BUILDING PEACE IN SOUTH EAST EUROPE:

MACROECONOMIC POLICIES AND STRUCTURAL REFORMS SINCE THE KOSOVO CONFLICT

A joint International Monetary Fund-World Bank paper
for the Second Regional Conference for South East Europe
Bucharest, 25-26 October 2001

This paper was prepared by the staff of the International Monetary Fund and the World Bank in Washington, DC. The main authors are Saumya Mitra (World Bank) and Dimitri G. Demekas, Johannes Herderschee, and James McHugh (IMF). The paper has benefited from extensive contributions by Abe Selassie (IMF) and Daniela Gressani (World Bank); comments and background material by the IMF and World Bank country teams on Albania, Bosnia and Herzegovina, Bulgaria, Croatia, FYR Macedonia, Romania, and FR Yugoslavia; and comments by the European Commission, the European Bank for Reconstruction and Development, the Organization for Economic Cooperation and Development, and the Stability Pact. IMF and World Bank staffs acknowledge, in particular, the helpful comments and insights provided by the authorities of the countries of the region. Research assistance was provided by Amber Hasan (IMF) and Zhicheng Li (World Bank). The views expressed in the paper do not necessarily correspond to those of the IMF or World Bank Executive Boards. This paper does not examine the social impact of the Kosovo crisis. The strategy to address the social consequences of the conflict by promoting social cohesion and social change has been laid out in "The Road to Stability and Prosperity in South Eastern Europe", prepared by the World Bank for the First Regional Conference for South East Europe, in March 2000.

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I. Introduction

Before the Kosovo conflict, the countries of South East Europe (SEE)—Albania, Bosnia and Herzegovina, Bulgaria, Croatia, FYR Macedonia, Romania, and FR Yugoslavia[1]—were at different stages of economic development, integration with the global market, and transition to a market economy. The economic performance of the group as a whole lagged behind that of Central Europe and the Baltics. The reasons for this development varied from country to country, but ethnic conflict, political instability, and a timid and fitful approach to structural reform characterized several of them.

The Kosovo crisis of spring 1999 and its aftermath was, in some ways, a defining event for the region. First, the crisis threatened all SEE countries, albeit to different degrees, underscoring their interdependence. Secondly, the international community decided to follow a regional approach in assisting these countries to cope with the crisis and build the peace that followed. This approach went well beyond the reconstruction and upgrading of shared infrastructure, such as bridges or road networks. It was aimed at fostering "peace, democracy, respect for human rights, and economic prosperity", as stated in the Cologne document of June 10, 1999 that created the Stability Pact for South East Europe. Furthermore, the Stabilization and Association process establishes a clear path for the integration of these countries with the EU (except for Bulgaria and Romania, which already were accession candidates). In this context, the donor community developed structures to coordinate assistance, such as the High Level Steering Group of the G-8, promoted interactions between countries of the region, and created incentives for reform.

After the conflict and the political and economic changes in FR Yugoslavia, there are encouraging, though early, signs of a broad-based improvement in the SEE countries' economic performance. Growth is strengthening and inflation is slowing in most SEE countries. Perhaps more importantly, policy makers appear to be more sharply focused on macroeconomic stability and market-oriented reforms. The major exception to both is FYR Macedonia, where the recent crisis has stalled progress. If this favorable trend takes hold, the South East Europe "region", which was born of historical circumstance and political vision, will become a community of shared prosperity.

The principal conclusions of the paper are the following.

- ***The impact of the Kosovo crisis was smaller than originally feared***. The problems associated with refugee flows were short-lived, and the main channel through which the crisis affected the region was disruption of trade. The relatively low degree of openness of most of these countries, however, meant that even this shock was

[1] In covering policies and reforms at the regional level, this paper makes references to these seven countries of the SEE region as well as, where relevant, to the two republics of FR Yugoslavia—Montenegro and Serbia—and to the province of Kosovo. For reasons of brevity and style, these are referred to as Montenegro, Serbia, and Kosovo, respectively.

manageable. The exception was FR Yugoslavia, where the trade sanctions and extensive destruction of infrastructure had a significant economic impact. Even though the crisis did not require major domestic policy adjustments in most countries, there were real risks of macroeconomic destabilization and setbacks in structural reforms, given the fragile state of transition to market economies in the region. That this risk was averted was perhaps the greatest success of domestic policy makers and the international community.

- ***Although performance has strengthened, the global economic slowdown is increasing downside risks.*** Growth in the post-conflict period has been stronger and more broad-based than that in the preceding decade. Continued growth will be crucial for tackling poverty and high unemployment—two stubborn problems. However, the deteriorating external environment today is increasing downward risks and external vulnerability remains a concern. The current slowdown in the world economy should have a relatively small impact on the region, albeit with considerable variation across countries. Given the fragility of the current external position of most countries, enhanced vigilance will be required to minimize external vulnerability in the period ahead.

- ***Governance remains a major weakness***. The management of public finances across the region is being strengthened, although some countries clearly lag behind. Institutions are still weak and good practices have not yet been ingrained. The region suffers from high levels of corruption and organized crime. Although anti-corruption initiatives have started in most countries, institutional development is rudimentary, capabilities are weak, civil service reforms are at an early stage, and the civil society is still to be adequately engaged. The region has still to adopt international conventions against corruption, and corporate governance standards are low.

- ***Integration with the rest of the world and within the region itself has made significant strides, and there is a clear momentum for continued reform.*** The EU initiatives for greater market access have been powerful incentives for trade liberalization and regional cooperation. The increasing openness of the economies and the emerging growth in regional trade are encouraging. The countries now need to pursue further trade liberalization on both bilateral and multilateral levels.

- ***The record of attracting foreign investment remains poor.*** Although improvements in the overall investment climate can be seen in much of the region, foreign investment continues to be low and generally linked to privatizations, while greenfield investment has been negligible. With diminishing political risk and a sustained record of reforms, the region should become more competitive over the medium term.

- ***Progress in creating an environment that stimulates private sector development is significant but uneven***. Except in the important area of competition policy, the legal framework for private economic activity has been improved. However, implementation remains weak. In addition, enterprise restructuring and privatization are now advancing across the region: certain countries are still at the stage of small enterprise privatization, while others are planning sales of large enterprises and utilities. However, work remains to be done in creating an efficient regulatory framework for public utilities and attracting private participation in infrastructure.

- ***Banking is being revived, but capital market development will be slow***. Bank intermediation is advancing through the withdrawal of the state from banking, entry of foreign banks, improving supervision, and institution of credible deposit insurance schemes—all of which have led to greater public confidence. However, insolvent banks have yet to be closed in some countries, and privatization of solvent ones is not complete. Achieving and maintaining high supervisory standards will be a challenge. The development of capital markets will require time and external technical assistance.

II. THE KOSOVO CRISIS: IMPACT AND POLICY RESPONSE

A. The region before the crisis

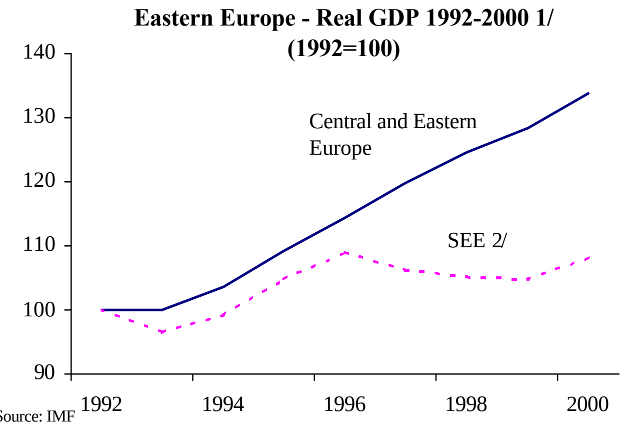
At the end of the 1990s, the region generally lagged behind Central Europe in terms of its transition. Within the group, Bulgaria, Croatia, and Romania were more advanced than the rest before the Kosovo crisis. These three countries had made greater progress in liberalizing prices and international trade and—to a lesser extent—in reforming their banking sectors, but were still at an early stage in corporate governance, enterprise restructuring, and capital market development (Box 1). Albania and FYR Macedonia lagged the first group in terms of privatization and banking reforms. Bosnia and Herzegovina brought up the rear, with weak performance on all indicators but for price and trade liberalization. FR Yugoslavia, including Montenegro and Kosovo, was not classified by the EBRD, but it would have shown uniformly the poorest indicators.

Box 1. Progress with transition in the region before the Kosovo crisis (data for 1998-99)

			Enterprises			Markets and trade			Financial Institutions	
	Population (million mid-2000)	Private sector share of GDP in %, mid-2000	Large-scale privatization	Small-scale privatization	Governance & enterprise restructuring	Price liberalization	Trade & foreign exchange system	Competition policy	Banking reform & interest rate liberalization	Securities markets & non-bank financial institutions
Albania	3.3	75	2	4	2	3	4+	2-	2+	2-
Bosnia & Herzegovina	4.1	35	2	2+	2-	3	3	1	2+	1
Bulgaria	8.1	70	4-	4-	2+	3	4+	2+	3	2
Croatia	4.5	60	3	4+	3-	3	4+	2+	3+	2+
FYR Macedonia	2.0	55	3	4	2+	3	4-	2	3	2-
Romania	22.3	60	3	4-	2	3	4	2+	3-	2

Source: EBRD *Transition Report, 2000*, based on data for 1998-99. For an explanation of the ranking, see Appendix I.

Initial conditions were not to blame for the difference between South East Europe and Central Europe and the Baltics. Significant cross-country differences notwithstanding, initial conditions in the region—especially in the republics of the former SFR Yugoslavia—had been favorable compared to those in several other transition economies, notably in the former Soviet Union. However, the transition process was very slow getting off the ground, reforms were timid, and implementation was fitful. The successor states of Yugoslavia were war-torn and Albania was affected by internal strife, but even Bulgaria and Romania performed poorly, even though they were minimally affected by conflicts before the Kosovo crisis. In the region as a whole, progress during the 1990s was much slower than in Central Europe and the Baltics, as shown by their relatively poor growth performance.



Source: IMF
1/ Real GDP index for each region, weighted by GDP in US dollars
2/ Due to data limitation, FR Yugoslavia and Bosnia-Herzegovina are excluded

B. The Kosovo crisis

When the military conflict in Kosovo erupted in March 1999, the international community quickly recognized the potential economic dislocation for the region and the need for a coordinated response. However, this response had to be formulated in a very short time and under considerable uncertainty. The International Monetary Fund was called upon to provide estimates of the costs of the crisis and the attendant financing needs. In April 1999, IMF and World Bank staff developed jointly two scenarios based upon different assumptions about the length of the military conflict (Box 2).

Box 2. Initial estimates of the impact of the Kosovo crisis

In April 1999, IMF and World Bank staff examined two scenarios in order to provide a range of possible financing needs arising from the Kosovo crisis.

Scenario A - The first scenario assumed that the military campaign would be prolonged and the refugee crisis would continue throughout 1999. All official trade with the FRY was assumed to be suspended, although limited transit trade to third countries would resume in the second half of 1999. The humanitarian costs under this scenario were projected to be around US$300 million, and the combined balance of payments gap for the South East Europe an countries was US$1.5 billion. The aggregate budgetary gap was projected to be around US$650 million.

Scenario B - The second scenario assumed that the military campaign would end quickly. Trade with the FRY would resume in the second half of 1999. Under this scenario, three fourths of the refugees would return home by the third quarter of 1999, and the rest by the end of the year. The estimated bill for humanitarian aid was projected to be around US$150 million, the balance of payments gap US$650 million, and the aggregate budgetary gap US$300 million.

The duration of the military conflict and the magnitude of the refugee problem were very close to Scenario B. The conflict was over by June 1999. The number of refugees was considerable. Nearly one million were displaced during the war, and at the peak of the conflict, some 700,000 were in Albania and FYR Macedonia, but they returned home even faster than anticipated. About 480,000 returned in the first three weeks of June and most other refugees followed quickly thereafter. As a result, the widely anticipated governance problems that a prolonged refugee crisis could cause in host countries failed to materialize. However, an estimated 210,000 Serbs and other non-Albanians were expelled from Kosovo following the end of the war and remain displaced to this day. The financial cost of refugee relief was almost entirely borne by international donors, which cushioned the impact on the region.

With the exception of Albania and FYR Macedonia, which were affected by a significant—albeit short-lived—refugee inflow, disruption of trade and infrastructure links were the main channels through which the Kosovo crisis impacted the region. The military campaign inflicted considerable damage on the transport and storage infrastructure in FR Yugoslavia, and the Danube could not be used to transport goods. Aggregate export receipts declined by a little over 7 percent in 1999. The disruption to trade was most keenly felt in FR Yugoslavia, whose exports fell 45 percent due to the closure of its borders. Exports of other countries also declined in 1999 (Table 2), with the exception of Albania, which may have benefited from trade diversion, and Romania, where there had been a large real depreciation in the previous year. By 2000, however, exports from all the other countries except the FR Yugoslavia had recovered to pre-crisis levels. The disruption to trade also affected imports, which dipped in 1999, but recovered in 2000. The decline in tourist receipts was largely limited to Croatia. Although Bulgaria also initially suffered from a decline in tourist visits, the industry quickly recovered once the conflict had ended.

Countries that had access to capital markets faced only a temporarily disruption. Indeed, despite the crisis, a number of important privatization sales, particularly in Bulgaria and Croatia, were finalized in 1999. Furthermore, in 2000 both Romania and Croatia regained access to international capital markets. Nonetheless, the conflict weakened investor sentiment about the region. The region has received significantly less foreign direct investment inflows compared to their Central European neighbors (see discussion in the following chapter).

On the whole, the Kosovo crisis was not the catastrophic external shock that many had feared. Indeed the overall impact on economic growth, albeit uneven, was short-lived (Table 1). FR Yugoslavia was clearly the hardest hit, with real GDP declining an estimated 15 percent in 1999, owing to the significant damage to infrastructure and its economic isolation during and after the crisis. Growth was negative in Croatia and Romania and slowed in Bulgaria in 1999, but rebounded in all three during 2000. In contrast, growth in FYR Macedonia and Albania was largely unaffected, in large part because the international community bore the cost of refugee relief. By 2000, growth had resumed in all countries in the region.

This benign picture, however, belies the risk that the Kosovo crisis represented for the economies of South East Europe . Given their external vulnerability, fragility of market-based institutions, and checkered reform record during the 1990s, the crisis could have easily triggered macroeconomic instability and a reversal in structural reform efforts.

This risk was averted thanks to appropriate domestic policies in the individual countries, as well as the rapid and effective response of the international community.

C. Domestic policy response

Despite the pessimistic outlook at the onset of the crisis, policy makers avoided hasty short-term measures that might have provided a temporary boost to output and employment but at the cost of long-term efficiency and stability. There was a widespread recognition throughout the region that long-term growth would best be served by safeguarding macroeconomic stability and persevering with structural reforms. Although policy implementation varied greatly from country to country, there was no significant backtracking. Indeed, most countries maintained macroeconomic stability and the structural reform momentum throughout the crisis. The exception, of course, was FR Yugoslavia, where reforms did not start until after the fall of the Milosevic regime. The steady support of the international community, including through IMF-supported macroeconomic policy programs and World Bank adjustment lending, was critical in bringing about this outcome.

Fiscal policies were largely unaffected by the crisis. Even in countries where fiscal policies went off-track in 1999, notably Croatia, this was due to domestic factors. On the revenue side, the crisis occurred at a time when efforts to strengthen the tax system had started to yield results. In Albania and FYR Macedonia, tax collection benefited from ongoing efforts to improve tax administration, while in Romania, the authorities raised taxes substantially in early 1999 as part of their macroeconomic stabilization program. In Bulgaria, the authorities continued a program of reforms in the budgetary sector by closing a large number of extra budgetary funds, unifying the collection of taxes and social contributions under a single agency, and introducing a separate health contribution. At the same time, losses in customs and other trade-based revenue were minimal owing to the short duration of the disruption to trade. As a result, tax revenues as a percent of GDP actually increased in 1999 in Albania, Bosnia and Herzegovina, FYR Macedonia, and Romania, and remained constant in Bulgaria.

Despite the generally improved tax revenue performance, fiscal deficits in 1999 increased in most South East European countries due to rising expenditures. This was most dramatic in Croatia, where the authorities increased social benefits and public sector wages. These increases, however, were largely unrelated to the Kosovo conflict. Although the budgetary cost of refugee relief was considerable in Albania and FYR Macedonia (about 1-1½ percent of GDP), it was largely covered by budgetary grants from international donors, thus having a neutral impact on the fiscal position.

Monetary and exchange rate policies in most countries remained focused—with varying degrees of success—on price stability. Policy makers did not use the exchange rate to offset the impact of the Kosovo crisis on exports. In Croatia, competitiveness had been boosted by an exchange rate depreciation that had taken place just before the conflict, and monetary discipline was maintained thereafter. Bulgaria and Bosnia and Herzegovina continued with their currency board arrangements. Albania and FYR Macedonia did not alter their monetary policy stance in response to the crisis (although the policy stance was relaxed in the former). As a result, inflation remained comparatively low throughout the crisis. In Albania, Bulgaria, Croatia, and FYR Macedonia inflation was kept below 10 percent for most of 1999 and 2000, and in Bosnia and Herzegovina, it was around 15 percent. Policy discipline was weaker in Romania where, partly because of large public sector wage increases, inflation remained high, undermining external competitiveness and necessitating continued exchange rate adjustments.

In general, the crisis did not create any serious difficulties for financial systems in the region. The exception was FYR Macedonia, where local banks experienced significant deposit withdrawals and delays in debt service payments by enterprises. The National Bank of Macedonia responded promptly by providing sufficient liquidity support. After the conflict ended, the liquidity positions of the local banks improved dramatically.

Finally, the momentum of structural policies in most countries, albeit slow, was broadly undiminished by the crisis. Bulgaria continued to implement a difficult agenda throughout 1999. In Romania, the authorities took some important decisions toward resolving the crisis in the banking system, but found it difficult to address problems in the enterprise sector and were not able to accelerate the privatization of large loss-making enterprises. There was also some progress in Albania, although in important areas, such as bank privatization, improving customs administration, and reducing corruption, there was a standstill. Elsewhere in the region, progress in implementing key structural reforms was slower. In Bosnia and Herzegovina, the authorities' commitment to structural reform priorities, such as bank and enterprise privatization, was rather lukewarm. The only case where the Kosovo crisis may have stalled the implementation of structural reforms was FYR Macedonia, which was unable to implement key undertakings under its IMF-supported program in the areas of enterprise restructuring and banking sector reform.

D. The contribution of donors

Donors reacted promptly to the security threat and humanitarian tragedy caused by the conflict. KFOR quickly established security in the territory of Kosovo, and UNMIK introduced the basics of a civilian administration. UNHCR and other relief agencies provided emergency shelter assistance to about 700,000 persons and food aid to about 900,000 persons during the winter of 1999. Repair or reconstruction of dwellings in Kosovo was also rapid (24,000 damaged homes had been made habitable again by end-2000), as was the rehabilitation of hospitals and utilities.[2]

More importantly, the Kosovo crisis prompted donors to re-think their relationship with the region on a longer-term basis and establish new vehicles for effective cooperation.

[2] UNMIK, *A Year and a Half in Kosovo*, December 2000.

- In April 1999, donors asked the European Commission and the World Bank to coordinate all bilateral and multilateral aid for reconstruction and development in South East Europe . In addition, the G-8 created a High-Level Steering Group to oversee this effort. The first donor conference for the region was held in mid-2000. Donors have pledged US$6 billion in reconstruction, investment, and budget support operations for the region since mid-1999[3], of which euro 4.7 billion is the commitment from the EU.

- In May 1999, the EU established the Stabilization and Association process to provide a clear path for the integration with the EU of those South East European countries that did not already have Europe Agreements. Stabilization and Association Agreements (SAAs) confer to the countries that sign them potential EU candidate member status, and are supposed to provide a concrete strategy for gradual institutional harmonization with the EU. Thus far, a SAA was signed with FYR Macedonia and another has been initialed with Croatia.

- In June 1999, the international community put in place the *Stability Pact for South East Europe* . The pact provides a forum for countries of the region, the major industrialized countries, and international financial institutions, and its work is organized around three Working Tables on democratization and human rights, economic reconstruction, and security.

The International Monetary Fund and the World Bank also stepped up their operations in the region. The *IMF* has continued to promote macroeconomic stability and structural reform, and increased its financial assistance to the countries affected by the crisis. Access under existing arrangements was augmented for Albania, Bosnia and Herzegovina, and FYR Macedonia, and the IMF supported the Bulgarian authorities' request for G-24 grants to cover the additional financing gap due to the Kosovo conflict. Moreover, the IMF approved new arrangements with Romania (August 1999) and Croatia (March 2001), as well as FR Yugoslavia after the latter was reinstated as member (Table 3). Finally, the IMF has provided significant technical assistance and training to all South East European countries, including the province of Kosovo under UNSC 1244.

The *World Bank* has stepped up its assistance to the region since the end of the Kosovo conflict in both policy advisory work and grant or lending assistance. It has also led the donor coordination effort, with the EC, for the region as a whole and for its constituent countries. In this context, it has co-chaired the High Level Steering Group for donors for the region established by the G-8 in mid-1999 as well as its Working Level Steering Group. Donor conferences have been held periodically for all countries in the region and two conferences at the regional level have been held. Examples of advisory work, quite apart from the traditional economic and sector policy work that forms the basis of the Bank's dialogue with its clients are the post-conflict reconstruction and recovery programs developed for Kosovo, jointly with the EC and with the UN interim

[3] Of this total, euros 2.4 billion has been provided by all donors for regional investment projects.

administration in Kosovo. A similar program was developed for the FR Yugoslavia upon its re-joining the Bank in 2001. The Bank has an active program of adjustment operations covering public finance, enterprise and the financial sectors in the region, using IDA credits (Albania, Bosnia and Herzegovina, FYR Macedonia, FR Yugoslavia) or IBRD loans (Bulgaria, Croatia, and Romania) or grants from its net income (Kosovo, FR Yugoslavia) (Table 4). The Bank's engagement with the region is expected to remain strong in the coming years.

III. Building Peace: Prospects and Policy Challenges for South East Europe

Following the Kosovo crisis, the political climate in the region has improved considerably. Democratic elections in all countries have taken place, most notably with the political change in FR Yugoslavia in October 2000. Most recently, the end of violence in FYR Macedonia provides hope for further normalization in this country, provided the peace agreement is ratified and the security situation improves. The SEE countries can now concentrate on the task of reconstruction and economic development, and pursue their long-term aspiration to move closer to the European Union in economic and political terms. To succeed in this task, these countries need peace and order. In economic policy terms, they need to sustain and deepen their efforts. This chapter discusses the prospects and challenges facing the SEE countries in the current global economic environment in four key policy areas: ensuring macroeconomic stability; strengthening governance; creating a liberal environment for trade and foreign investment; and encouraging the growth of the private sector.

A. Macroeconomic stability

Domestic policies and the support of the international community averted a deterioration in the macroeconomic situation as a result of the Kosovo crisis. Notwithstanding significant differences among the countries, the region as a whole emerged from the crisis well placed to benefit from the new environment of peace and stability. The civil crisis in FYR Macedonia was a major setback for the economy of this country, but its impact was localized and, hopefully, temporary. However, the recent deterioration in the prospects for the world economy are clouding the near-term horizon for South East Europe, underscoring the vulnerability of some countries, and posing new macroeconomic policy challenges for all.

The current macroeconomic situation, near-term prospects and risks

With the exception of FYR Macedonia, economic growth in South East Europe rebounded in 2000 and 2001, averaging some 4 percent year-on-year in the region as a whole in the first half of 2001. By contrast, real GDP in FYR Macedonia declined during the same period because of the insurgency crisis. The recovery in agricultural production was particularly notable in Bosnia and Herzegovina, Croatia, and FR Yugoslavia. Industrial growth varied across the region, depending largely on the extent to which economic restructuring and privatization had taken root, while developments in the services sector were also dominated by country specific circumstances. Tourism recovered in Albania, Croatia, Montenegro, and Bulgaria. Construction and trade made significant contributions to the recovery in some of the smaller economies of the region, notably Albania and Kosovo.

Inflation edged downward in all the countries during 2000-01, although it continued to be dominated by adjustments in administrative prices, as well as prices of imported energy. This was particularly evident in FR Yugoslavia, where price liberalization was the main factor behind the jump in headline inflation to 113 percent in the year to December 2000. In Croatia, excise tax increases and electricity prices accounted for over a third of the country's 7.4 percent inflation during 2000. By contrast, Bulgaria during the pre-election period, kept headline inflation low in 2000 in part through delays in scheduled adjustments in administered prices.[4]

The external positions of the SEE countries generally strengthened during 2000-01, as evidenced by lower current account deficits and higher official exchange reserves in most countries, although they remain fragile. International transfers, including foreign aid, play a critical role in a number of economies, notably Bosnia and Herzegovina, FYR Macedonia, and FR Yugoslavia and, to a lesser extent, Albania. The external situation worsened significantly in FYR Macedonia in the first half of 2001, as both the current account deteriorated and there was a sharp capital outflow during February-July. This deterioration was somewhat cushioned by the inflow from the privatization of the telecommunications company in January 2001 of US$323 million (some 9 percent of GDP). The agreement reached on dividing the assets of SFR Yugoslavia was a welcome development that increased foreign exchange resources for the successor states.

Economic prospects for the region in the remainder of 2001 and in 2002 have been clouded by the weakening prospects for the global economy. The IMF baseline projections for the World Economic Outlook of September 2001, prepared prior to the September 11 terrorist attacks, foresaw a major slowdown in growth in the EU—the most important external partner for South East Europe —from 3.4 percent in 2000 to 1.8 percent in 2001, and a gradual rebound in 2002 to 2.2 percent. This slowdown, however, was not expected to significantly affect South East Europe. Growth in 2001 in most of the region was projected to increase or remain broadly unchanged relative to 2000—with the exception of FYR Macedonia, where a deeper slowdown was projected due to the domestic factors—and continue on an upward path in 2002. There were three reasons for the region's partial immunity to world developments. First, economic integration of several of these countries with the EU is relatively low. Second, there is an expectation of growing intra-regional trade, which would also act as a cushion to the declining export demand from the EU. Third, domestic demand is rising and will increasingly stimulate growth in most SEE countries.

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[4] After Bulgaria's inflation peaked at 12.4 percent in October 2000, year-on-year inflation returned to the single digits in January 2001.

The latter factor also meant that the outlook for the current account deficits for 2001-02 was mixed. Croatia and, to a lesser extent, Bulgaria were expected to register an improvement, but a deterioration was projected in Albania, Bosnia and Herzegovina, and Romania. The current account deficits in FYR Macedonia and FR Yugoslavia were also expected to increase, but would be financed by sustained foreign aid and concessional capital inflows. With the possible exception of Croatia, the external position of South East European countries was projected to remain fragile this year and next.

- The terrorist attacks of September 11 and their aftermath have increased the downside risks to the near-term outlook for the advanced economies and, as a result, for South East Europe as well. While precise estimates are not yet available, there will clearly be a negative short-term effect on activity in the advanced countries, and the recovery projected for 2002 is likely to start later and be slower. This would affect South East Europe in two ways.

- Export demand from the EU will be even lower than projected earlier. Although, for the reasons mentioned above, the incremental impact of this additional weakening in external demand would not be large, it would come on top of an already mediocre outlook.

- Access to international financial markets will become more difficult, because global risk aversion increased after September 11, as indicated by spreads of high-yield and emerging market debt. Since most SEE countries do not rely significantly on commercial market access for their external financing needs, the impact of this change in sentiment on the region will be very limited. However, it is possible that foreign direct investment flows may diminish, if potential investors decide to postpone or re-evaluate projects in the new, uncertain environment.

Macroeconomic policy challenges

Against this background, external vulnerability is the single biggest risk for the SEE countries, especially in the new global environment. The external current account deficits in Bosnia and Herzegovina, FYR Macedonia, and FR Yugoslavia that are now largely financed by concessional capital inflows, are unsustainable in the long run. Albania and Romania remain vulnerable, while the currency board, combined with prudent fiscal and incomes policies since 1997, provides reassurance in Bulgaria. In all these countries, ensuring a sustainable and strong external position should thus remain a key medium-term macroeconomic policy priority.

Tackling this challenge requires a coordinated effort over a broad front, encompassing structural reforms and sound macroeconomic policies. The former, discussed in detail later in this paper, are needed to encourage the development of a strong and competitive domestic productive capacity, while the latter are key for maintaining stability and consumer and investor confidence. This section discusses the principles that should underlie macroeconomic policy formulation.

Fiscal policy is the only macroeconomic policy instrument in Bosnia and Herzegovina and Bulgaria, and the central policy instrument in the rest. It is thus the main tool for minimizing the risk of external vulnerability. However, considerable uncertainty about the macroeconomic setting, notably the behavior of private sector savings and weak institutional frameworks complicates the task of formulating fiscal targets. A fragile tax base and a low degree of tax compliance make revenue forecasts particularly problematic. Nonetheless, these uncertainties should not prevent, but rather prompt a strong medium-term orientation for fiscal policy. Bulgaria and Romania, as EU accession countries, have already started formulating medium-term fiscal plans in the context of their Pre-Accession Economic Programs. Other countries within the region should gradually introduce similar frameworks. IMF and World Bank supported policy programs provide a natural vehicle for designing fiscal policy in the medium-term setting.

Although circumstances differ across countries, there are some common themes. In Albania, Bosnia and Herzegovina, and FYR Macedonia, the authorities are faced with the prospect of declining concessional external financing. In Bulgaria, Croatia, and Romania, health and pension reforms have reached a crucial stage. The authorities in these countries have developed medium-term strategies to confront the demographic challenges, but now must move decisively towards the implementation stage.

On the revenue side, efforts should focus on widening the tax base and improving tax administration. Although Albania, and Romania have made considerable progress towards strengthening the tax base, revenue to GDP ratios in both countries are low compared to other countries in the region. The best way to promote long-term growth is to design a simple, transparent tax system, with the widest possible base and low and uniform tax rates, and ensure its strict and fair enforcement. However, the authorities should resist the temptation to grant tax exemptions to groups, regions, or categories of goods. International experience has shown that such measures have at best a temporary impact on growth. Moreover, in countries with weak institutional capacity, such measures hamper tax administration and give rise to corruption. On the expenditure side, medium-term expenditure targets must be suitably firm to catalyze upfront agreement on the necessary reform measures, notably in civil administration, pensions, and social welfare. At the same time, targets should be sufficiently flexible to allow authorities to react to a changing environment.

The plans for privatization in SEE countries raise the question of the appropriate use of privatization receipts. It is critical for country authorities to realize that these receipts are one-off. These resources should not be used to finance recurrent spending or investments with a low rate of return. The authorities should use privatization receipts to reduce public debt or contingent liabilities, for example, by financing the transition from pay-as-you-go to fully funded pension schemes or to cover the cost of one-off structural reforms.

The international community also has a role to play in helping the SEE countries achieve and maintain fiscal sustainability. Albania, Bosnia and Herzegovina and FYR Macedonia will need continued budgetary support in the form of grants or concessional aid. FR Yugoslavia’s fiscal outlook depends critically on concessional debt relief to reach a sustainable path. In addition, FYR Macedonia and Kosovo will continue to rely on direct assistance for providing security and good governance to their populations in the near future.

Monetary and exchange rate policies, where they are available, should remain firmly oriented towards price stability. Inflation has been brought down significantly in most SEE countries (except in FR Yugoslavia and Romania), and exchange rates have recently been relatively stable. This is a notable achievement: low inflation and relatively stable exchange rates facilitate trade and build confidence in the economy. The disinflation strategy from now on should rest on two pillars. *First*, except where currency boards exist (Bosnia and Herzegovina and Bulgaria), and in territories using the euro/deutsche mark (Montenegro and Kosovo), it will be important to maintain exchange rate flexibility. Given the external vulnerability of many South East European countries, exchange rate-based disinflation programs ("soft pegs") are likely to create significant risks, if they are seen as providing an exchange rate "guarantee" to domestic borrowers or offer an easy target for speculative attacks. Nonetheless, the exchange rate will remain too important to be neglected in these small and increasingly open economies. Moving toward broad inflation targeting frameworks may thus be an increasingly attractive option. *Second*ly, coordination between fiscal and monetary policies, as well as incomes policy targets and administered price adjustments, is crucial. In the absence of policy coordination, either the inflation objectives will not be achieved, or the cost of achieving them will escalate.

Once inflation moves firmly into the single digits and nominal convergence with Western Europe begins to be within reach, inflation targets will need to be set carefully. Even with sound demand management, the required administered price adjustments and the impact of differential growth in productivity with the rest of the world (Balassa-Samuelson effects) will continue to generate some equilibrium real appreciation pressures in all these countries. Depending on the exchange regime in place, these pressures may need to be wholly or partly vented through somewhat higher headline inflation.

B. Governance

State and private sector institutions in SEE countries were weak even before the Kosovo crisis, due to the low level of economic development, political volatility, half-hearted approach to reform in many countries, and the impact of civil unrest and ethnic tensions. The Kosovo conflict, and the associated breakdown of law and order and widespread criminality, was an additional major setback to the process of normalization of the region. As a result, the economies of region today are not only vulnerable to corruption, tax evasion, and other economic crime, but are also threatened by international organized crime, which is drawn to the weakest links in law and law enforcement. Re-establishment of safety, security, and the rule of law, as well as strengthening of governance, were thus rightly placed on top of the policy agenda by the country authorities and the international community following the Kosovo crisis.

Good governance is predicated on peace, order, and effective law enforcement. These areas lie outside the scope of this paper. Instead, this section focuses on two narrower topics of importance for economic policy makers: management of public finances; and corruption and economic crime.

Management of public finances

The efforts to rationalize and streamline the tax and expenditure management systems, as well as the budget preparation and implementation process, were dictated by the need to establish firm control over fiscal policy—a basic requirement under IMF-supported macroeconomic adjustment programs. It was understood, however, that progress in this area would also have broader benefits in terms of transparency, accountability, and governance. The reform agenda included designing a modern, market-oriented tax system; improving tax and customs administration; establishing control over public expenditure; unifying the treasury; introducing modern accounting and auditing; and strengthening the budget process, from formulation to implementation. Donors supported this agenda with significant technical assistance, and the IMF, in particular, has devoted considerable resources in assisting SEE countries in the areas of tax policy and administration and treasury management. The World Bank has provided considerable support to improving expenditure management in the region through implementing single treasury accounts, reviewing expenditure priorities, and strengthening budget preparation and implementation processes that has included establishing medium term expenditure frameworks.

Progress on such a broad front was, of course, uneven. Considerable advances have been made in tax policy, where most countries have tried to widen the tax base and lower tax rates, and now rely for most of their tax revenue on broad-based taxes. A VAT has been introduced in Albania, Bulgaria, Croatia, Romania and, recently, in FYR Macedonia and Kosovo. In addition, Bulgaria and Romania have made progress in expanding the base of direct taxes. The main challenge in these countries now is to build capacity in tax administration and ensure a fair, transparent, and equitable application of tax laws. Improvements in transparency and governance in customs administration is still a major challenge in some countries, notably FYR Macedonia. Deeper institutional transformations, particularly in the ways of working and interacting with taxpayers, will also be required. Over time, these reforms will spread a culture of compliance and reduce the burden on enforcement. The unfinished agenda is bigger in Bosnia and Herzegovina, and includes introducing a VAT and addressing serious shortcomings in the customs service. Finally, FR Yugoslavia is at the early stages of a fundamental overhaul of its tax system. Serbia is implementing a far-reaching reform of the highly complex and distorted tax system by unifying sales taxes and surtaxes into a single-rate consumption tax (to be replaced by VAT in due course); rationalizing excises; and shifting the tax burden towards indirect taxes. In addition, the base for income and social security taxes is being widened and rates reduced, and financial transaction taxes are being unified. Montenegro is preparing for the introduction of VAT, and making efforts to improve tax administration.

Public expenditure and treasury management has improved in all countries of the region. Extra budgetary funds—notably mandatory pension, health and unemployment funds—are now included in the budgetary process in all countries except the FR of Yugoslavia that started the transition process later than the other countries in the region. A new chart of expenditure accounts was introduced in Albania, Bulgaria, and FYR Macedonia, and is planned for FR Yugoslavia. The monthly reporting lag has been reduced to some 20-30 days in Albania, Bulgaria, Croatia, Romania, and FR Yugoslavia, except for local authorities. Single treasury systems were introduced in Albania, Bosnia and Herzegovina, Bulgaria, Croatia, and Romania, and are planned for FR Yugoslavia (with Montenegro being slightly more advanced that Serbia). The implementation of a single treasury in FYR Macedonia is planned for end-2001 or early 2002, and has already had a positive impact in expenditure control and monitoring.

Finally, improvements are underway in budget preparation and implementation. Initially, the primary objective of these reforms was to provide better control of the fiscal aggregates, given the need for macroeconomic stability. These reforms, however, also serve the broader objective of rationalizing the allocation of public resources, increasing transparency and accountability, and improving service delivery. Bulgaria and Romania, for instance, have introduced medium-term fiscal plans in the context of Pre-Accession Economic programs, while Albania has initiated with the support of the World Bank a three-year Medium-Term Expenditure Framework, which is being used as a strategic basis for the formulation of the annual budgets. These reforms should continue, with the ultimate objective of strengthening the link between budget policies and resource allocation in a coherent and integrated framework. Finally, accountability also needs to be enhanced through the establishment of external and internal audit functions.

Corruption and economic crime

Corruption and economic crime is ubiquitous in South East Europe, albeit with considerable variation across countries. It ranges from tax evasion to corruption, extortion, and money laundering. To start addressing this problem, in February 2000, SEE countries adopted an Anti-Corruption Initiative under the Stability Pact. The Initiative aims at promoting an anti-corruption strategy at both the national and the regional level, and envisages legislative initiatives, administrative, judicial and enforcement agencies' reforms, and the establishment of anti-corruption teams or units in countries to coordinate the fight against corruption and help monitor progress. The Initiative also calls for greater involvement of the civil society in sensitizing citizens to corruption and exercising vigilance.

Some progress under the Anti-Corruption Initiative has been recorded, but much remains to be done. This is most notable in the legislative front, although there are still gaps in legislative coverage in even advanced countries. Criminal legislation relating to corruption and bribery has been overhauled, and bribery of public officials is a crime, with sanctions that are appropriate in most countries but still too weak in some. In some cases, laws should be strengthened with tighter definitions, bribing of foreign public officials should be criminalized, and corporate liability tightened. But as in other areas, the main challenge for SEE countries now is to accelerate institutional development that despite significant cross-country differences, is generally at a rudimentary stage. Some anti-corruption units have been set up, but institutional capacity to implement and enforce modern accounting and auditing standards is still weak. Police and the judiciary lack the technical skills to investigate and prosecute economic crime. Public awareness and the involvement of civil society in monitoring economic crime are at their infancy. Clearly, reversing the legacy of corrupt ways of doing business and managing public services and assets will undoubtedly require a prolonged effort.

The region has seen the passage of legislation to reform recruitment and performance standards in the civil service, with some exceptions. Nevertheless, implementation remains weak and supporting institutions still have to be created for training and management of the civil service. Modern public procurement laws have been passed in Albania, the federation entity of Bosnia and Herzegovina, Croatia, FYR Macedonia, and Romania, but they may need to be modified to become consistent with WTO requirements and/or EU directives. In the rest of the region, public procurement laws are still to be adopted and procurement agencies are weak.

Progress in implementing anti-money laundering measures has been mixed. Croatia and Romania have fairly comprehensive legislation, and Croatia has made laundering of proceeds from serious crimes, including bribery, a criminal offense. The law in Albania is broadly appropriate, but there has been a serious delay in its implementation. The law in Bosnia and Herzegovina needs to be broadened. FR Yugoslavia lags behind in this area, although draft anti-money laundering legislation is under preparation in Kosovo. However, even in countries like Romania, where legislation is on the books, enforcement remains a major problem.

C. Economic integration with the global economy through trade and investment

Opening up the economies of SEE countries and deepening their integration with each other and with the rest of the world is critical for strengthening long-term prospects for sustained economic growth. It has therefore been a key theme of the strategy pursued by the international community since the end of the Kosovo conflict. Indeed the EU has made it clear that genuine contributions by individual countries to regional cooperation would be taken as evidence of readiness to move forward in their bilateral relationship with the Union. And in 2000, the Zagreb Summit of leaders of the seven SEE countries endorsed this strategy by stating that “rapprochement with the EU will go hand in hand with the process of developing regional cooperation”. This section discusses the status of and prospects for trade liberalization, regional trade integration, and foreign direct investment.

Trade liberalization[5]

Two years ago, trade regimes of SEE countries varied greatly, and were characterized by high effective protection rates due to differentiated tariff structures; quotas and specific duties for various products; and—in some cases—extensive licensing requirements. The

[5] This section draws on *The Road to Stability and Prosperity in South East Europe,* World Bank, 2000, as well as subsequent work by World Bank and IMF staff.

EU already was the single biggest trading partner of these countries (although their exports accounted for a minute share of EU imports) but intra-regional trade was small (12-14 percent of the total, excluding unrecorded flows, which were probably significant) (Tables 5 and 6).

Since then, a number of significant steps have been made towards trade liberalization (Table 7). In many cases, the IMF and the World Bank have actively supported these measures. The most notable progress took place in FR Yugoslavia; Serbia eliminated nearly all licensing requirements and quantitative restrictions, while the remaining restrictions are to be removed in the context of WTO negotiations. Serbia also reduced the rate and dispersion of tariffs. Montenegro liberalized further its trade regime, which was already more open than the rest of FR Yugoslavia. The UN administration in Kosovo introduced a very simple, liberal regime, with a flat 10 percent tariff rate. Croatia engaged in significant liberalization in the context of WTO accession: a new tariff schedule came into effect in mid-2000 reducing the rate and dispersion of tariffs, and further tariff reductions for both industrial and agricultural products are scheduled to take place over the next five years in line with the WTO accession agreement. Progress, albeit at a slower pace, also took place in Bosnia and Herzegovina, but FYR Macedonia lagged behind. The trade policies of Bulgaria and Romania had already been liberalized in the context of their WTO accession. At present, Albania, Bulgaria, Croatia and Romania are members of the WTO; Bosnia and Herzegovina, FYR Macedonia, and FR Yugoslavia have applied for WTO membership and are at different stages of the accession process (Table 8).

In addition, in the framework of the Stabilization and Association process launched by the EU in May 1999, the EU extended in 2000 autonomous trade preferences (ATPs), which provide highly liberal access to EU markets for SEE exporters.[6] The ATPs grant duty-free access to the EU market for all products, with the exception of some fishery products, wines and textiles (which are subject to quotas) and beef (for which quotas are granted only for baby beef). The liberal market access granted by the ATPs is expected to be consolidated and expanded in a contractual form in the Stabilization and Association Agreements that have been or are in the process of being negotiated with the SEE countries. In fact, these Agreements—which guide more broadly political and economic EU relationships with the SEE countries—envisage the establishment of free trade between the EU and the SEE countries. This would be accomplished with an asymmetric process of liberalization favoring the SEE countries; the establishment of free trade areas consistent with GATT/WTO principles among the SEE countries; the harmonization of country legislation and regulations with those of the EU; and EU assistance to achieve these objectives.

[6] The ATPs were initially extended from November 2000 for a period of 26 months. This period has since been extended to December 2005. These measures initially applied to Albania, Bosnia and Herzegovina, Croatia and Kosovo-FR Yugoslavia. In November 2000, the ATPs were extended to FYR Macedonia and, following the collapse of the Milosevic regime, to FR Yugoslavia.

These steps towards trade liberalization are yet to be translated into sizeable gains in trade integration. This process will require adjustment in the productive structure of the SEE countries. As Table 2 shows, despite a significant rebound of trade flows following the end of the Kosovo crisis, the degree of trade openness still remains lower in South East Europe than in Central Europe: the median total trade-to-GDP ratio in 2000 was about 85 percent in the former, compared with 125 percent in the latter. In addition, most of the progress in 2000 was accounted for by large increases in exports and imports in Romania, Bulgaria and—to a lesser extent—FR Yugoslavia (following the end of sanctions), while trade growth in other countries was more subdued.

It is now critical to capitalize on the momentum of recent trade liberalization measures. The South East European countries need to implement a sustained, general liberalization of all trade, and extend the existing bilateral free trade agreements to other countries in the region:

- The abolition of remaining quantitative restrictions and the establishment of a tariff range with very few, low rates and with minimal exceptions should be the immediate policy goal for all SEE countries;

- Efforts to promote regional trade integration—discussed below—should be sustained and accelerated; and

- Institution-building and upgrading the capacity of customs services should be made a priority, if trade liberalization is to be effective.

The EU has a key role to play in maintaining this momentum. The trade agreements offered by the EU should embody liberal access in all sectors; sensitive EU sectors could be protected though surveillance rather than outright quotas (as already done for textiles). The trade agreements negotiated with different countries should be strongly coordinated and virtually identical in rules, product coverage and exceptions. Countries should also consider a more ambitious timetable for the establishment of a free trade area. The EU should continue to foster regional trade integration, and consideration should be given to wider integration by means of membership of the non-CEFTA SEE countries to CEFTA.

Regional trade integration

In addition to overall trade liberalization, regional trade integration has been an important complementary goal of the international community and domestic policy makers. First, regional trade integration would create more attractive conditions for domestic and foreign investors. Second, regional trade integration is an important vehicle for greater regional cooperation and the promotion of peace and stability in South East Europe . For this reason, in the Zagreb Summit of 2000, the leaders of the seven countries undertook—with the strong encouragement of the international community—to create a regional free trade area. Third, regional trade has the potential of generating benefits, with access to each other’s markets being made easier for historical, cultural, and linguistic reasons.

In June 2001, the SEE countries under the auspices of the Stability Pact signed a wide-ranging Memorandum of Understanding (MOU) on Trade Liberalization and Facilitation (Box 3). The MOU includes a number of measures to promote regional trade, and obliges the signatories to negotiate free trade agreements between themselves by end-2002.

Box 3. The Memorandum of Understanding on Trade Liberalization and Facilitation

On June 27, 2001, Albania, Bosnia and Herzegovina, Bulgaria, Croatia, FYR Macedonia, Romania, and FR Yugoslavia adopted a memorandum of understanding (MOU) on regional trade liberalization. The MOU calls for a network of bilateral free trade agreements to be reached by end-2002 that would be in compliance with WTO rules and any existing trade agreements with the EU.

The MOU set out the following core principles for future trade agreements:

- Each agreement would initially cover goods, but would contain clauses that would envisage the future liberalization of trade in services.
- New trade restrictions would be banned, while all export duties, and all quantitative restrictions on imports and exports would be abolished once any agreement comes into force.
- Import duties on the majority of goods would be abolished at the time each new free trade agreement comes into force.
- Import duties on at least 90 percent of each country’s mutual trade, defined by value, would be abolished within a transition period lasting no more than six years.

The MOU also contains clauses covering common rules of origin; anti-dumping; simplifying customs procedures; harmonizing legislation, documentation, and procedures with those of the European Union; the protection of intellectual property rights; and the elimination of discriminatory rules on public procurement and state aid. However, the memorandum avoided the politically difficult issue of agriculture.

This agreement is potentially a powerful instrument promoting regional integration. It commits the countries to work in a regional context, sets minimum standards for bilateral agreements, and involves time-bound commitments of mutual liberalization. However, there is a risk that the bilateral free trade agreements called for by the MOU would result in different liberalization schedules. This would create tensions between the more developed countries in the region and the less developed ones and stimulating unwarranted trade diversion. It is thus important to emphasize that these agreements will realize their full potential only if the South East European countries undertake concurrently a substantial multilateral liberalization and standardize the bilateral free trade agreements.

Regardless of the approach, successful regional trade integration—and, more broadly, trade integration with the rest of the world—also requires a stable macroeconomic environment. In this context, the estimates of the revenue loss from regional trade liberalization are reassuring: the impact is estimated to be small (with the possible exception of Bosnia and Herzegovina) and should not generate a problem for macroeconomic policy (Table 9).

Foreign direct investment

Net Foreign Direct Investment in South East Europe, 1989-2000

	Cumulative FDI inflows (US$ million)	Cumulative FDI inflows per capita
Albania	592	173
Bosnia and Herzegovina	340	79
Bulgaria	3,286	404
Croatia	4,274	938
FYR Macedonia	437	219
Romania	6,732	301
FR Yugoslavia	990	116
South Eastern Europe	15,661	319

Source: IMF and EBRD estimates.

SEE countries have received significantly less foreign direct investment (FDI) compared to those in Central Europe. Over the 1989-2000 period, the region received just over US$300 per capita of FDI, compared with about US$1,200 in Central Europe and the Baltics. Within the region, Croatia has clearly been in the lead, although the fastest rise is now expected to take place in FR Yugoslavia and Bulgaria.

The composition of FDI inflows to date is also disappointing. FDI inflows have been mostly tied to privatizations. For example, one-third of FDI in Bulgaria and Croatia in 2000 and two-thirds of the inflow in Albania in the same year was accounted for by sales of a bank and the award of a mobile telephone license. The early 2001 sale of the government's stake in FYR Macedonia's telephone company generated as much FDI as the preceding decade. In contrast, FDI into greenfield investment and existing private companies has been low and remains a major challenge.

The experience of other emerging economies has shown that foreign direct investment is key for upgrading rapidly the physical and human capital, reducing external vulnerability, and boosting the structural reform momentum. Recognizing this, both the South East European countries and the international community made the promotion of foreign direct investment a central objective of their strategy following the end of the Kosovo conflict. Countries undertook to improve the climate for foreign investment by developing open, stable, non-discriminatory legal frameworks towards foreign investors; ensuring fair treatment of domestic and foreign investments, including repatriation of capital and earnings; setting up arbitration mechanisms for investment disputes; establishing predictable customs regimes; and pursuing privatization in a transparent and competitive manner. Countries also took measures to limit corruption and improve the general business climate, which were discussed in other sections of this paper.

Donors encouraged and supported these efforts of the SEE countries. The Investment Compact under the Stability Pact provided resources and advice for developing programs to promote investment (both domestic and foreign) with assistance by the OECD. The Foreign Investment Advisory Service (FIAS) of the World Bank has conducted diagnostic studies of the barriers to foreign investment and, more broadly, general barriers to investment. Finally, a number of bilateral donors have extended technical assistance in preparing regulations and setting up institutions.

By the standards of the region, Bulgaria has a well-developed FDI regime and institutions, and efforts are underway to promote FDI, notably through the preparation of investment guides and business information networks. Policies should now focus on preparing an arbitration law and strengthening public administration on business-related issues. Romania and Croatia have also attracted sizeable FDI inflows in absolute terms, but still have significant administrative barriers and complex and discriminatory procedures for foreign investors. In the latter, FIAS has identified visa and work permits delays and impediments on real estate transactions and building of new premises as significant obstacles, and its recommendations provide a blueprint for policy action.

Albania, Bosnia and Herzegovina, FYR Macedonia, and FR Yugoslavia still have to tackle more fundamental problems in order to attract FDI. In Albania, FIAS has identified weak governance, complex tax, customs and business laws and regulations, and difficult access to land and construction permits as the major factors deterring foreign investment. In addition, there is a need to establish independent offices for the resolution of commercial disputes, ratify agreements on arbitration, and strengthen judicial tribunals. Bosnia and Herzegovina has adopted a liberal foreign investment law at the state level, but consistent legislation needs to be adopted and implemented at the level of the two entities. Once the security situation in FYR Macedonia returns to normal, the authorities' success in attracting FDI will hinge on easing restrictions on real estate ownership and use, releasing of state-owned land for investment, streamlining cumbersome licensing requirements, and improving governance. Finally, FR Yugoslavia has the potential of attracting significant FDI inflows as it emerges from a decade of near-isolation. It will be important to clarify the respective policy and execution responsibilities of the federal, republic and provincial levels of government, and remove the anachronistic requirement of reciprocity of treatment. Both the federal and the Serbian legal framework governing FDI needs to be radically modernized, while Montenegro has adopted a liberal, comprehensive law on foreign investment, defined a strategy for attracting FDI, and established a promotion body, and the interim UN administration in Kosovo is drafting legislation to support foreign investment.

The region is clearly making an effort to attract foreign investment. However, success will depend greatly on not just removing discriminatory measures against foreign investors, but improving the overall climate for private activity and deepening integration with the EU. The following section discusses this are in more detail.

D. Private sector development

Sustainable growth in South East Europe in the long run can only be based on the development of a sound, dynamic private sector. The first step in this direction is defining and enforcing property rights and introducing a market-oriented and transparent legal framework for business activity. At the same time, the role and discretion of the state in the economy should be reduced through privatization and deregulation. Most SEE countries have already made considerable—albeit uneven—progress in these areas. But as the experience of all transition economies shows, this is not enough: building the institutional capacity to enforce the new legal framework, improving transparency and accountability in government, and establishing a level playing field between the private and public sectors are also important. The banking system and, more broadly, the financial sector also has a key role to play in evaluating and pricing risk, allocating savings, and enforcing good accounting and management practices.

There are close linkages between the set of reforms in the enterprise sector and that in the banking and financial sectors. Improvements in the competition and commercial environment, e.g., through greater transparency and predictability of administrative and regulatory decisions, or through effective enforcement of bankruptcy laws, will help foster growth in banking and equity markets; similarly, a growing role for bank intermediation accompanied by well-supervised banks that lend on commercial criteria will ease access to finance for the enterprise sector. The SEE countries have moved in tandem on these tracks with visible results, but many tough decisions lie ahead.

The legal and regulatory framework for business

The region has made solid progress in setting up an appropriate environment for the formation and functioning of private enterprises through the passage of company and commercial laws, laws on collateral and secured lending, and bankruptcy laws, but progress in establishing effective legislation for protection of competition has been much slower. However, effective and fair enforcement of these laws remains a major weakness. In Albania and Bulgaria, for instance, adequate company laws and commercial codes exist, but their effectiveness is undermined by gaps in implementation, failure to operate licensing requirements in an unambiguous and predictable manner, and the imposition of lengthy and confusing procedures. Inconsistent implementation and interpretation of laws and regulations gives rise to discrimination between different types of investors and, thereby, to corruption. Also in Albania, although bankruptcy legislation has been in force for nearly five years, there has not been a single bankruptcy.

The top policy priority is to develop a legal framework for securing competition. The top implementation requirement is to build effective institutions and promote even-handed application of the existing legal and regulatory frameworks. Training and capacity building are key components, as are ensuring the independence of the judiciary.

An important deterrent to private investment is uncertainty about the legal and tax regime governing private economic activity. Bulgaria and Romania have suffered from frequent and unpredictable revisions of tax and other laws (even while EU-consistent laws and standards are being designed), as well as arbitrary interpretation of tax and customs laws. In Romania, in particular, the volatility and unpredictability of the general commercial legal framework adds considerably to the cost of doing business. As efforts to implement competition legislation get under way (Bulgaria is a notable early example), the consistency and transparency of decisions by competition agencies will also be crucial.

In certain cases, fundamental legislative reforms are still awaited. In Bosnia and Herzegovina, the basic commercial and competition framework is deficient: despite the wide-ranging legal reform program, there is still a labyrinth of formal and informal rules across state, entity, cantonal, and municipal levels leading to a fragmentation of the current commercial framework. The company laws of the entities need to be harmonized, a single economic space for the country be created, and competition legislation be enacted. In FR Yugoslavia, a radical change in the whole range of commercial legislation and a clarification and protection of property rights are needed, not least to ensure that private investors compete on equal terms with state-owned and socially-owned firms. Given the recent history of political interference in the judicial system, special attention should be paid on the fair and transparent enforcement of laws.

Privatization and private sector participation in the provision of public services

The legislative framework for privatization was introduced in most South East European countries early on, and was amended in light of the experience in order to promote greater transparency and use of clear competitive sales methods in parts of the region, notably in Bosnia and Herzegovina, Bulgaria, and FYR Macedonia. Common problems are the lack of clarity regarding ownership of assets, including land and, in the case of successor states of former SFR Yugoslavia, conflicting succession claims.

These problems and, more broadly, fear of the political cost of closing or restructuring unviable state enterprises meant that privatization in South East Europe has thus far been fitful and uneven. Progress was notable most recently in Bulgaria, where large enterprises have been sold, usually to foreign investors, as well as in Croatia and FYR Macedonia. In other parts of the region, however, restructuring of loss-making state enterprises has been more controversial and, as a result, the cost was sometimes higher than necessary. In Romania, for example, prolonged delays in privatization resulted in mounting quasi-fiscal costs; country authorities have now understood better the costs of delayed restructuring and privatization and are showing a firmer resolution to complete the task, but a stronger, credible commitment to openness in transactions is required.

The main policy challenges are now to resolve outstanding claims and succession disputes and prepare the large enterprises remaining in state hands, including public utilities, for privatization. The latter is a complex task: the privatization of state monopolies is fundamentally different than that of small and medium-size commercial firms, and has to be carefully prepared. It requires introducing proper accounting, unbundling activities, removing state support schemes, restructuring balance sheets, creating the post-privatization regulatory framework, and deciding which parts of the enterprise are to be privatized and which to remain in government hands. Moreover, the specific nature of the sale, the share of private ownership, the terms of the tender, investment requirements, etc. must be designed so as ensure complete transparency. These are tasks that can only be carried out with significant donor assistance.

A key to obtaining private, especially foreign, investment is opening the provision of public services to the private sector. Except in telecommunications, progress here has been very limited. Bulgaria and Romania have passed legislation unbundling and opening to private sector participation electric power, railways, and water and sewerage services. In addition, in Bulgaria, the municipality of Sofia awarded a concession to a foreign investor for the operation of the Sofia water and sewerage system. But progress in the other countries has been minimal. This is disappointing because the large capital requirements in public infrastructure sector can best be met through a high degree of private participation. The EBRD and the World Bank are active in this area, helping countries develop the appropriate legal and regulatory frameworks.

Development of small- and medium-size enterprises (SMEs)

Development of the SME sector has been one of the priorities of both country authorities and donors. Policies in this area have been—and still are—oriented towards reducing administrative barriers (such as registration requirements, permits, and discretionary actions by public agents); setting up facilitation centers for SMEs; and encouraging the development of financial intermediaries for SMEs, as well as reducing the risks associated with lending to SMEs. Donors have contributed technical assistance resources, initiated partnerships to introduce modern technologies and marketing methods, and participated in risk-mitigating schemes. The World Bank and EBRD, in particular, have focused much of their energies on this sector.

The SME support framework is currently most advanced in Bulgaria, which has eased administrative burdens, developed a network of regional agencies for business facilitation, and put in place a number of financing channels (a credit guarantee fund, a micro credit line, and a long-term investment credit line). In Albania, Croatia, and Romania, strategic decisions have been made and legislation is being prepared to remove administrative barriers and to provide facilitation through public institutions. Matters are at a considerably less advanced stage in Bosnia and Herzegovina and FYR Macedonia. Finally, within the FR Yugoslavia, Montenegro has devised an ambitious program of SME reform and support with the assistance of donors, and Kosovo maintains a simple business environment and favorable tax system. Serbia, however, still has to tackle the challenge of sweeping away past habits and ways of doing business and creating a liberal, supportive environment for SMEs.

Financial intermediation

The starting point for deepening financial intermediation and, more generally, developing the domestic capital market was very low in most SEE countries. In addition to the challenge of reforming inefficient, state-dominated, non market-oriented banking systems—as in all other transition economies—several of the countries had a history of banking crises and insolvencies and, in some cases, confiscation of deposits. These had sapped public confidence in banks, and driven intermediation down to negligible levels.

Most SEE countries have recently made substantial progress in reviving banking intermediation through the establishment of a privately owned banking system and greater confidence on the part of the general public engendered by strengthened banking supervision and deposit insurance schemes. The liquidity and solvency conditions of banks has also improved, with market criteria playing an increasing role in bank decisions in contrast to the past where political and other factors determined the direction and volume of bank lending as well as links between banks and their founding enterprises.

Ratio of broad money to GDP
(in percent)

	1998	2000
Albania	52.0	60.8
Bosnia and Herzegovina	24.9	27.8
Bulgaria	28.6	35.0
Croatia	41.6	46.1
FYR Macedonia	14.9	21.2
Romania	24.9	23.2

Source: IFS; and national authorities.

There is clearly a large, unfinished reform agenda that requires efforts and that will take time to bear fruit. Moreover, progress in this area will only be made if reforms advance simultaneously in a number of other fronts, notably a market-oriented commercial legal framework, enforcement of property rights and bankruptcy legislation, appropriate pledge and mortgage regulations, introduction of property registries, and strengthening of accounting standards and corporate governance. In the financial sector proper, the priorities in the near future should be improving supervision and privatizing state-owned financial intermediaries.

Efforts to strengthen financial sector supervision are underway in all South East European countries. The internationally accepted standards—notably the Basel Committee 25 Core Principles for Bank Supervision—and the EU Banking Directives provide a clear blueprint for reform, and the IMF has taken a leading role in providing policy advice and technical assistance in central banks and other supervisory institutions this area. Ensuring effective supervision of a rapidly evolving financial sector is not a one-off task: first, the legal and regulatory framework has to be put in place, and then sustained efforts are needed to build capacity, train supervisors, and ensure their operational independence. FR Yugoslavia is still close to the start line, although UNMIK has made significant progress in Kosovo. FYR Macedonia recently passed a new banking law, and is now preparing a law strengthening central bank independence. Croatia plans to reinforcing the supervisory powers of the central bank and its ability to act against non-complying banks. Bulgaria and Romania are relatively more advanced, and their efforts now focus on regulatory harmonization with the EU. In the latter, the supervision capabilities of the central bank are being strengthened by an early warning system. Strengthening of supervision in Croatia is being assisted by the World Bank. In the medium term, SEE countries should also undergo Financial Sector Assessment Programs (Bulgaria has already requested one) to assess the systemic soundness and macroeconomic linkages and risks of their financial sectors.

The process of withdrawal of the state from the banking system has started in all South East European countries by closing insolvent state-owned banks and privatizing solvent ones. In some cases, this process still requires major portfolio clean ups, given the volume of poor assets inherited from the past. The unfinished agenda is still daunting in some countries. Bank privatization is now complete in Croatia (with the exception of the postal bank) and advancing in Albania, where work is under way to privatize the savings bank in 2002. In Romania, two small banks and one major bank have been privatized, a large institution liquidated, and the largest commercial bank (Romanian Commercial Bank) is slated for sale in 2002 under a World Bank adjustment operation. In Bulgaria, the process is planned to be completed by 2003. Both Bulgaria and Romania need to focus on efforts to improve and accelerate the asset recovery operations to dispose of bank bad assets. In Bosnia and Herzegovina, bank privatization has been delayed due to lack of resolve in tackling insolvency issues. Finally, bank privatization in FR Yugoslavia will have to be part of a broader banking sector restructuring strategy, including liquidation, rehabilitation, and sales.

IV. Final Observations

This paper has documented the encouraging progress made by the SEE countries since the end of the Kosovo conflict in highly difficult conditions in pursuing market-oriented reforms and strengthening integration with the rest of the world. Although it is too early to tell whether the momentum will continue, and the situation in FYR Macedonia is still a source of concern, there are reasons to be optimistic. The progress is real, and there are signs of a deeper and broader consensus on both the ultimate goal of sustainable growth and on the policy means to achieve it.

The roots of this progress are found in a maturing of the political economy in the SEE countries. Free elections have taken place in all of them over the past two and a half years, and governments have changed in an orderly fashion. In some cases, notably Bosnia and Herzegovina, Croatia, and FR Yugoslavia, power shifted from groups that represented a nationalistic and dirigiste past to liberal forces committed to creating competitive market economies. The emergence of FR Yugoslavia as a force for peace and ethnic tolerance will do much to stabilize the region. There are also signs of a growing will to fight corruption, especially in countries where governments that espoused ethnic politics and had originally came to power in conditions of war, have been replaced. Finally, the constituency for reform may be growing: taxpayers appear to be tiring of supporting loss-making enterprises or banks, and public opinion is becoming less tolerant of misuse of public resources.

Significant political risks persist. The crisis in FYR Macedonia is a reminder of continuing ethnic tensions in the region and the havoc they wreak in the economy. The peace agreement will require full support at home and by the international community. Until clarity on the final constitutional arrangements in FR Yugoslavia is reached, investment is likely to be impeded. In Kosovo, ethnic wounds continue to challenge stability and recovery. State institutions still function poorly in Bosnia and Herzegovina, and inter-entity cooperation is a shadow of what it ought to be. In all countries, entrenched interest groups that oppose reform continue to survive in state enterprises, in political groups linked with agriculture or banks, or in privileged companies with political links.

Absent backsliding of reforms, economic growth is expected to be durable in the medium term, notwithstanding the increased downside risks arising from the current global slowdown. This is the best news for the struggle against poverty. The region is the poorest in Europe, with low social indicators and high unemployment rates. Reform efforts in education and health and improvements of public services, in general, will make an important contribution to the fight against poverty.

The unfinished policy agenda remains daunting. The paper identified several common challenges: designing sound medium-term fiscal policy frameworks; ensuring continued disinflation; creating a competitive environment; developing an appropriate framework for private participation in public service provision; and adopting and enforcing anti-corruption laws and rules. In all these areas, as well as in many others that are country-specific, work is just beginning. The paper also argued that many of the achievements so far have mainly been on the legislative front, while implementation is still weak or nonexistent. This requires supporting institutions, trained staff, powers for enforcement and, above all, wide public acceptance and understanding of the “new” ways of doing business. This will inevitably take much time; and herein lies the development challenge for the region.

The foremost responsibility for continued progress rests with the authorities of the individual countries. They will have to design the right policies and develop the institutions to implement these policies. Another message of the paper is that donors also have a responsibility. The speed with which the Kosovo crisis was overcome owes much to the coordinated and regional character of the donor response, both financial and technical. The policy advice, financial and technical support, greater access to trade, and realistic prospect of deepening integration to Europe have all been powerful incentives to reform. Donor engagement will remain vital in the coming years. The EU and the accession process has been a beacon for good policies in the Central European countries, and it can play a similar role within South East Europe.

Finally, lasting success will depend on the willingness of the private sector—domestic and foreign—to invest in these countries. Foreign investment, in particular, is a bellwether of the credibility of macroeconomic and structural policies in each of the countries, and of the belief that a strong private market framework is here to stay. When the region begins to attract foreign investment in amounts seen today in Central European countries, it can be confident that its reform credentials have won wide acceptance.

Appendix I. EBRD Transition Indicators

This classification system is simplified and builds on the judgment of the EBRD'S Office of the Chief Economist. More detailed descriptions of country-specific progress in transition are provided in the transition indicators at the back of the EBRD's Transition Report. The classification system presented here builds on the Transition Report 1994. To refine further the classification system, pluses and minuses have been added to the 1-4 scale since 1997 to indicate countries on the borderline between two categories.

Private sector share in GDP

The private sector share of GDP represent rough EBRD estimates, based on available statistics from both official (government) sources and unofficial sources. The underlying concept of private sector value added includes income generated by the activity of private registered companies as well as by private entities engaged in informal activity in those cases where data are reliable.

Large-scale privatization

1 Little private ownership.
2 Comprehensive scheme almost ready for implementation; some sales completed.
3 More than 25 percent of large-scale enterprise assets in private hands or in the process of being privatized (with the process having reached a stage at which the state has effectively ceded its ownership rights), but possible with major unresolved issues regarding corporate governance.
4 More than 50 percent of state-owned enterprise and farm assets in private ownership and significant progress on corporate governance of these enterprises.
4+ Standards and performance typical of advanced industrial economies: more than 75 percent of enterprise assets in private ownership with effective corporate governance.

Small-Scale privatization

1 Little progress.
2 Substantial share privatized.
3 Nearly comprehensive program implemented
4 Complete privatization of small companies with tradable ownership rights.
4+ Standards and performance typical of advanced industrial economies: no state ownership of small enterprises; effective tradability of land.

Governance and enterprise restructuring

1 Soft budget constraints (lax credit and subsidy policies weakening financial discipline at the enterprise level); few other reforms to promote corporate governance.

2 Moderately tight credit and subsidy policy but weak enforcement of bankruptcy legislation and little action taken to strengthen competition and corporate governance.
3 Significant and sustained action to harden budget constraints and to promote corporate governance effectively (e.g., through privatization combined with tight credit and subsidy policies and/or enforcement of bankruptcy legislation).
4 Substantial improvement in corporate governance, for example, an account of an active corporate control market; significant new investment at the enterprise level.
4+ Standards and performance typical of advanced industrial economies: effective corporate control exercised through domestic financial institutions and markets, fostering market-driven restructuring.

Price liberalization

1 Most prices formally controlled by the government.
2 Price controls for several important product categories: state procurement at non-market prices remains substantial.
3 Substantial progress on price liberalization: state procurement at non-market prices largely phased out.
4 Comprehensive price liberalization; utility pricing which reflects economic costs.
4+ Standards and performance typical of advanced industrial economies: comprehensive price liberalization; efficiency-enhancing regulation of utility pricing.

Trade and foreign exchange system

1 Widespread import and/or export controls or very limited legitimate access to foreign exchange.
2 Some liberalization of import and/or export controls; almost full current account convertibility in principle but with a foreign exchange regime that is not fully transparent (possibly with multiple exchange rates).
3 Removal of almost all quantitative and administrative import and export restrictions; almost full current account convertibility.
4 Removal of all quantitative and administrative import and export restrictions (apart from agriculture) and all significant export tariffs; insignificant direct involvement in exports and imports by ministries and state-owned trading companies; no major non-uniformity of customs duties for non-agricultural goods and services; full current account convertibility
4+ Standards and performance norms of advanced industrial economies: removal of most tariff barriers; WTO membership.

Competition policy

1 No competition legislation or institutions.
2 Competition policy legislation and institutions set up; some reduction of entry restrictions or enforcement action on dominant forms.
3 Some enforcement actions to reduce abuse of market power and to promote a competitive environment, including break-ups of dominant conglomerates; substantial reduction of entry restrictions.
4 Significant enforcement actions to reduce abuse of market power and to promote a competitive environment.
4+ Standards and performance typical of advanced industrial economies: effective enforcement of competition policy; unrestricted entry to most markets.

Banking reform and interest rate liberalization

1 Little progress beyond establishment of a two-tier system.
2 Significant liberalization of interest rates and credit allocation: limited use of directed credit or interest rate ceilings.
3 Substantial progress in establishment of bank solvency and of a framework for prudential supervision and regulation; full interest rate liberalization with little preferential access to cheap refinancing significant lending to private enterprises and significant presence of private banks.
4 Significant movement of banking laws and regulations towards BIS standards; well-functioning banking competition and effective prudential supervision; significant term lending to private enterprises substantial financial deepening.
4+ Standards and performance norms of advanced industrial economies; full convergence of banking laws and regulations with BIS standards; provision of full set of competitive banking services.

Security markets and non-bank financial institutions

1 Little progress.
2 Formation of securities exchanges, market-makers and brokers; some trading in government paper and/or securities; rudimentary legal and regulatory framework for the issuance and trading of securities.
3 Substantial issuance of securities by private enterprises; establishment of independent share registries, secure clearance and settlement procedures, and some protection of minority shareholders; emergence of non-bank financial institutions (e.g., investment funds, private insurance and pension funds, leasing companies) and associated regulatory framework.
4 Securities laws and regulations approaching IOSCO standards; substantial market liquidity and capitalization; well-functioning non-bank financial institutions and effective regulation.
4+ Standards and performance norm of advanced industrial economies: full convergence of securities laws and regulations with IOSCO standards; fully developed non-bank intermediation.

Table 1. South East Europe: Main Macroeconomic Indicators

	1997	1998	1999	2000	2001 Proj.
	Real GDP growth (percent change)				
Albania	-7.0	8.0	7.3	7.8	7.3
Bosnia and Herzegovina	36.6	9.9	9.9	5.9	6.2
Bulgaria	-7.0	3.5	2.4	5.8	4.5
Croatia	6.6	2.5	-0.4	3.7	4.0
FYR Macedonia	1.4	3.4	4.3	4.3	-4.0
Romania	-6.1	-5.4	-2.3	1.6	4.5
FR Yugoslavia	10.1	1.9	-15.7	5.0	5.0
Median SEE	*1.4*	*3.4*	*2.4*	*5.0*	*4.5*
Median CEEC-8 1/	*6.5*	*4.5*	*1.5*	*4.5*	*4.0*
	End of period inflation, percent				
Albania	42.1	8.7	-1.0	4.2	3.0
Bosnia and Herzegovina	…	5.6	14.0	16.1	…
Bulgaria	549.2	1.7	7.0	11.4	4.0
Croatia	3.8	5.4	4.4	7.4	4.5
FYR Macedonia	3.2	-2.4	2.6	6.1	6.2
Romania	151.4	40.6	54.8	40.7	29.0
FR Yugoslavia	…	44.5	49.9	113.5	35.0
Median SEE	*42.1*	*5.6*	*7.0*	*11.4*	*5.4*
Median CEEC-8 1/	*10.0*	*6.5*	*3.8*	*4.9*	*3.9*
	Fiscal deficit, in percent of GDP 2/				
Albania	-12.8	-10.4	-11.4	-9.1	-9.5
Bosnia and Herzegovina 3/	…	-2.2	-3.3	-4.0	…
Bulgaria	-2.5	1.0	-1.0	-1.1	-0.5
Croatia	-2.0	-3.0	-7.4	-5.7	-5.3
FYR Macedonia	-0.3	-1.7	0.0	2.5	-7.8
Romania	-5.2	-5.5	-3.8	-3.7	-3.5
FR Yugoslavia 4/	…	…	…	-0.2	-2.8
Median SEE	*-2.5*	*-2.6*	*-3.5*	*-3.7*	*-4.4*
Median CEEC-8 1/	*-1.9*	*-2.8*	*-3.6*	*-2.9*	*-2.2*
	Current account deficit, in percent of GDP				
Albania	-12.1	-6.1	-7.2	-7.0	-7.5
Bosnia and Herzegovina	-42.0	-23.7	-21.0	-19.9	-20.3
Bulgaria	4.4	-0.5	-5.3	-5.8	-6.7
Croatia	-11.6	-7.1	-6.9	-2.1	-3.8
FYR Macedonia	-7.6	-9.7	-3.4	-3.1	-14.7
Romania	-6.1	-7.1	-4.1	-3.9	-6.0
FR Yugoslavia	-9.4	-4.8	-7.5	-7.6	-16.4
Median SEE	*-9.4*	*-7.1*	*-6.9*	*-5.8*	*-7.5*
Median CEEC-8 1/	*-5.6*	*-7.0*	*-4.8*	*-5.3*	*-5.3*

Source: WEO, IMF Staff estimates and projections

1/ CEEC-8 are: Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovenia and the Slovak Republic

2/ General government budget balances, where available.

3/ Includes State and entity budgets.

4/ Consolidated general government accounts are unavailable prior to 2000.

Table 2. South East Europe: External Trade
(millions of US dollars, unless otherwise indicated)

	1997	1998	1999	2000
		Exports of Goods		
SEE	**21873**	**22327**	**20698**	**23975**
Albania	167	205	275	256
Bosnia and Herzegovina	575	697	649	732
Bulgaria	4809	4194	4006	4812
Croatia	4,210	4,604	4,395	4,567
FYR Macedonia	1,235	1,292	1,192	1,319
Romania	8431	8302	8503	10366
FR Yugoslavia	2447	3033	1677	1923
		Imports of Goods		
SEE	**33777**	**50296**	**31036**	**34813**
Albania	685	826	1121	1070
Bosnia and Herzegovina	2,333	2,656	2,502	2,348
Bulgaria	4488	4574	5087	5988
Croatia	9,407	8,752	7,693	7,771
FYR Macedonia	1,625	1,711	1,601	1,875
Romania	10411	10927	9736	12050
FR Yugoslavia	4799	4849	3296	3711
		Trade openness 1/		
SEE	**78.6**	**72.5**	**74.8**	**86.9**
Albania	46.5	41.3	55.2	59.3
Bosnia and Herzegovina	102.5	98.4	78.2	77.1
Bulgaria	126.4	97.7	99.6	122.1
Croatia	97.7	88.8	89.2	95.8
FYR Macedonia	87.9	99.8	98.0	114.4
Romania	65.5	56.1	62.6	73.7
FR Yugoslavia	50.9	66.4	56.0	81.2

Source: IMF, National Authorities, and DOTS database
1/ Exports plus imports (including services) scaled by GDP

Table 3. South East Europe
IMF Outstanding Purchases and Loans

	31 Dec 1998	31 Dec 1999	31 Dec 2000	31 Jul 2001
Outstanding purchases and loans, millions of SDRs				
SEE	**1,570**	**1,645**	**1,811**	**1,774**
Albania	45.8	58.7	67.5	70.7
Bosnia and Herzegovina	54.5	68.4	80.4	94.4
Bulgaria	792.3	910.7	1,014.6	978.3
Croatia	166.1	143.2	121.4	110.5
FYR Macedonia	72.7	74.1	62.3	58.4
Romania	382.8	333.8	347.7	294.3
FR Yugoslavia	56.1	55.6	116.9	166.9
Change in outstanding purchases and loans, millions of SDRs				
SEE	**32.1**	**74.4**	**166.2**	**-37.3**
Albania	5.0	12.9	8.8	3.3
Bosnia and Herzegovina	24.2	13.9	12.0	14.0
Bulgaria	94.2	118.5	103.9	-36.4
Croatia	-6.5	-22.9	-21.8	-10.9
FYR Macedonia	7.4	1.4	-11.8	-3.9
Romania	-92.3	-49.0	13.9	-53.4
FR Yugoslavia	0.0	-0.4	61.3	50.0

Source: IMF Treasurers Department

Table 4: World Bank Lending and Grants, from 1995-2001
(in US million)

	1995-1998 Annual average	1999	2000	2001 Projection
Total				
Commitments	915	1130	470	762
o/w Grants	136	46	100	73
Disbursement	541	857	727	408
Albania (IDA only)				
Commitments	66	140	58	30
o/w Grants	20	1	4	5
Disbursement	40	81	64	36
Bosnia & Herzegovina (IDA only)				
Commitments	206	197	94	123
o/w Grants	110	34	53	2
Disbursement	47	93	85	83
Bulgaria (IBRD only)				
Commitments	104	176	135	88
o/w Grants	3	3	2	2
Disbursement	91	221	71	30
Croatia (IBRD only)				
Commitments	125	139	15	205
o/w Grants	1	2	1	0
Disbursement	82	88	56	26
FYR Macedonia (IDA and IBRD)				
Commitments	82	94	60	52
o/w IDA	48	60	29	36
IBRD	33	32	30	16
Grants	0	2	0	0
Disbursement	53	57	51	32
Romania (IBRD only)				
Commitments	332	382	69	138
o/w Grants	3	2	1	8
Disbursement	229	317	386	92
FR Yugoslavia (Serbia & Montenegro) (IDA only) 1/				
Commitments				101
o/w Grants				31
Disbursement				84
FR Yugoslavia (Kosovo) 1/				
Commitments		2	39	24
o/w Grants		2	39	24
Disbursement		1	14	24

Source: The World Bank.

Note: 1/ FRY has outstanding IBRD debt of US$1.8 billion (of which US$1.7 billion is in arrears) which is in the process of being consolidated. Commitments to FRY in 2001 will be contingent upon resolution of arrears.

Table 5. South East Europe: Direction of Trade, Export shares (1995-2000)

	1995	1996	1997	1998	1999	2000
			(in percent)			
SEE	**100**	**100**	**100**	**100**	**100**	**100**
EU	50	51	53	58	59	59
Intra-regional trade	9	9	9	9	9	10
Rest of the world	41	40	38	33	32	31
Albania	**100**	**100**	**100**	**100**	**100**	**100**
EU	79	86	87	93	94	91
SEE	5	4	7	2	2	1
Rest of the World	15	10	5	5	5	8
Bosnia and Herzegovina	**100**	**100**	**100**	**100**	**100**	**100**
EU	56	44	44	49	60	65
SEE	17	34	36	31	19	13
Rest of the World	28	22	20	19	20	22
Bulgaria	**100**	**100**	**100**	**100**	**100**	**100**
EU	39	40	45	51	54	52
SEE	13	11	7	7	10	13
Rest of the World	48	49	48	42	36	36
Croatia	**100**	**100**	**100**	**100**	**100**	**100**
EU	58	51	51	48	49	55
SEE	10	14	17	16	15	13
Rest of the World	32	35	31	36	36	32
FYR Macedonia	**100**	**100**	**100**	**100**	**100**	**100**
EU	34	43	37	44	45	49
SEE	34	32	33	29	31	30
Rest of the World	32	25	30	27	25	21
Romania	**100**	**100**	**100**	**100**	**100**	**100**
EU	54	56	57	65	66	64
SEE	2	2	1	3	3	4
Rest of the World	44	42	42	32	31	32
FR Yugoslavia	**100**	**100**	**100**	**100**	**100**	**100**
EU	58	76	83	73	70	68
SEE	4	3	3	7	8	9
Rest of the World	38	21	14	21	22	23

Source: DOTS database, IMF

Table 6. South East Europe: Direction of Trade, Import shares (1995-2000)

	1995	1996	1997	1998	1999	2000
			(in percent)			
SEE	**100**	**100**	**100**	**100**	**100**	**100**
EU	51	52	54	55	56	54
Intra-regional trade	5	6	6	6	6	6
Rest of the world	44	42	40	39	38	40
Albania	**100**	**100**	**100**	**100**	**100**	**100**
EU	77	76	84	83	80	76
SEE	11	10	6	5	7	6
Rest of the World	12	14	11	12	13	18
Bosnia and Herzegovina	**100**	**100**	**100**	**100**	**100**	**100**
EU	24	37	39	41	43	44
SEE	45	32	31	30	24	21
Rest of the World	32	31	29	29	33	35
Bulgaria	**100**	**100**	**100**	**100**	**100**	**100**
EU	38	36	42	46	50	45
SEE	4	3	3	3	2	4
Rest of the World	57	60	55	51	48	51
Croatia	**100**	**100**	**100**	**100**	**100**	**100**
EU	62	59	59	59	57	56
SEE	1	2	2	3	2	2
Rest of the World	37	39	38	38	41	42
FYR Macedonia	**100**	**100**	**100**	**100**	**100**	**100**
EU	40	39	37	36	40	48
SEE	29	21	22	22	20	19
Rest of the World	31	40	41	42	40	33
Romania	**100**	**100**	**100**	**100**	**100**	**100**
EU	51	52	52	58	61	57
SEE	1	1	1	1	1	1
Rest of the World	48	47	46	41	38	42
FR Yugoslavia	**100**	**100**	**100**	**100**	**100**	**100**
EU	72	67	76	65	61	57
SEE	8	14	5	8	12	18
Rest of the World	20	19	20	27	28	25

Source: DOTS database, IMF

Table 7. South East Europe: Description of trade barriers

	Tariffs Simple average (min, max)	Additional Tariff based barriers	Non-tariff barriers	Export taxes	Import surcharges
Albania	7.8 (0, 15)	Differential excise taxes	import licences and permits are acquired the eggs, used tyres, wool, and unprocessed leather.	None	None
Bosnia and Herzegovina	6.8 (0, 15)	1% Customs entry fee	export restrictions on unprocessed leather.	Taxes on raw and cut timber	There are import surcharges on various agricultural products.
Bulgaria	12.4 (0, 74)	There are seasonal tariffs on some agricultural goods and a high number of tariff bands	Some minor state trading	None	Eliminated in January 1999
Croatia	7.1 (0, 90)	226 tariff lines are subject to compound duties	There are no bands, quantitative restrictions, or restrictive licensing requirements.	None	None
FYR Macedonia 1/	15.2 (0, 60)	1% import processing fee (to be eliminated in January 2002)	import bands and quotas removed in 1996	None	A 0.1% import fee levied for export promotion.
Romania	19.5 (0, 248)	Tariff quotas on a limited number of goods	No significant non-tariff barriers	None	Eliminated in 2001
FR Yugoslavia 2/	9.4 (0, 30)	1% Customs inspection duty. A seasonal tariff of up to 20 percent is applied to a number of agricultural goods. Montenegro and Kosovo apply their own external tariff schedules.	Import licences are required for about 200 tariff lines.	None	None

Source: IMF
1/ Data is for 1998
2/ Data is for 2000

Table 8. South East Europe: Trade agreements

	WTO membership	Regional bilateral free trade agreements	Regional trade agreements	Relations with the European Union
Albania	September 2000		Signed regional Memorandum of Understanding on Trade Liberalisation	Autonomous Trade preferences (1999) 1/, Duty free access to EU Markets(2000). Negotiating an EU Stability and Association Agreement
Bosnia and Herzegovina	Applied for membership in May 1999	Croatia, Macedonia	Signed regional Memorandum of Understanding on Trade Liberalisation	Autonomous trade preferences (1996). Included in the EU Stability and Association process.
Bulgaria	December 1996	Macedonia, Romania	CEFTA, bilateral agreement with EFTA, Signed regional Memorandum of Understanding on Trade Liberalisation	Accession Country
Croatia	November 2000	Bosnia, Macedonia, Slovenia	Signed regional Memorandum of Understanding on Trade Liberalisation. Bilateral agreement with EFTA 2/	Duty free access to EU markets. Preliminary agreement on a Stability and Association Agreement. Final agreement due to be signed in Autumn 2000
FYR Macedonia	Applied for membership in December 1994	Bulgaria, Bosnia, Croatia, FRY	Signed regional Memorandum of Understanding on Trade Liberalisation. Bilateral agreement with EFTA.	Signed a Stability and Association agreement, which has been in effect since June 2001
Romania	January 1995	Bulgaria	CEFTA, bilateral agreement with EFTA, Signed regional Memorandum of Understanding on Trade Liberalisation	Accession Country
FR Yugoslavia	Applied for membership in January 2001	Macedonia	Signed regional Memorandum of Understanding on Trade Liberalisation	Preferential trade agreement (Dec 2000). Included in the EU stability and association process

Source: IMF Trade policy Division, PDR; European Commission

1/ Replaced the Trade and Co-operation Agreement signed in 1992

2/ Agreement with EFTA will take effect on January 1, 2002

Table 9. South East Europe: International Taxes

	1997	1998	1999	2000	Direct revenue loss from SEE trade liberalisation 1/
	(in percent of GDP)				
Albania	6.5	7.6	7.2	8.7	0.5
Bosnia and Herzegovina 2/	5.7	5.5	5.9	6.3	1.3
Bulgaria	2.1	2.1	1.1	0.9	0.0
Croatia	3.7	3.1	3.1	2.5	0.1
FYR Macedonia	3.0	3.5	4.0	3.3	0.6
Romania	1.3	1.6	1.5	1.1	0.0
FR Yugoslavia 3/	2.7	2.3	2.3	2.4	0.4

Source: IMF

1/ Estimated share of international taxes paid on imports from SEE countries

2/ Includes revenues received by entities.

3/ Federal government only