at a discount and were to be paid in instalments (usually over a period of five years). Altogether DEM 341 mn were paid to the Agency for Privatization by the end of 1998 out of close to DEM 4 bn estimated book-value.
- (4) The capital market has remained underdeveloped because there is not much to trade in.
- (5) The investment funds have not been active because there was no mass privatization (there was no voucher privatization).
- (6) There has been little if any foreign investment participation (about DEM 50 mn in all).

These developments will have to be corrected in the post-privatization process. It is not at this moment apparent how that is going to be done. A number of industrial, extraction and agricultural (basic production and food-processing) firms have been slated for sale this year. The key issue will be foreign investment participation, but it is not clear what it will be at this point. In any case, the Macedonian economy is now, at least nominally, largely based on private ownership as the private sector contributes more than 70% to the GDP. For interested investors, the best opportunities are to be found in the extraction sector (non-ferrous metals), in the food processing industries, in the banking sector and in the utilities.

Privatization prospects

The former-Yugoslavia states are at different stages in the privatization process. In Macedonia the owners have been mainly identified while in Croatia, Bosnia and Herzegovina and Yugoslavia (Serbia and Montenegro) this is yet to be done. However, in no case has the market played a significant role. In addition, the participation of foreign capital has been generally low except through direct sales essentially unrelated to the main process of privatization. Finally, the economies in all of these states are dominated by post-self-management and state sectors.

It is not obvious what will happen in the future. In the case of Bosnia and Herzegovina, Yugoslavia (Serbia and Montenegro) and Macedonia the adverse economic

circumstances may lead to a speeding-up of market-based privatization or rather trade in ownership rights in order to increase the efficiency of these economies. In the case of Croatia that may also happen for essentially the same reasons though in a different legal and international environment.

The most promising business opportunities to be found in all of these countries, as can be seen from the above country-specific comments, are in the following sectors:

Utilities (Telecom, energy, oil), food processing, banking, mining and the extraction sector as a whole, metal-processing, wood industry, construction (roads and railroads), tourism (hotels etc.). However, it is not to be expected in practically all of these countries that foreign investment will be as welcomed as it is in some other, though not all, transition economies.

Longer-term issues

The Western Balkans presents the picture of a backward area appended to a developed one. The way things are now, this may very well last for quite a while. This will certainly be the case if the region continues to disintegrate internally and fails to integrate with the European Union. The EU regional approach tends to preserve this long term divergence of the Western Balkans.

The key deficiency, as in all backward regions, is the limited possibility to generate internal savings and thus increase investments. Because of that, foreign investments are crucial to growth and development. Those, however, are sapped by security concerns and by institutional rigidities. These can be seen to have existed in the past too. Thus, chances are that they will persist in the future too.

The social and public ability and capacity cannot be improved because of the security problems that cannot be solved in the short run. In addition, the international involvement, as can be observed in Bosnia and Herzegovina, creates dependence rather than self-governance. This will also be the case in other countries or areas in the region where it will happen. This, in the end, will undermine the EU regional approach, which is not altogether credible anyway.

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Note: Meanwhile a detailed study on the Kosovo has been published by WIIW – see V. Gligorov and N. Sundström, 'The Costs of the Kosovo Crisis', *WIIW Current Analyses and Country Profiles*, No. 12, April 1999.

Additional Tables

Table 4

Services and transfer balance, USD mn

	S e r v i c e s				
	1994	1885	1996	1997	1998
Croatia	1662	1208	1764	2022	2100
B&H	-88	-23	-74	39	.
Yugoslavia	.	.	411	456	.
Macedonia	-155	-200	-155	-145	-150
Albania	-84	-1	22	-7	.

	T r a n s f e r s				
	1994	1995	1996	1887	1998
Croatia	523	800	1028	852	750
B&H	879	1002	1094	772	.
Yugoslavia	.	.	180	130	.
Macedonia	229	233	213	290	300
Albania	264	300	425	250	.

Note: Estimates for 1998.

Table 5

Foreign debt indicators, 1998, USD mn

	Stock	Reserves	Debt service	Imports	Exports
Croatia	8000	2800	1200	8400	4500
B&H	4000	300	.	1500	300
Yugoslavia	11500	200	.	4800	2800
Macedonia	1200	340	120	1700	1200
Albania	760	300	.	700	200

Notes: Debt service for Croatia and Macedonia for 1999. Debt stock for B&H and Albania for end-1997.

Table 6

Foreign direct investment, end of period, stock, USD mn

	1994	1995	1996	1997	1988
Croatia	209	311	844	1192	2000
B&H	.	.	.	.	.
Yugoslavia	.	.	.	2000	2500
Macedonia	56	33	44	60	82
Albania	205	201	291	339	300

Note: For Croatia 1998 estimate. For Yugoslavia both years are estimates. For Albania and Macedonia, June 1998.

Kosovo Crisis: Consequences, Costs and Prospects

Political consequences

The military conflict in Kosovo has ended with a political agreement that is clearly to be seen as a temporary one. As such, it does not definitely resolve any of the political and security issues that have caused the Kosovo crisis to erupt in the first place. In fact, it could be argued that it has opened up the issue of the political status of the territory of Kosovo even more sharply than it was the case before. With this, the political viability of Kosovo but also of Serbia, Macedonia and Bosnia and Herzegovina have been put into question. The political answers are yet to be contemplated.

In the short run, the political decisions about Kosovo will be made by a number of international organizations and agencies together with the European Union, NATO and a number of interested nations, e.g., Russia, with some role to be played by the authorities of the affected states too. It is not easy at this point to even describe, let alone analyse, how this quite complex political configuration will function and what will be its immediate achievements.

In the longer run, however, it is difficult to see anybody else running Kosovo but the people who are going to live there. It is, therefore, realistic to assume that Kosovo will be run by the Albanians. The key issue will be how is that fact going to be legalized and legitimized for some kind of a permanent political solution to be arrived at. The solution has to satisfy three conditions of legitimacy:

- it has to be acceptable to the parties in conflict, i.e., to the Serbs and to the Kosovo Albanians;
- it has to be acceptable to the other affected countries in the region (e.g., Albania, Macedonia, Greece, Bosnia and Herzegovina);
- it has to be internationally acceptable.

It is difficult to see, at this moment, what could be the concrete arrangement that would satisfy these conditions. The problem is not only that the territorial issue is difficult to resolve in any case, but even more in the fact that whatever solution is opted for it will have to be based on a more general principle the application of which could invite new problems in the region and even more generally. In this respect, the key dilemma is whether to treat the Kosovo issue as a territorial or as one of human rights. If the former approach is taken, other territorial problems in the Balkans may arise. If the latter is followed, it will be difficult to secure the agreement from the parties in conflict, especially from the Albanians.

The current position, as it was formulated in the relevant UN resolution, is that Kosovo will have a political autonomy. It is not at all clear, at this point, what does that mean and how is it to be legalized. The normal procedure would be the constitutional one. Either the Serbian constitution would have to be changed or a constitution for Kosovo would have to be drawn up that would then be somehow harmonized with the Serbian or the Yugoslav constitutions. Whichever approach is chosen, the Serbian and the Albanian sides would have to co-operate and compromise, and that seems now all but impossible.²⁶

Economic consequences

The interim solution provided by the current agreement and by the UN resolution may prove to be enough to enable the return of the refugees and it may also provide the necessary political support for the reconstruction of Kosovo. However, for the economic recovery of Kosovo and of Serbia as well as of the whole region, that will not suffice. A more ambitious programme will depend on the long-term political solution for the Kosovo problem and for the region as a whole. The task that is faced can be summarized by going through the costs of the Kosovo conflict.

Damage costs: Damages can be expressed in physical terms and only incompletely. Monetary estimates are yet to be made and will depend on the purpose which they are to serve. The damage expressed in physical terms consists of:

- number of refugees: up to 1 million;
- number of killed: less than 1 thousand soldiers and policemen on the Yugoslav side (according to the authorities); about 1500 civilians (according to the Serbian authorities); the number on the side of the Kosovo Albanians is unknown;
- large number of villages, towns, houses, industrial plants, infrastructure objects etc. destroyed, significantly damaged or damaged; lists that exist are incomplete especially when it comes to the destruction of Kosovo; the inventory will have to be made once the process of reconstruction starts.

Economic costs: Those can be expressed in a number of ways. In a summary way, loss in GDP can be taken as a proxy for the aggregate economic costs. Thus, in the case of Yugoslavia, the decline of GDP, assuming no significant reconstruction effort will extend to Serbia, might amount to 50% in 1999. In other words, given that the Yugoslav GDP was about USD 15 billion in 1998, that in 1999 will amount to USD 7 to 8 billion.

²⁶ On some of the constitutional problems in former Yugoslavia see V. Gligorov, *Why Do Countries Break Up? The Case of Yugoslavia*, Uppsala: Acta Universitatis Upsaliensis, 1994.

The same indicator can be used to estimate the costs for the neighbouring countries. The most affected are Macedonia, Albania and Bosnia and Herzegovina. Bulgaria and Croatia are also significantly affected. Romania and Hungary are among the least affected. Thus, Macedonia can be expected to lose about 5% of its GDP in 1999, Bosnia and Herzegovina may lose somewhere between 3 and 5 percent (the costs will mainly fall on the Serbian Republic), Albania's losses may be smaller because its economy is already almost at subsistence level. GDP shortfall in Bulgaria may be about 2%, in Croatia about 1% and in Romania and Hungary about 0.5%.²⁷

Table 1

GDP growth forgone in 1999²⁸

The Economic Consequences of the Kosovo Crisis:

May 25, 1999



International Monetary Fund



Current Analyses and Country profiles

No.12 April 1999

Vladimir Cligorov and Niclas Sundström
The Costs of the Kosovo Crisis

	Scenario			
	A	B		
Croatia	-3%	-2%	Croatia	-1%
Bosnia and Herzegovina	-8%	-5%	Bosnia and Herzegovina	-5%
			Hungary	-0.5%
Romania	-0.5%	-0.4%	Romania	-0.5%
Bulgaria	-2.5%	-1.5%	Bulgaria	-2%
Macedonia	-9%	-8%	Macedonia	-5%
Albania	0%	0%	Albania	-2%
			Yugoslavia	-25%
Total	-2.4%	-1.7%		

The sources of these declines are in the losses in foreign trade, in investments and in consumption. No reliable estimates of these losses are available. This is so because of the presence of the refugees, because of the international aid and assistance and because of the emergency lending and financial support. Thus, these precise costs can only be known *ex post facto*.

Reconstruction costs: These refer to Kosovo itself and to Yugoslavia as a whole. As far as Kosovo is concerned, the reasonable estimate on analogy with Bosnia and Herzegovina, and taking into account the difference in the size of the population and in the level of development, would be somewhere between USD 2 and 3 billion for the first

²⁷ More on this in V. Gligorov and N. Sundström, "The Costs of the Kosovo Crisis", *WIIW Current Analyses and Country Profiles*, No. 12, April 1999.

²⁸ These are losses in GDP growth, not GDP growth rates for 1999. The figure for Yugoslavia was as of April 1999. As is indicated in the passage preceding the table, the GDP loss looks more like 50% in June 1999.

three years.²⁹ If the reconstruction effort is extended to Yugoslavia as a whole, assuming the political conditions for that are met, the cost may reach USD 10 billion for the first three to five years (that is including Kosovo).

Macroeconomic costs: These consist of budget and balance-of-payments support for the neighbouring countries (excluding Serbia) and have been estimated by the IMF at around USD 2 billion for 1999.

Recovery costs: These consist of the investments that could be underpinning the so-called Marshall Plan or Stability pact for South-East Europe. This would be a long-term financial project and may involve as much as USD 100 billion for a decade for the region as a whole.

Table 2

Summary of the reconstruction and recovery costs

RECONSTRUCTION

Kosovo:	USD 2-3 billion for three years
Serbia (including Kosovo):	USD 10 billion for three to five years

RECOVERY

Macroeconomic support:	USD 2 billion in 1999
Stability support:	USD 1-2 billion per year
Financing of growth:	USD 10 billion per year for ten years

Prospects

The prospects for Kosovo, Serbia and the region as a whole can be treated in a positive and in a normative way. To make positive predictions, it would be necessary to assume some kind of a realistic scenario for the international financial and other involvement. This assumption, however, depends on what are the international intentions, i.e., on the normative aspect of the whole issue. Thus, it is appropriate to start with that.

The current thinking is centred around the more longer-term and more comprehensive programme for the recovery of the whole Balkan region or the region of South-East Europe.³⁰ The fundamental assumption is that the region will need significant help in

²⁹ The European Union has announced that it will provide USD 1.5 billion for three years for the reconstruction of Kosovo.

³⁰ The framework document is the one adopted at the meeting in Cologne, June 10 by the European Union, all the countries in the region, except Yugoslavia (it was not invited), the United States of America and a large number of regional and international organizations and institutions. The documents is entitled, "Stability Pact for South

order to move to the path of sustainable growth. The help has to be financial, of course, but in order to be effective it has to be put into a proper institutional environment. It is at this point that the problems emerge.

To illustrate the problems, it is convenient to look more closely at the proposals to introduce free trade in the whole area and between the countries in the area and the European Union and to introduce currency boards or to go for euroisation outright.³¹ There is no doubt that trade liberalization is very important. There is no doubt, also, that local currencies are seen as inferior to the German mark in the whole region.³² It is also quite clear that there are significant problems that the countries in the region face in both public and private financing. Indeed, both public and private governance leaves a lot to be desired.³³ These observations are not controversial. The policy proposals mentioned above and also those that should support them are.

The key idea of all of these proposals is that a new approach to the Balkan or South-East European enlargement should be envisaged. While in the case of the Eastern enlargement the guiding idea was that the speed of the integration will be presumed on the speed of economic, political and institutional convergence of the applicant countries to the European Union, it is now argued that the Balkans should be treated differently. Integration is not seen as an incentive for reforms in the applicant countries but as an instrument of reform. In other words, rather than waiting for the Balkan countries to converge enough to the European Union, they should be integrated immediately in order to make the reforms and transitions in the whole region possible.

This idea by itself may not be altogether controversial, at least at the normative level.³⁴ The ways to achieve it are controversial. To take one example, let us look at the proposal to scrap tariffs between the countries in South-East Europe and between these countries and the European Union and to compensate these countries for the public revenues thus lost. The problem with this idea is not so much the amount and the source of financing that would be needed, but the fact that there are any number of substitute instruments that could play the role of the tariffs. Thus, in order to achieve the intended goal, i.e., trade liberalization, a comprehensive look at the issue of public finances in these countries should be taken. If the same logic of, let us call it budget-compensation, is applied to the other sources of the public revenues, that would mean

³¹ Some of these proposals can be found in „A System for Post-War South-East Europe“, CEPS WD 131, May 1999 and in D. Gross, „An Economic System for Post-War South-East Europe“, paper prepared for the CEPS conference, A System for Post-War South-East Europe, May 1999.

³² On this see V. Gligorov, 'Trade and Investment in the Balkans' in V. Gligorov and H. Vidovic (of the States on the Territory of Former Yugoslavia', *WIIW Research Reports*, No. 250, 1998.

³³ More on that in V. Gligorov, 'Patterns of Divergence in the Western Balkans', *The Vienna Institute Monthly Report*, No. 5, 1999.

³⁴ See some thoughts on that in V. Gligorov, 'Delaying Integration', study prepared for the Federal Chancellery, April 1999.

that the European Union should take over almost completely the budgets of all the states in the whole region. This is in fact already happening to some extent. Budget and balance-of-payments deficits that are common and persistent in the whole region have been, in one way or another, financed from international sources. However, the current proposals for the speedy integration of the Balkans into the European Union would go down the same road in a more radical manner.

If monetary policy for the region is delegated to the European Central Bank and if the public finances are transferred to the appropriate bodies in the European Union, the countries in the region would lose the instruments to conduct economic policy. Even if this were desirable and feasible, as indeed it is not, there will be other functions that states perform that will have to be taken care of, i.e., who is to supply security and legality in the region?

Putting the issue of security aside because it is clearly not to be dealt with by the European Union, there is the issue of legality. It should be clear that very little if anything can be achieved if there is no rule of law. Obviously, neither the laws nor their implementation can be supplied by the European Union. Indeed, looking at the experience of Bosnia and Herzegovina, there is no doubt that once the most basic reconstruction effort is finished, the recovery cannot proceed as long as there is no stable legal environment. This is for the reason that the process of economic recovery has to be supportive of private business, and the latter will not be flourishing as long as there is no rule of law of some kind. And this has to be supplied and implemented locally.

Given the problems with the public finances and with the other functions normally performed by nation states, even if they are in federations, let alone in political systems like that of the European Union, it becomes obvious that the programmes for the South-East Europe have to be more realistic to be feasible.³⁵ There is a problem with realism, however. The advantage of the bold projects like those that argue for speedy integration of the Balkans into the European Union is that they can disregard the political and institutional problems characteristic of the region. Once more realistic programmes are discussed, these problems have to be addressed. To see what that means, it is enough to take into account only the fact that there is no political will to include Serbia into the programme for the reconstruction and the recovery of the Balkans as long as Mr. Milosevic is the president of Yugoslavia. That essentially means that as long as he is there, only the reconstruction of Kosovo is realistic. All the other more ambitious programmes will have to be put on hold. This can be generalized to the point that it can be argued that the whole process of recovery in the region will be difficult to implement

³⁵ The key issues of South-East European development have been discussed by Rosenstein-Rodan in his classic paper, 'Problems of Industrialization of Eastern and South-Eastern Europe', *Economic Journal* 53 (1943): 202-211.

as long as an appropriate political solution for the regional security problems is not found; other words, the current security and political arrangement for Kosovo is not supportive of the more ambitious recovery and integration programmes for the region.

If that is so, it is realistic to expect that the following things will happen as far as the relationship between the Balkans and the European Union is concerned:

- the negotiations on the association agreements or some other types of contractual relations will be speeded up for countries like Macedonia, Albania, Bosnia and Herzegovina and Croatia;
- reconstruction of Kosovo will proceed in one way or another;
- financial aid to the countries in the region will continue;
- some specific additional projects will be undertaken in some of the countries in the region; those may include even projects with Serbia, e.g., those that are related to the clearing up of Danube and to the rebuilding of transit road and railroad connections (especially the bridges on the river Danube);
- more ambitious programmes will be put off until political solution to the pressing problems in Kosovo and in other countries are agreed on.

Conclusion

Given the complexity of the political and economic problems and given the institutional and political capabilities of the European Union and of the countries in the region, there is a danger that a situation similar to the one that exists in Bosnia and Herzegovina will develop. In other words, there will be a less than transparent political set-up, weak and corrupt local governments and backward economies. Current initiatives to speed up the development in the Balkans are designed with the aim to avert that kind of an outcome, but it is far from clear whether they will succeed.

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