CHAPTER 1

POSTWAR RECONSTRUCTION AND DEVELOPMENT IN SOUTH-EAST EUROPE

1.1 Introduction

International politics and relations in the first half of 1999 have been dominated by the Kosovo crisis. The failure to reach a political settlement at Rambouillet in March resulted in a large-scale military operation by the NATO alliance, which involved prolonged and intensive air strikes against a large number of targets in the territory of the Federal Republic of Yugoslavia. The direct impact of the bombing – and of military operations within Kosovo – on the economy of the Federal Republic of Yugoslavia has been devastating: entire sectors of economic activity have been virtually destroyed and the country's transport and communication infrastructure has been severely damaged. In addition, the conflict has had serious and wide-ranging economic implications for other countries in Europe and especially for those which are close neighbours of Yugoslavia.

The focus of this chapter is on the impact of the Kosovo conflict on the seven transition economies in south-eastern Europe which have been the most heavily affected and which, at the same time, are the poorest and most vulnerable economies in Europe. This is not to imply that the negative impact of the conflict is confined to this region: needless to say, it has had much broader and wider implications. Other neighbouring transition economies have also claimed serious war-related economic damage.[1] In addition, the loss of the Danube as a major international transport route has a pan-European negative economic impact as it is causing costly interruptions in shipments for all countries along its flow.[2]

Among the immediate costs of the conflict has been the tragic outflow of hundreds of thousands of refugees from Kosovo to neighbouring countries and territories. Apart from being an humanitarian catastrophe, this exodus has had grave economic consequences and will impose a heavy burden on both the countries in the region and the international community for quite some time to come, even after the political aspects of the refugee problem have been resolved.

One broader effect of the crisis has been to focus – for the first time – wide public attention on the economic situation in the whole of south-eastern Europe, a region that has long been neglected in the mainstream discussions on international economic policy.[3] When considering the effects of the conflict on south-eastern Europe, it is essential to stress that they are falling on countries where the process of economic and political transformation during the past decade has proved to be much harder than in central Europe and, as a result, they have fallen further behind the rest of Europe rather than embarking on a process of "catching up".

The economic impact of the Kosovo conflict on the fragile economies of south-east Europe is equivalent to a strong negative external shock which is aggravating further their economic situation. It is important to stress that the fallout from the conflict carries considerable risks not only for the economic and political stability of the region but also for Europe as a whole. Thus the problems of the postwar economic development of south-east Europe and the eventual reintegration of its component countries into the European economy is an issue of pan-European importance.

Recognizing the serious economic implications of the Kosovo conflict, various international bodies (notably the European Union and the World Bank) have

[1] For example, the Slovenian authorities claim that the losses to the tourism industry might be as high as 30 per cent of the total tourism-related revenue (that is, more than $300 million), statement by Janko Razgorsek, Minister for Tourism and Small Business, *Reuters*, 23 April 1999. According to estimates by Ecostat (a research branch of the Hungarian Central Statistical Office), the war-related damage to the Hungarian economy during the first 50 days of the Kosovo conflict amounted to $200 million, *Interfax News Agency*, "Daily Financial Report", 22 May 1999. Other countries such as the Republic of Moldova, Ukraine, Turkey, Greece, and Italy have also suffered heavy economic losses. In the latter two, losses have mainly been in the tourism industry.

[2] Countries like Austria, Germany, Hungary and Ukraine have also reported serious losses related to the halt of navigation.

[3] In this chapter, the subregion of south-east European transition economies (sometimes referred to as "south-east Europe" for short) is defined to include the following countries: Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Romania, The former Yugoslav Republic of Macedonia and Yugoslavia. This working definition coincides with the sub-aggregate SETE-7 in the tables regularly published in successive issues of this *Survey*.

made proposals for a much more extensive and generous assistance to the countries in the region than was available in the past and for speeding up their integration into the larger European economy. However, not only the economic consequences of the conflict but also the miserable state of most of the south-east European transition economies before it started add a daunting dimension to the postwar tasks of reconstruction and recovery. It should be stated clearly that if the proclaimed task of bringing this region closer to Europe within a reasonable time span is to be taken seriously by the international community, then the costs of the effort, not only to repair the immediate effects of the conflict but also to set the region on a sustained path of economic growth, are going to be very high even by the standards of the industrialized world. Most of the estimates being quoted in the international press, some for example reaching some $5 billion a year for six years, would appear to fall considerably short of what is likely to be reached. Hence, an unprecedented commitment will be needed to raise the necessary financial and technical resources for a long-term "assistance-for-development" effort for these countries.

In addition, the successful implementation of a concerted regional effort by the international community will require, firstly, a carefully thought out long-term regional programme for economic rehabilitation and growth, and secondly, adequate institutional arrangements and an appropriate managerial infrastructure to implement such a programme. Implementation is also likely to require much closer cooperation among the south-east European economies themselves, including economic coordination and the undertaking of joint activities when needed. A small number of regional institutions do exist but economic integration among the south-east European economies at present is de facto virtually non-existent and the coordination of joint economic activity has proven to be very difficult. Hence the postwar reconstruction and recovery effort will probably have to include the creation and institutionalization of new forms of regional economic cooperation and integration.

1.2 Pre-war conditions and the burden of the past

(i) A decade of economic decline

The deep economic problems that the transition economies in south-eastern Europe have been facing since the start of their economic and political transformation in the early 1990s are complex and interrelated.[4] The increasing number of transformation failures in the region provides strong evidence of the prime importance of a number of factors for the overall success of the transformation process which – although not entirely neglected – were generally given inadequate attention in much of the academic and policy debates in the early phases of transition. Among these factors – which have seriously impaired the process of economic transformation – are the obvious locational disadvantages of the region (in terms of its distance from the important west European markets), the highly unfavourable starting conditions (in terms of inherited economic distortions), and the lack of historic traditions in institutional development (which has contributed to a persistent institutional hiatus in these countries).

The regional economy had already been destabilized before the conflict by the breakup of the former SFR of Yugoslavia, and the ensuing conflicts in Croatia and Bosnia and Herzegovina, and more recently by the escalation of the Kosovo crisis. The negative side effects of United Nations sanctions on Yugoslavia were particularly detrimental for some of the countries in the region (Albania, Bulgaria, Romania and The former Yugoslav Republic of Macedonia, for example) and in effect amounted to a strong external shock that added to an already severe transformational recession. Military conflicts, political unrest and general instability in the region have been a strong deterrent to foreign direct investment (FDI); south-eastern Europe never became an attractive destination for FDI, unlike the not-so-distant central European transition economies. Regional trading links, never very strong, have been broken during a decade of military conflicts and economic sanctions, and there are now many barriers to their restoration, a factor which adds to the discentives for significant FDI in the region.

Historically the south-eastern part of Europe has always been among the least developed regions in Europe. Located on the periphery of the continent, it has remained largely underdeveloped. The process of industrialization that took place in over four decades of communist rule was not soundly based; investment decisions reflected the arbitrary preferences of central planners rather than comparative advantage and expected market returns. Once these countries were exposed to competitive pressures from world markets, a large share of the existing capital stock was rendered economically non-viable as it had little or no value under market conditions.

In general, the transition economies in this region were also lagging behind in the process of integration

[4] The UN/ECE secretariat recognized the specific economic problems of the south-eastern European countries and their need for greater international assistance at a very early stage (UN/ECE, *Economic Bulletin for Europe*, Vol. 43 (1991), pp. 7-10). Over the years the UN/ECE secretariat has devoted a special effort to analysing these problems and assessing their policy implications: see, for example, the analysis of the transition crises in Bulgaria (UN/ECE, *Economic Survey of Europe in 1996-1997*, pp. 75-84) and in Romania (UN/ECE, *Economic Survey of Europe, 1999 No. 1*, pp. 70-81).

into the larger European economy. Only two countries (Bulgaria and Romania) have managed to establish association agreements with the EU; the rest, for various reasons, have been left out of the process of establishing closer relations with the most important and powerful economic grouping in Europe.

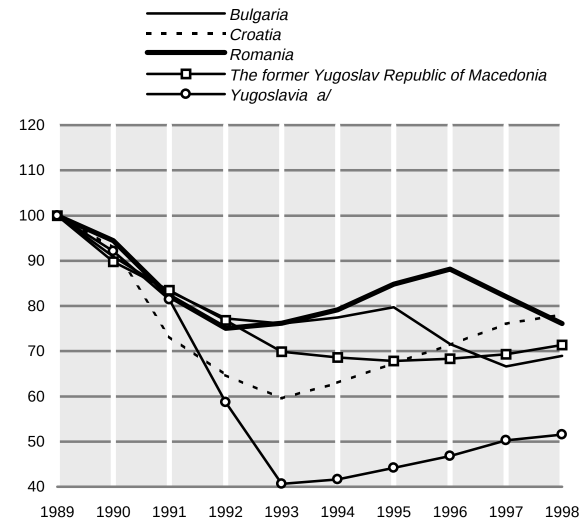
In fact, the decade of the 1990s in south-east Europe has been one of economic regress. With the possible exception of Croatia, none of the economies in the region have managed to emerge from the transition depression and to embark on a path of sustained growth. The contrast between the transition economies of south-east Europe and those in central Europe during the 1990s is especially striking (charts 1.2.1 and 1.2.2). The transformational recession in the central European economies lasted for some three to four years and after 1993 they began to recover (the Czech recession of 1998 can be regarded as belonging to a new cycle). The depth of the total output decline in these countries varied, but at the lowest point was roughly between 75 and 85 per cent of the pre-transition (1989) level. By 1998, GDP in most of these countries had more or less regained its 1989 level, while in Poland it had already surpassed it in 1996 (chart 1.2.2). In contrast, the cumulative decline of GDP in the south-east European economies was much greater and in 1998 it was still generally below 80 per cent of the 1989 level.[5] These countries have followed different patterns of growth during the second half of the 1990s but, apart from Croatia, sustained recovery has failed to materialize.

The differences in terms of employment levels (table 1.2.1) are no less striking. For the south-east European region as a whole, total employment in 1998 was one quarter below its level in 1989, a considerably larger decline than in the central European transition economies[6] where employment fell by roughly one sixth during this period. Thus, parallel to the plunge in economic activity, a great number of people in south-east Europe were forced out of employment and subsequently out of the labour force altogether. Although the data are not always available or reliable, unemployment rates are very high and there has been significant migration, much of it illegal, to the more prosperous parts of Europe. The combination of widespread poverty and limited prospects for employment in many parts of the region has led to increases in many manifestations of social stress, including crime.

CHART 1.2.1

GDP in selected south-east European transition economies, 1989-1998

(Indices, 1989=100)



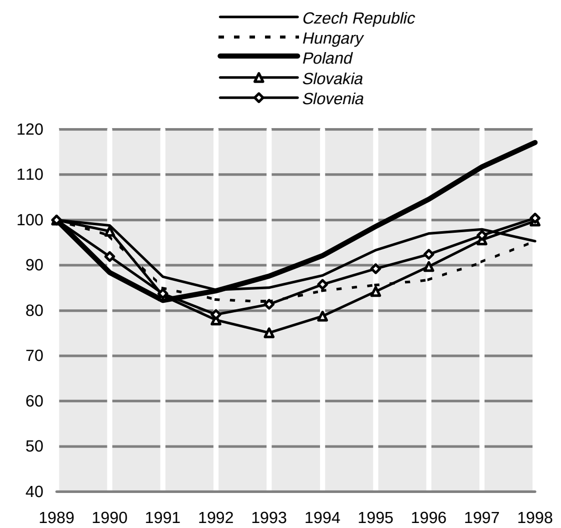
Source: UN/ECE secretariat, based on national statistics.

a Gross material product.

CHART 1.2.2

GDP in selected central European transition economies, 1989-1998

(Indices, 1989=100)



Source: UN/ECE secretariat, based on national statistics.

As a result of these developments, the income disparities vis-à-vis the rest of Europe have not only failed to narrow in the 1990s but have increased substantially. In terms of income levels, south-eastern Europe has always been lagging behind the rest of Europe, but during the 1990s the countries of the region

[5] Due to the lack or scarcity of reliable data, it is difficult to assess precisely the changes in aggregate output in Albania and Bosnia and Herzegovina during this period.

[6] The Czech Republic, Hungary, Poland, Slovakia and Slovenia. These countries constitute the aggregate CETE-5 in the tables regularly published in this *Survey*.

TABLE 1.2.1

Employment and unemployment in the south-east European transition economies, 1996-1998
(Percentage change)

	1996	*1997*	*1998*	*1998* [a]
Total employment *(percentage change over preceding year)*				
Albania	-2.0	-0.7	-0.4	-23.4
Bosnia and Herzegovina	123.0	52.7	5.9	-37.2 [b]
Bulgaria	0.1	-3.9	-1.6	-26.7
Croatia	–	-0.7	-2.0 [c]	-26.6
Romania [d]	-1.2	1.0	-1.9	-22.8
The former Yugoslav Republic of Macedonia	-4.4	-5.4	-3.5 [c]	-35.2
Yugoslavia	-0.5	-1.5	-1.7 [c]	-18.1
Memorandum items:				
CETE-5	1.2	1.4	–	13.7
SETE-7	-0.2	0.2	-1.8	25.8
Unemployment *(per cent of labour force)*				
Albania	12.3	14.9	17.6	..
Bosnia and Herzegovina	..	39*	38*	..
Bulgaria	12.5	13.7	12.2	..
Croatia	15.9	17.6	18.6	..
Romania	6.6	8.8	10.3	..
The former Yugoslav Republic of Macedonia [e]	39.8	42*	..	..
Yugoslavia [e]	26.1	25.6	27.2	..
Memorandum items:				
CETE-5	11.2	9.8	10.2	..
SETE-7	12.5	14.3	15.4	..

Source: UN/ECE secretariat estimates, based on national statistics.

[a] Cumulative change over 1989.

[b] 1998 over 1991, the last year of normal economic activity before the 1992-1995 war.

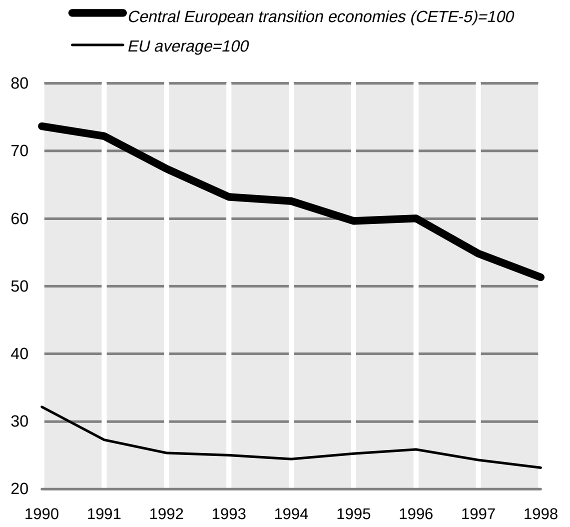
[c] Three quarters only.

[d] End of year data based on labour force balance up to 1997; from 1997, annual average figures based on labour force survey data. Consequently, the regional aggregates which include Romania are not fully comparable before and after 1997.

[e] The data for employment cover only the social sector in agriculture; unemployment rates therefore are biased upwards.

CHART 1.2.3

Average per capita GDP at PPPs [a] in the south-east European transition economies relative to central Europe and the EU average, 1990-1998
(Per cent)



Source: 1996 European Comparison Programme; UN/ECE secretariat estimates.

[a] Purchasing power parities (PPPs).

became still poorer both in relative and in absolute terms. In fact, the gap in per capita income relative to both the EU and the central European transition economies has increased considerably (chart 1.2.3). Indeed, the latter has widened so much during the past decade that at present the difference in average GDP per head (on a purchasing power parity (PPP) basis) between south-eastern and central Europe is comparable to that between the central European transition economies and the EU average. In other words, the south-east European economies have as much to do to catch up with the current central European average income level, as the central European transition economies have to do in order to catch up with the EU average. The time required for such a catching-up to occur is somewhat alarming: unless the current trends in economic performance are decisively broken, it will take decades, even on the more optimistic scenarios, for these poorest European countries to reach only the mediocre level of per capita income currently enjoyed by the more advanced central European transition economies.

The actual experience of reforms and economic transformation in south-eastern Europe has been highly problematic. Over the past decade none of the transition economies in the region has been able to embark on a path of sustained economic growth. Many of them still face basic problems of macroeconomic stabilization; and financial and currency crises have been all too common in recent years. These persistent failures have raised considerable doubts about the wisdom of the actual transformation paradigm that has been pursued in these countries during the last decade. The policy approach – heavily influenced by the "Washington Consensus" – presumed that sustainable macroeconomic stabilization could be easily and rapidly achieved through rapid liberalization and monetary austerity; it was supposed (at least implicitly) that this would then pave the way for high and sustained rates of economic growth, supported strongly by inflows of private capital from abroad. This paradigm embodied strong reliance on the automatic operation of the market mechanism in restructuring the economy, an assumption incorporated – at least implicitly – in the design of the transition programmes.

This model of transformation, however, has not proved to be very successful in south-eastern Europe. The reasons are much too complex to be spelled out here, but basically they are related to the factors outlined above: the locational disadvantage of the region, highly unfavourable starting conditions, and the lack of strong traditions in institutional development. In some cases, the rapid liberalization and opening of the economies turned out to be premature and detrimental as they were totally unprepared to cope with the external shocks. The scale and speed of the latter greatly exceeded the possible rate at which internal economic restructuring and the re-allocation of capital and labour could be achieved in these economies, and this resulted in a too rapid rate of destruction of productive assets and much higher levels of unemployment than were necessary.

It should be stressed that Yugoslavia occupies a special position in the south-eastern region of Europe. Being one of the relatively large economies and strategically located on some of the main transport routes to western Europe, it is both an important market for neighbouring countries and an important transit country. However the Yugoslav economy has been in a parlous state for a long time. Following the second oil shock in 1979 the economy was virtually stagnant for most of the 1980s; it then suffered from the breakup of the former SFR of Yugoslavia, leading to the loss of markets, economies of scale, etc., and then from four years of conflict and international sanctions. After the Dayton Accord of November 1995, little progress was made in restructuring the economy and pushing forward the process of transition to a market economy.

During the period 1989-1993 (when the breakup of the former SFR of Yugoslavia took place) GDP in the Federal Republic of Yugoslavia plunged by almost 60 per cent (chart 1.2.1). With the public finances in a chaotic state, in 1992-1993 there was a period of hyperinflation of a magnitude that was unprecedented in world history. Although a period of modest recovery followed thereafter, the cumulative output decline in Yugoslavia was probably the largest among all the central and eastern European transition economies (with the possible exception of Bosnia and Herzegovina, for which no reliable data are available). During the second half of the 1990s the rate of inflation, although remaining high, has fallen, but the Yugoslav economy has continued to be marred by persistent and severe macroeconomic imbalances.

The process of economic and political transformation that was underway, at varying rates and with varying degrees of success, in most of the other transition economies never got started in Yugoslavia. The persistence of military conflict and external economic sanctions were used by the authorities to justify the maintenance of a strong administrative grip over the economy which became even tighter during periods of open conflict. In addition, after the disintegration of the former SFR of Yugoslavia, the Federal Republic of Yugoslavia never regained membership in the IMF as a successor state due to unresolved issues related to the division of the assets and liabilities of the former SFR of Yugoslavia vis-à-vis the Fund. This exclusion, in itself, would have been sufficient to curb its access to international finance (which for most of the time was blocked by sanctions anyway). Thus the long periods of conflict and external sanctions have led to a vicious circle of reform stalemate and deteriorating economic performance. Over the past decade, this has perpetuated a very specific economic regime in Yugoslavia, largely based on the unreformed, "self-governed" firms (which, however, remained closely controlled by the authorities through the political nomination of management) and unreformed state institutions which function in a manner somewhat similar to those in an economy on a war-footing. Thus, despite mimicking some reforms (such as partial privatization), Yugoslavia has basically remained a non-starter in the process of economic and political transformation.

(ii) South-east Europe on the eve of the Kosovo conflict

(a) Economic growth

As noted above, economic growth in the south-east European transition economies has been persistently lagging behind that in the transition economies of central Europe. This was especially pronounced in the years immediately preceding the Kosovo conflict: while in 1997-1998 robust economic growth generally prevailed in central Europe, aggregate GDP in the seven south-east European economies (SETE-7) declined substantially in both years (table 2.3.1). Despite differences among individual countries (Croatia being a notable exception, with strong growth in 1996-1997), economic activity was generally weak in most of them, with some falling into severe recession.

Overall economic performance in south-east Europe was made even worse in 1998 due to the highly unfavourable external conditions. A number of factors, such as the escalation of global financial turmoil, the Russian crisis, falling global demand and the collapse of world prices for basic commodities and intermediate goods (important export items for all of the south-east European countries – see table 1.2.2), caused a significant weakening of economic activity in the region and actual economic growth in all the countries (with the possible exception of Bulgaria) was less than forecast (see table 2.3.1).

TABLE 1.2.2

Exports of selected south-east European transition economies by commodity and major partner groups, 1997

(Per cent of total exports to corresponding partner group)

	Total	*Food, beverages and agricultural products (0+1+4)*	*Raw materials except fuels (2)*	*Fuels (3)*	*Chemical products and intermediates (5+6)*	*Machinery and transport equipment (7)*	*Other manufactured goods (8+9)*
Albania							
World	100.0	11.1	21.9	1.7	12.8	5.7	46.8
Western Europe	100.0	10.8	20.1	1.1	13.7	1.6	52.7
CEFTA-5	100.0	11.4	67.3	–	16.0	–	5.2
South-east European transition economies	100.0	15.4	17.1	9.9	3.4	53.6	0.6
Other countries	100.0	7.4	57.9	–	8.7	14.3	11.7
Bosnia and Herzegovina:							
World	100.0	3.0	12.5	4.6	53.4	12.7	13.8
Bulgaria:							
World	100.0	13.3	5.5	7.6	46.6	11.1	16.0
Western Europe	100.0	8.0	7.8	4.2	47.7	9.0	23.3
CEFTA-5	100.0	10.6	8.8	8.2	55.6	11.6	5.2
South-east European transition economies	100.0	15.6	6.2	4.3	40.3	28.7	5.0
Other countries	100.0	18.5	2.8	10.8	44.5	12.3	11.1
Croatia							
World	100.0	12.0	7.4	9.8	26.7	17.3	26.7
Western Europe	100.0	3.9	10.8	4.3	26.0	10.5	44.4
CEFTA-5	100.0	32.6	1.1	20.2	25.7	11.7	8.7
South-east European transition economies	100.0	17.3	8.9	23.6	31.8	12.5	5.9
Other countries	100.0	9.7	1.4	1.4	25.0	55.8	6.7
Romania							
World	100.0	6.8	4.7	6.1	33.4	14.0	35.1
Western Europe	100.0	3.1	1.8	1.6	27.3	12.0	54.2
CEFTA-5	100.0	12.0	7.1	3.3	34.8	28.5	14.3
South-east European transition economies	100.0	8.5	9.8	17.2	43.0	17.5	4.0
Other countries	100.0	12.2	8.8	13.2	43.0	15.5	7.3
Yugoslavia:							
World	100.0	16.1	5.5	2.0	57.5	8.7	10.2
Western Europe	100.0	13.8	6.8	0.9	62.4	4.2	11.8
CEFTA-5	100.0	20.5	2.7	3.6	53.7	13.1	6.4
South-east European transition economies	100.0	16.1	4.5	4.0	64.4	5.3	5.7
Other countries	100.0	12.5	9.3	0.2	53.9	12.0	12.0

Source: National statistics and United Nations COMTRADE Database.

Note: Commodity groups are Sections of the United Nations Standard International Trade Classification (SITC Rev. 3). Western Europe includes the EU (15) and EFTA countries. CEFTA-5 includes Czech Republic, Hungary, Poland, Slovakia and Slovenia; south-east European transition economies cover Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Romania, The former Yugoslav Republic of Macedonia and Yugoslavia.

In Romania two years of deep recession almost wiped out the output growth of the four preceding years. The Romanian economy is plagued by structural weaknesses and macroeconomic imbalances (most notably, an ill-structured foreign debt with heavy debt service pending in 1999-2000). Inconsistent stop-go policies and the lack of a coherent reform effort have not produced the urgently needed macroeconomic adjustment; instead, they have exacerbated the crisis, leading to a severe economic downturn coupled with dangerous macroeconomic destabilization. After the introduction of the currency board in 1997, Bulgaria made considerable progress in price stabilization, breaking the previous trend. However the economy seems to have been exhausted by several years of macroeconomic and financial turmoil coupled with progressive decapitalization due to very low rates of fixed investment. Due to its very low growth potential, the Bulgarian economy is fragile and highly vulnerable to external shocks; indeed the manufacturing sector was badly hit by the Russian and global crises in 1998. After several years of stagnation, there was a modest economic recovery in The former Yugoslav Republic of Macedonia in 1998. However, as in Bulgaria, it is drained of resources and lacks the internal driving forces of economic growth; being landlocked and strongly dependent on trade, the economy is especially vulnerable to external disturbances. Both Bosnia and Herzegovina and Albania are heavily dependent on the inflow of foreign resources (official aid in the case of Bosnia and Herzegovina and private transfers in the case of Albania). These are probably the two poorest countries in Europe and, in addition to economic backwardness, they have been devastated in recent years by war (Bosnia and Herzegovina) or political chaos (Albania). At present neither of these economies has sufficient vitality to sustain economic recovery on its own.

Despite its own problems, Croatia is probably the healthiest of all the south-east European transition economies. Indeed, recovery in Croatia continued for five consecutive years between 1993 and 1998 (chart 1.2.1); and its per capita income is the highest among the south-east European transition economies.[7] The most acute problem of the Croatian economy has been the persistent current account deficit, which in 1997 was the largest of all the east European and Baltic countries (table 2.3.2). The general tightening of monetary and fiscal policy in 1998, in response to this problem, was successful in reducing the current account deficit to less dangerous proportions. However, it also led to a substantial dampening of economic growth which was much greater than expected (table 2.3.1).

Before the start of the Kosovo conflict the Yugoslav economy was already on the verge of collapse. In the absence of a consistent reform programme and due to the continuing external sanctions, Yugoslavia developed a persistent twin deficit problem. Due to its isolation from international financial markets, the economy was facing a choice between two equally unpleasant alternatives: to cover the fiscal gap by monetary emission and thus unleash another round of inflation – or hyperinflation – or to absorb the acute balance of payments constraints through a deep output recession. Arguably, this economic policy dilemma may have been a factor in the escalation of the Kosovo conflict as a means of diverting domestic public attention from the difficult economic policy choices to be made.

(b) Inflation

Rapid and sustained rates of economic growth, by facilitating large gains in productivity and making restructuring less painful, is a fundamental requirement for maintaining low rates of inflation.[8] However, sequencing disinflation and growth, in that order, rather than pursuing them simultaneously, has not been a successful strategy in most of the south-east European economies, nor indeed, in most of the CIS countries. In 1998, the rapid achievement of low inflation rates at a high cost in terms of lost output has again been a major and general feature of these economies. The deliberate or de facto tightening of monetary policy led to large increases in real interest rates and a contraction of commercial credit which, in turn, reinforced the economic downturn and the depressed state of economic activity.

Among the seven south-east European countries in 1998 (table 2.3.5), inflation accelerated only in Yugoslavia and, albeit at a much lower rate, in Croatia.[9] In general disinflation continued in the other countries, and more rapidly than expected *ex ante*, essentially because of depressed demand and falling import prices. However, the former being undesirable and the latter unsustainable, the prospects for further declines in the inflation rate in these countries remain uncertain.

In Croatia the acceleration in the rate of inflation was mainly due to the one-off effect of the introduction of VAT (at a 22 per cent flat rate) in January 1998 when consumer prices rose by 2.4 per cent.[10] After January the average monthly rate fell to less than 0.3 per cent for the rest of the year despite the slow but continuous depreciation of the kuna, mainly because domestic demand was suppressed by tight monetary and fiscal policies.

In Yugoslavia, however, where all attempts to achieve price stability in recent years have proved to be unsustainable, the sharp acceleration in the inflation rate in 1998 – with the year-end rate reaching some 46 per cent, or more than 35 percentage points higher than in 1997 – reflected the devaluation of the dinar (by 45 per cent at the end of March and again in May), the lagged effect of monetary expansion in the second half of 1997 and, particularly in the last quarter, an increase in the rate of monetary emission to finance a rapidly growing budget deficit and to alleviate a growing stock of wage and pension arrears. Furthermore, the government introduced a new sales tax in October to raise revenue to support the increase in military expenditure. These factors, in addition to increased cost pressures during the second half of the year from the renewed downward pressure on the dinar and significantly weaker industrial production, prepared the ground for another period of soaring inflation, in spite of tighter price controls.

In Romania, the inflation rate in 1998 continued the downward trend which had started in the second quarter of 1997, but the deceleration has been slow and was achieved largely through depressed consumer demand, in turn a result of shrinking real incomes. The actual year-end rate of inflation (just under 41 per cent) was below the target agreed with the IMF (45 per cent).

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[7] In 1998 per capita GDP in Croatia, measured at current PPPs, was some 40 per cent higher than for south-east Europe taken as a whole. UN/ECE secretariat calculations based on the results of the 1996 European Comparison Programme (ECP).

[8] For a detailed discussion on the role of growth in disinflation see UN/ECE, *Economic Survey of Europe, 1999 No. 1*, pp. 111-125.

[9] Croatia and Yugoslavia were the only economies among all the 15 east European and Baltic countries where the annual rate of inflation in 1998 was higher than in 1997.

[10] In Croatia, industrial producer prices actually fell, by just over 2 per cent, during the 12 months to December 1998.

The policy of high real interest rates pursued by the central bank in order to control inflation (the leu appreciated strongly in real terms),[11] has not only continued to choke production, but has also increased the cost of borrowing to an already heavily-indebted industry, which is under intense pressure to restructure and increase efficiency.[12] However while high interest rates probably had some dampening effect on prices (which had also been raised by tax and tariff increases designed to limit the growing fiscal deficit) they also had a negative impact on output and unit labour costs.

In Bulgaria, after the severe financial crisis in 1996 and a period of hyperinflation in the closing months of that year and early 1997, a currency board was introduced in mid-1997 and the lev was pegged to the deutsche mark. Inflation started to fall rapidly and the monthly rate fell from 243 per cent in February to less than 1 per cent in the last quarter of 1997. During 1998, prices rose by only 0.9 per cent for the year as a whole (equivalent to less than 0.1 per cent per month), the lowest rate among all the east European and Baltic countries and well below the government's year-end target of 16 per cent (equivalent to a monthly rate of 1.2 per cent). However, this impressive improvement in price stability has been achieved at the cost of a severe depression in aggregate demand: there was only a slight recovery of GDP in 1998 after the collapse of output in 1997 and industrial production continued to fall sharply.

Exchange rate policies and weak demand have also been crucial factors behind the rate of disinflation in 1998 in Albania, Bosnia and Herzegovina and, to a lesser extent, in The former Yugoslav Republic of Macedonia, where there was also a sizeable recovery in measured industrial productivity, mostly due to output growth rather than falling employment, as has been the case in recent years. In the second and third quarters, consumer prices in The former Yugoslav Republic of Macedonia actually fell, largely reflecting the waning influence of the July 1997 devaluation of the dinar and a significant increase in wage arrears which further depressed consumer demand.

In short, with the main exception of Yugoslavia, there was notable progress towards price stabilization in the south-east European countries in 1998, but this was largely achieved at the expense of a deterioration – or, at least no improvement – in the other dimensions of macroeconomic performance.

(c) Labour markets

As noted above, the severe transformation problems that the seven south-east European transition economies have been facing since the early 1990s have resulted in a growing gap between them and the transition economies of central Europe, in terms not only of economic growth but also in labour market performance. Between 1989 and 1998, employment fell on average by more than one quarter in these economies, nearly twice the rate of decline in central Europe (table 1.2.1). In addition to high rates of *registered* unemployment in the south-east European economies there are also many who have lost their jobs but who have not registered as unemployed and are not actively seeking work since the incentives to do so are often weak. Not only are unemployment benefits small or non-existent but the low probability of finding a job encourages people to leave the labour market altogether. This growing number of the "discouraged unemployed" leads to the erosion of work skills, increases poverty and threatens support for the reform process. Frictional unemployment is also increasing rapidly not only due to the restructuring which is an unavoidable part of the transition to an open market economy, but also because the mobility of labour is hampered by the scarcity of housing and the rudimentary state of many public services and of much of the infrastructure which are continuing to deteriorate under the pressure of tight fiscal policies. Given the stance of macroeconomic policies, which in general are giving overwhelming priority to price stabilization, the labour markets in south-east Europe are caught in a vicious circle which has to be broken if the reform process is to remain on track.

As a result of the large decline in employment, *unemployment* in these countries has increased sharply, reaching levels that must inevitably raise questions about the prospects for social stability. By the end of 1998, the average rate of unemployment in the seven south-east European countries was 15.4 per cent compared with 10.2 per cent in the five central European countries. The numbers unemployed as a proportion of the active population exceeded one quarter in Yugoslavia and one third in Bosnia and Herzegovina and The former Yugoslav Republic of Macedonia.[13] At the end of 1998, only Bulgaria and Romania had relatively modest rates of unemployment (i.e. similar to the central European average) but these

[11] The appreciation of the exchange rate was especially pronounced in the first half of 1998 when the leu increased in real terms (CPI deflated) by 29.5 per cent against the dollar and by 34.5 per cent against the deutsche mark. For 1998 as a whole the rates of real appreciation were 23.2 per cent and 25 per cent, respectively.

[12] For an extended discussion of the difficult economic situation in Romania see UN/ECE, *Economic Survey of Europe, 1999 No. 1*, pp. 70-81.

[13] In The former Yugoslav Republic of Macedonia, the most recent official data on unemployment refer to December 1997; since then the statistics office has stopped publishing the figures. Some semi-official estimates suggest that by the end of August 1998, the rate of registered unemployment stood at 44 per cent. However, a large number of those registered as unemployed work in the black economy or are engaged in agriculture so that the true unemployment rate may be around 35 per cent. A labour force survey conducted in April 1998 put the rate at 34.5 per cent.

are more a reflection of delayed restructuring and stop-go policies, designed to avoid or reduce social tension, rather than of an improvement in underlying economic performance. Thus, the very small increase in the unemployment rate in Bulgaria after the 1996 crisis[14] suggests that most of the restructuring remains to be done, but this will be particularly difficult to undertake without a strong recovery in aggregate demand and output. Sustaining the recent achievement of near price stability in Bulgaria may therefore prove to be costly in terms of overall macroeconomic performance and social cohesion.

Employment in the south-east European countries as a whole, which had stagnated in 1996 and 1997, fell by nearly 2 per cent in 1998 (table 1.2.1), reflecting in the main the continued weakness of industrial production. It increased only in Bosnia and Herzegovina, albeit at a much slower rate than in 1997 and, again, thanks mainly to the postwar reconstruction activity. On the other hand, the rate of decline in employment accelerated in Croatia, where economic activity slowed considerably in response to restrictive macroeconomic policies. In Romania, after some gains in 1997, employment was falling again in 1998 as a result of the deep economic recession that started in 1997 and of massive layoffs particularly in the mining sector. In the other countries of the region, employment continued to fall but at slower or similar rates to those in 1997. The highest rate of decline in employment in 1998 was in The former Yugoslav Republic of Macedonia (3.5 per cent), bringing the total reduction in the number of people employed to more than 35 per cent since 1989. Considering that the countries in south-east Europe are still in the early phases of economic transformation, particularly in terms of microeconomic restructuring, the labour market situation can be expected to worsen and the difference between them and the more advanced reformers in central Europe to become even wider.

(d) Trade

Since 1995, the growth of south-east European exports and imports has varied considerably from year to year and from country to country reflecting, *inter alia*, the lagged effects of the economic disturbances created by military campaigns and by United Nations-imposed sanctions against Yugoslavia in 1992-1995, and by the recessionary conditions that are prevailing in the region. The uneven trade performance in the past few years, however, also reflects the limited capacity of these economies to respond to market developments. Once initial reserves of exportable goods had been exhausted in response to trade liberalization, they have faced increasing difficulties in establishing and developing new, competitive export sectors and acquiring the necessary flexibility to redirect their exports from one market to another. The need for such flexibility was strongly underlined in 1998 when global import demand weakened considerably and, especially, when the demand for imports in the important CIS market collapsed in early autumn.

The difficulties of south-east European countries in switching exports to alternative markets stem not only from the weakening of global demand and increased competitive pressures on western markets, but also from the structure of their exports (table 1.2.2). In general it is the internationally less competitive agricultural products and manufactured goods, including machinery and equipment, that are traded within the region and with the CIS while exports to western markets consist mainly of intermediate products and some consumer goods produced under outward processing arrangements.

In the first three months of 1999, prior to the Kosovo conflict, foreign trade was already falling throughout south-east Europe:[15] preliminary figures for four countries for the first quarter of 1999 show their exports falling in aggregate by some 14 per cent and imports by some 11 per cent (as compared with the same period of 1998). These changes resulted not only from the persistence of external demand constraints – there was no recovery in the CIS, import demand in both eastern and western Europe weakened, and world market prices for major intermediate goods continued to decline – but also from disruptions to domestic production and increasing tension within the region arising from the escalation of the Kosovo crisis in Yugoslavia.

The worst affected country was Bulgaria: the dollar value of its exports slumped by nearly one fourth and its imports by 11 per cent, compared with the same period of 1998 (table 2.3.7). Exports to the CIS region were down $102 million (or more than 60 per cent), those to the five CEFTA countries by nearly a half, while trade with the other south-east European countries fell by some 35-40 per cent. The loss of exports to western markets was less severe, 7-8 per cent, mainly because of markedly increased exports to Belgium, France, Switzerland and the United States. There were similar market trends in Croatia and Romania, where

[14] In Bulgaria, the registered unemployment rate increased from 12.5 per cent at the end of 1996 to 13.7 per cent at the end of 1997 and then fell back to 12.2 per cent in December 1998. In Poland, for example, after seven years of high growth rates, the registered unemployment rate in December 1998 was still only 1.8 percentage points lower than in Bulgaria.

[15] At the moment of writing this *Survey*, estimates for total exports and imports in January-March 1999 were available for only four of the seven countries in the region: Bosnia and Herzegovina, Bulgaria, Croatia and Romania (see table 2.3.7); full year 1998 data were available for all of them but the geographical and commodity breakdown was still missing in some cases.

total exports declined by 11 and 9 per cent, respectively, but those to the CIS markets sank by 50-60 per cent and to eastern Europe by 15-20 per cent.

The commodities most heavily affected by these falls in exports were food, beverages and tobacco: down by 40 per cent in Bulgaria, for instance, in January-March 1999 over the same period of 1998. Exports of electrical machinery, vehicles and spare parts, generally traded with other transition economies, were nearly halved while export earnings from raw materials and intermediate goods declined by one third mainly because of falling commodity prices.

According to the latest full-year data for 1998, the aggregate trade deficit of south-eastern Europe increased to nearly $13 billion (tables 2.3.2 and 2.3.7). However, in two of the relatively large economies – Bulgaria and Romania – there was a particularly marked deterioration in their trade deficits (by some $700 million in both cases) as compared with 1997. In the other countries of the region trade balances either improved or remained broadly unchanged although export performance was on a downward trend. In Croatia, exports to the CIS stagnated in 1998 but those to eastern Europe fell by 7 per cent.[16] Only The former Yugoslav Republic of Macedonia and Yugoslavia seem to have been unaffected by the CIS market collapse: according to the latest available data the value of Yugoslavia's exports to Russia increased by some 40 per cent in 1998 and those of The former Yugoslav Republic of Macedonia by more than 20 per cent.[17] The apparent strong growth in the exports and imports of Albania and Bosnia and Herzegovina[18] is partly a statistical artefact – a combination of low values to begin with and better monitoring by the customs authorities which has led to better coverage in the more recent data.

(e) External financial positions

The problems of slow reform, lagging economic performance, inherited debt, periodic difficulties in obtaining foreign assistance and a generally poor investment climate have meant that the south-east European countries have not developed the financial strength required to achieve sustained economic growth. At the beginning of 1999 their financial positions were generally precarious. Some were either facing financing gaps or were already heavily dependent on official finance. The conflict in Yugoslavia has increased the balance of payments pressures on these countries and further reduced their access to the international capital markets. In consequence, financing gaps have increased and so has the need for additional assistance.

While the south-east European countries, as noted above, have experienced significant losses in their merchandise trade, their earnings from international services have also been disrupted. On average, these earnings are relatively more important than in the central European transition economies (table 2.3.4). Tourism has been an important source of foreign currency income in Albania, Bulgaria and Croatia, while Romania has been trying to develop its great potential in this sector. Receipts from transport services and transit fees are relatively important in Bulgaria, Croatia, Romania and Yugoslavia. On the expenditure side, the share of payments for transport in the total is significantly above the central European average in Albania, Bulgaria, Romania and The former Yugoslav Republic of Macedonia (table 1.2.3).

Although financial positions in south-east Europe vary considerably from country to country, there are a number of common features (table 1.2.4). Inflows of foreign direct investment have been generally much smaller than those to central Europe and the Baltic states and the development of local securities markets has been slow, thereby holding down the potential for importing portfolio capital**.** None of the countries has achieved sustained export growth, thus making debt servicing difficult. Foreign currency reserves have generally been low, although in Albania and Bulgaria they have increased sharply since 1997. Other indicators show a greater diversity among these countries. Bosnia and Herzegovina, Bulgaria and, probably, Yugoslavia are severely indebted countries, while the other countries are classified as low-to-moderately indebted.[19] Nonetheless, some countries in this latter group have already faced debt servicing problems in 1999 and the number could increase if current account earnings continue to weaken. Only Croatia has an investment grade rating from the major agencies, while Bulgaria and Romania are rated as speculative risks.[20] Although conditions in the international capital markets have generally eased since the beginning of the year, the conflict in Yugoslavia has made investors more cautious about most of the countries in south-east Europe. In consequence, market access has become more difficult and a number of bond

[16] Overall, Croatia's exports rose by 9 per cent in 1998 but this was entirely due to the shipbuilding sector: several oil tankers were launched and delivered in the second half of 1998 to Liberian and Russian shipping companies. *Reuters Business Briefing*, 8 and 17 October 1998.

[17] There was probably a slowdown in the exports of The former Yugoslav Republic of Macedonia to Russia in the fourth quarter of 1998, since exports grew by 32 per cent in the first three quarters. IMF, *Direction of Trade Statistics Quarterly* (Washington, D.C.), March 1999.

[18] Here and throughout the text, as well as in all the tables, the reported foreign trade figures for Bosnia and Herzegovina do not include the trade of Republika Srpska.

[19] These categories of indebtedness are those employed by the World Bank.

[20] The (subinvestment grade) credit ratings of Romania were reduced during 1998.

TABLE 1.2.3

Structure of current account flows in the south-east European economies, 1998
(Billion dollars, per cent)

	Receipts						Expenditures				
	Total[a] (billion dollars)	Per cent of total					Total[a] (billion dollars)	Per cent of total			
		Goods	Total services	of which: Transport	of which: Travel	Net transfers		Goods	Total services	of which: Transport	of which: Travel
Albania	0.8	23.8	9.4	1.3	5.7	66.7	0.9	83.3	16.7	7.6	0.3
Bosnia and Herzegovina[b]	1.8	32.2	24.1	..	..	43.6	2.6	85.0	15.0	..	..
Bulgaria	5.8	74.3	21.7	7.8	7.6	4.0	5.7	80.6	19.4	9.1	3.9
Croatia	9.3	49.7	42.7	6.1	29.4	7.6	10.7	82.3	17.7	3.2	5.6
Romania	10.1	82.0	11.9	5.0	2.6	6.1	12.6	86.4	13.6	5.0	3.6
The former Yugoslav Republic of Macedonia	1.8	75.4	7.5	3.5	0.8	17.1	2.0	85.0	15.0	7.1	1.5
Yugoslavia[b]	3.3	72.0	24.9	9.5	1.2	3.2	5.2	93.0	7.0	2.3	0.4
CETE-5	121.2	80.0	16.8	3.6	6.9	3.2	136.2	87.0	13.0	1.8	3.6
SETE-7[c]	31.0	67.9	24.0	6.1	11.4	8.1	37.1	85.1	14.9	4.9	3.6
Eastern Europe[c]	152.2	77.6	18.3	4.1	7.8	4.2	173.3	86.6	13.4	2.4	3.6

Source: UN/ECE secretariat, based on national balance of payments statistics.

a Excluding investment income flows.

b 1997. Includes official transfers for Bosnia and Herzegovina.

c Excluding Bosnia and Herzegovina.

issues have had to be postponed.[21] Under more normal conditions, such moderately indebted countries (as well as Bulgaria) would have been able to refinance their debt. Concern about stability in the region is also likely to reduce the already modest inflows of FDI although a number of countries were counting on them to finance a significant part of their current account deficits in 1999.

Bosnia and Herzegovina has been heavily dependent on foreign assistance since the cessation of hostilities in 1995. Various official current transfers ($558 million and $422 million in 1996 and 1997, respectively)[22] have helped to finance a large current account deficit which, excluding official transfers, was over one third of GDP. Capital transfers to finance reconstruction have been running at around $700-$800 million annually, and multilateral and bilateral credits have also been important. These resources have been provided under a $5.1 billion programme to support economic reform and reconstruction.[23] Although the programme has helped to generate average GDP growth of around 40 per cent,[24] albeit from a very low base, there is concern that there are still few signs that economic activity can be sustained without such assistance. So far there has been little foreign investment. However, a privatization programme was due to move ahead in 1999 including the sale of parts of the banking sector. Due to the economic recovery that has taken place, the financial ratios have improved rapidly and thus have to be used with care (the country was still rated as severely indebted in 1998).[25] In 1997 over half of the country's external debt was in the form of arrears to official and commercial creditors, the accumulation of which allowed the build-up of foreign exchange reserves to the equivalent of about three and a half months of imports in 1997.

The estimated financing requirement of over $2 billion faced by Croatia in 1999 has been partially filled by a €300 million issue, and negotiations on a new $200 million IMF standby facility are underway. The large current account deficit fell in the first quarter of 1999, but nonetheless it appears that additional private market financing and FDI (from planned privatizations) will be required. Steeply falling exports in the first few months of the year, contracting output, and a further reduction

[21] So far, the only bond issues from south-east Europe in 1999 have been the €300 million by Croatia (February) and the €50 million of the City of Sofia in March, at a costly 700 basis points over the German bund.

[22] The largest current transfers have been made by United Nations agencies and various donors of goods and services.

[23] A total of $4.2 billion was pledged for 1996-1998, and a further $1.05 billion was committed in May 1999 at the Fifth Donor's Conference, jointly chaired by the EC and the World Bank. According to World Bank estimates, the country will need an additional $2.6 billion of external funding during 2000-2004. World Bank, *Bosnia and Herzegovina, 1996-1998 Lessons and Accomplishments – Review of the Priority Reconstruction Program and Looking Ahead Towards Sustainable Economic Development* (Washington, D.C.), May 1999.

[24] Exports were also recovering rapidly until they foundered in early 1999.

[25] In 1995 the ratio of debt to GDP was 156, but by 1998 it had fallen substantially due to the recovery of output and despite steady increases in gross debt.

TABLE 1.2.4

Selected external financial indicators for the south-east European economies, 1998
(Billion and million dollars, per cent)

	Current account/ GDP (per cent)	Gross debt (billion dollars)	Gross debt/ exports (per cent)[a]	Gross debt/GDP (per cent)	Net FDI/ current account[b] (per cent)	Cumulative FDI inflow/ per capita[c] (dollars)	Official reserves (million dollars)	Reserves in months of imports[a]	Credit ratings Moody's/ S&P[d]
Albania	-6.4	0.8	213	26	19	120	349	4.5	–
Bosnia and Herzegovina	-38.5*[e]	4.8	624	117	..	..	859	3.3	–
Bulgaria	-2.1	10.1	173	82	159	162	2 831	5.4	B2/B
Croatia	-7.3	8.5	95	40	49	469	2 816	3.0	Baa3/BBB-
Romania	-7.9	9.6	99	25	68	199	1 663	1.5	B3/B-
The former Yugoslav Republic of Macedonia[f]	-8.2	1.2	83	34	41	89	306	1.8	–
Yugoslavia[g]	-4.6*	15.1	638	58	..	..	200	0.5	–
CETE-5	-4.1	110.7	90	37	77	681	54 876	4.5	..
SETE-7[h]	-6.8	30.1	115	38	63	236	7 965	2.8	..
Eastern Europe[h]	-4.6	140.8	94	37	73	503	62 840	4.2	..

Source: National statistics; IMF, *International Financial Statistics* (Washington, D.C.), June 1999; IMF estimates for the gross debt of Albania, Bosnia and Herzegovina and the Russian Federation; World Bank for the gross debt of Yugoslavia; press reports; UN/ECE secretariat estimates.

[a] Exports of merchandise and services and income receipts. Total imports of merchandise and services and income payments. For Poland, excludes net receipts from non-classified current account items.

[b] FDI flows are net.

[c] Cumulated since 1989.

[d] International credit ratings by Moody's and Standard & Poor's. Croatia's ratings are investment grade.

[e] Excluding official transfers.

[f] Gross debt includes only medium- and long-term debt.

[g] The estimate of the current account balance has been adjusted to exclude imports for outward processing (see text). Gross debt and exports of goods and services are for 1997.

[h] Excluding Bosnia and Herzegovina and Yugoslavia.

of foreign exchange reserves are causes for concern.[26] The authorities have maintained that Croatia should not experience significant costs as a result of the Kosovo conflict, although the impact on tourist revenues could be significant.

The 1998 improvement in the chronically difficult financial position of The former Yugoslav Republic of Macedonia appears to have been reversed in early 1999. Exports, which had been stagnant until the shift towards the west European markets in 1998, have faltered and various long-term loans and trade credits appear to have dried up, causing reserves and imports to drop and the current account to contract. The country has run sizeable current account deficits which have been financed largely by guaranteed trade credits and loans, and, early in the decade, by arrears. Plans for a credit rating and bond issue were scrapped in the wake of the global financial crisis. FDI has been minimal although there was some improvement in 1998.

Financial indicators for the Yugoslav economy before the Kosovo conflict already suggested a moderate or severely indebted country with virtually no financial reserves (table 1.2.4).[27] The sources of financing of its persistent current deficit[28] are uncertain, but they are believed to include private bank accounts held offshore as well as foreign exchange reserves secreted abroad to escape sanctions.[29] FDI flows have been limited[30] and the international capital markets have

[26] Some $800 million was reported to have been spent in defence of the kuna in early 1999. M. Skreb, Governor of the Central Bank of Croatia, *Wall Street Journal Europe*, 16 April 1999.

[27] Data for 1997 yield a very high gross debt/export ratio but the gross debt/GDP ratio suggests moderate indebtedness. However, both indicators are bound to have worsened considerably in 1999. The level of foreign exchange reserves at the end of 1998, however, is uncertain. They are reported to have fallen to around DM 800 million ($470 million) in September 1998, but this may include some gold and currency held abroad by commercial banks.

[28] According to the central bank, the current account deficit in 1997 was $1.8 billion. It reflects the value of imports of goods used for finishing and processing ($520 million), but exports include only the value added from this activity. Removing this item from imports lowers the current account deficit to $1.3 billion (and also helps to reduce the figure for unexplained financial inflows). *Trziste Novac Kapital* (Belgrade), July-September 1998.

[29] The former SFR of Yugoslavia reported reserves of around $5 billion, but a substantial share is believed to have been transferred abroad prior to the imposition of economic sanctions.

[30] There seems to have been little recent foreign investment aside from the sale of 49 per cent of the state telephone company to Telecom Italia and OTE (Greece) for $950 million. The prime motive for the sale was believed to be the need to raise cash quickly.

remained inaccessible to Yugoslav borrowers. Prior to the conflict in Kosovo, negotiations were underway for readmission to the Bretton Woods organizations.[31]

Although Bulgaria's reserve position is strong, exports have been stagnant or declining for several years, and recently the current account balance has deteriorated rapidly. This has been due in large measure to external factors but it is also possible that the currency is overvalued.[32] The external debt burden is very high and debt servicing obligations have been met thanks to official loans. In 1999, privatizations and a bond issue are being counted on to boost the inflow of private capital, but the prospects for both plans are now very uncertain in the wake of the Kosovo conflict.

Romania took a step towards filling the large financing gap projected for 1999 by concluding a preliminary agreement with the IMF on a new credit in May.[33] A bond repayment falling due in May was met (apparently by drawing down the country's already low reserves), but another is due in June.[34] However, the country will still require fresh capital market financing and the authorities maintain they can attract $1.4 billion of FDI if the privatization programme is successful. Although the present level of foreign debt is modest, both merchandise exports and GDP have been falling for some years thus raising questions about the development of future debt servicing capacity.

Albania's financial condition has recovered substantially after the disruptions caused by the collapse of the pyramid schemes in 1997. In 1998, exports boomed, economic growth resumed and official reserves have been rebuilt to a relatively high level. However, the current account has been in deficit throughout the 1990s, even with sizeable inflows of workers' remittances. The country has relied heavily on official flows of finance, chiefly transfers (especially at the beginning of the decade) but also multilateral and bilateral loans. There seems to have been virtually no private loans. FDI has been a modest source of financing, but it is unclear how much of the stock of foreign investments survived the events of 1997.

1.3 Impact of the war

The economic implications of the Kosovo conflict are so numerous and diversified that it is difficult to provide an exhaustive list. The most urgent tasks in the immediate future are related to the consequences of the outflow of hundreds of thousands of refugees from Kosovo. Apart from the humanitarian side of the problem – the international action to organize the return of the refugees to their homes and to support the costs of caring for them in the meantime – the displacement of such a large number of people has caused considerable strains on the economies of Albania and The former Yugoslav Republic of Macedonia, the two main host countries. As noted above, the economies of these countries are fragile and susceptible to disturbance, and the influx of refugees alone has been a major economic shock for them. There is clearly an urgent need for extraordinary special assistance to these two countries on the part of the international community. However, although official donors pledged considerable amounts of financial support, there has been a regrettable lack of synchronization between actual disbursements and the rapidly mounting costs borne by the host countries; the actual disbursement of financial assistance during the first two months of the conflict was negligible.

The most direct and visible economic consequence of the war is the damage to the Yugoslav economy caused by months of air strikes on numerous targets and by the hostilities within the territory of Kosovo. The destruction of assets has been considerable: the transport and communication infrastructure of the country has been wrecked, the electric power grid has been severely damaged, and entire industries have practically collapsed due to the heavy damage inflicted on them. As a result of the air strikes Yugoslavia lost an enormous amount of assets;[35] according to an independent group of Yugoslav economists, Group-17, the total economic damage caused by the war is estimated at around $30 billion.[36] In addition, the hostilities within Kosovo have caused enormous damage, particularly to individual property (houses, farms, etc.). Although there is bound to be a significant margin of error surrounding all such estimates until detailed surveys can be carried out, there is little reason to doubt that the destruction of the country's capital stock is very extensive.

[31] Unlike the other successor republics of the former SFR of Yugoslavia, Yugoslavia has failed to normalize its relations with the London and Paris Clubs.

[32] Bulgaria established a currency board in July 1997 which fixed the nominal exchange rate at first against the deutsche mark and subsequently against the euro.

[33] The previous agreement had been suspended. Romania is negotiating an increase in the new standby credit.

[34] The IMF has encouraged Romania to negotiate a restructuring of these bond repayments in order to conserve official reserves.

[35] Among the targets reportedly destroyed during this period were more than 200 factories, 190 schools, 50 hospitals, 50 bridges and 5 airports. Quoted by RosBusinessConsulting (http://www.rbc.ru/), 2 June 1999. According to other assessments, 1,134 buildings were destroyed in Belgrade alone. *Le Temps* (Geneva), 10 June 1999.

[36] Group-17, "Economic consequences of NATO bombing: estimates of damage and finances required for economic reconstruction of Yugoslavia", mimeo (Belgrade), June 1999.

However, the impact of the conflict is by no means restricted to the territory of Yugoslavia. Indeed, the Kosovo conflict has added a further dimension to the already unfavourable external environment for many transition economies, worsening further their short-term economic outlook. The conflict-related economic damage incurred is already quite substantial. Neighbouring countries (Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Hungary, Romania, The former Yugoslav Republic of Macedonia) have lost markets as well as traditional suppliers in Yugoslavia. The transport links to and from the south-eastern part of Europe have been severely impaired: navigation along the Danube has been paralyzed by the destroyed bridges and all traffic through Yugoslavia (ground, rail and air) has been brought to a halt. The negative effects are especially strong for international trade between western Europe, the main trading partner, and the countries locked in the Balkan region (in particular Bulgaria, Romania and The former Yugoslav Republic of Macedonia): as the available alternative routes are of limited capacity, this has resulted in the direct destruction of important trade flows. In addition, the loss of the Danube as a waterway has a pan-European negative impact as it is causing costly interruptions in shipments for all the riparian countries as well as some in the Black Sea region.[37] The conflict has undoubtedly increased investors' perception of risk in the whole area surrounding the immediate conflict zone and this will restrain access to international financial markets and raise borrowing costs for the affected countries, which in general are badly in need of fresh finance. As noted above, the inflow of FDI to this region − an important force for economic restructuring as well as balance of payments support − is also likely to be curbed. The fact is that the conflict has had – and is continuing to have – a significant negative economic impact on all the countries in south-east Europe, most of which were already in a precarious economic state.

Quantitative estimates of the costs of the damage to any individual country must necessarily be largely guesswork due to the lack of precise information as well as unresolved methodological difficulties.[38] However, it is useful to mention some of the transmission channels through which the conflict has affected the neighbouring countries.[39] The principal ones are: the cost of supporting refugees in the host countries, the loss of exports and imports as a result of the disruption of transport routes (which is likely to be the most important source of damage); increased costs/prices of exports and imports (and, indirectly, further losses due to the deterioration in competitiveness) as a result of having to use alternative and more costly transport routes; lower fiscal revenue due to foregone export revenue and lower imports (hence lower duty and other customs receipts); reduced income from tourism (both foreign exchange earnings and fiscal revenue); smaller inflows of FDI due to perceptions of increased risk by foreign investors; and higher borrowing costs on international financial markets. The combined effect of all these negative factors has already had a serious macroeconomic impact comprising a severe balance of payments shock, a loss of aggregate output, increased unemployment and a deterioration in the fiscal balance. Without assistance this impact will be more severe the longer the disruptive effects of the conflict last. In addition, the countries which have received most of the refugees, Albania and The former Yugoslav Republic of Macedonia, are still bearing considerable extra direct and indirect costs (costs related to the construction of refugee camps, the provision of logistic support and, partly, to the care of the refugees, as well as foregone income from the areas of land allocated for the camps).

The loss of the Yugoslav market in itself has been a serious blow for the economies of some of the neighbouring countries. Judging from the data on the pre-war geographical composition of trade (table 1.3.1), the direct effect from the loss of this market is likely to be greatest in the case of The former Yugoslav Republic of Macedonia which used to send more than 9 per cent of its total exports to Yugoslavia. The impact is also likely to be sizeable for Bosnia and Herzegovina, Bulgaria and Romania where the relative importance of Yugoslavia as an export market was also significant.[40] For most of the neighbouring countries however the disruption of the transport routes has probably been the most serious source of dislocation. For all these economies (with the exception of Bosnia and Herzegovina) the EU is the main trading partner (table 1.3.1) and the disturbance in the international transport system has resulted in sizeable losses.

[37] For example, Ukraine (which maintains a large Danube fleet) claims direct daily losses due to the blockage of the Danube amounting to $300 thousand. Statement by Ukrainian Foreign Minister Borys Tarasyuk, *RFE/RL*, "Weekday Magazine", 13 April 1999.

[38] One of the methodological approaches to the assessment of the "cost" of the Kosovo conflict suggested in some recent studies has been to treat the latter as an external shock that shifts the aggregate demand curve. Following this approach it has been estimated that the likely cost of the conflict on the neighbouring transition economies may range from 1 to 5 percentage points of their GDP growth rates in 1999. V. Gligorov and N. Sundström, "The costs of the Kosovo crisis", *WIIW Current Analyses and Country Profiles*, No. 12 (Vienna), April 1999.

[39] It should be noted that not all of the affected countries have actually prepared official estimates of the inflicted damage, while those that have apparently apply different methodologies. Hence the figures quoted below are mainly for illustrative purposes and cannot be used for direct cross-country comparisons; these figures do not provide any measure of the relative magnitude of the damage either.

[40] The reported trade data on Bosnia and Herzegovina in table 1.3.1 only partly include the trade of Republika Srpska; these data, therefore, do not reflect the full impact of the loss of the Yugoslav market for the Federation as a whole as Yugoslavia is the main trading partner of Republika Srpska.

TABLE 1.3.1

Trade of the south-east European transition economies: exports and imports by direction, 1997
(Million dollars, per cent)

	Albania	Bosnia and Herzegovina	Bulgaria	Croatia	Romania	The former Yugoslav Republic of Macedonia	Yugoslavia [a]
Exports to:							
World *(million dollars)*	141	193	4 914	4 171	8 431	1 075	2 376
Share in total exports *(per cent)*	100.0	100.0	100.0	100.0	100.0	100.0	100.0
North Europe	88.9	28.2	46.8	67.1	61.9	50.2	58.3
EU and EFTA	87.9	17.7	44.2	50.9	57.8	44.0	54.7
CEFTA-5 and BAFTA	1.0	10.5	2.6	16.1	4.1	6.2	3.6
South-east Europe	7.1	60.2	6.7	18.6	2.9	16.3	27.8
Albania	..	0.1	0.5	0.1	–	1.1	–
Bosnia and Herzegovina	–	..	0.1	15.6	0.1	0.1	15.8
Bulgaria	–	0.1	..	0.2	0.7	1.9	1.5
Croatia	4.2	57.0	0.3	..	0.2	3.6	–
Romania	–	–	1.3	0.4	..	0.4	1.9
The former Yugoslav Republic of Macedonia	2.6	1.8	2.0	1.9	0.1	..	8.6
Yugoslavia	0.3	1.2	2.5	0.5	1.7	9.3	..
CIS	–	1.7	17.4	4.7	6.2	11.4	6.5
Other countries	4.0	9.9	29.1	9.6	29.0	22.0	7.4
Memorandum items:							
Greece	20.3	-	8.3	0.4	2.1	1.7	4.5
Turkey	0.9	0.4	9.0	0.2	4.2	2.5	0.4
Imports from:							
World *(million dollars)*	620	1 555	4 886	9 104	11 280	1 808	4 801
Share in total imports *(per cent)*	100.0	100.0	100.0	100.0	100.0	100.0	100.0
North Europe	87.8	72.7	42.3	76.9	59.7	58.0	54.5
EU and EFTA	84.9	51.8	38.3	62.1	54.0	45.5	49.1
CEFTA-5 and BAFTA	2.9	21.0	4.1	14.8	5.7	12.4	5.4
South-east Europe	5.6	20.1	2.3	2.6	1.2	22.4	16.7
Albania	..	–	–	–	–	0.2	–
Bosnia and Herzegovina	–	..	–	1.5	0.1	0.1	5.6
Bulgaria	2.7	0.1	..	0.2	0.5	5.3	2.8
Croatia	0.4	19.0	0.2	..	0.1	4.7	–
Romania	0.3	0.1	1.2	0.3	..	0.7	2.3
The former Yugoslav Republic of Macedonia	2.1	0.7	0.1	0.5	–	..	6.0
Yugoslavia	0.1	0.1	0.8	0.1	0.5	11.5	..
CIS	0.5	0.4	32.8	5.5	14.9	6.9	10.1
Other countries	6.0	6.7	22.5	15.1	24.2	12.7	18.8
Memorandum items:							
Greece	26.6	0.1	4.2	0.2	1.7	2.1	3.7
Turkey	4.4	1.6	2.1	0.3	1.9	4.7	1.2

Source: National statistics; for The former Yugoslavia Republic of Macedonia, IMF, *Direction of Trade Statistics*, December 1998.

Note: CEFTA-5: Czech Republic, Hungary, Poland, Slovakia and Slovenia. BAFTA: Estonia, Latvia and Lithuania.

[a] Shares are based on revised data for January-September 1997.

As far as the losses in intraregional trade are concerned, the most affected countries appear to be Bosnia and Herzegovina, Croatia and The former Yugoslav Republic of Macedonia; for Bulgaria and Romania intraregional trade has been of limited importance (table 1.3.1). However, one way or another, the conflict in Yugoslavia has brought about a major disturbance in the foreign trade flows of all the neighbouring countries, a disturbance which follows closely on the CIS market collapse and the weakening of import demand over the past year in the west and east European markets. Its effects are likely to be long-lasting and, hence, the region's foreign trade is most likely to be in decline throughout 1999.

Since the start of the Kosovo conflict all the south-east European countries have reported large negative impacts on their foreign trade and payments including the direct loss of export revenue and the indirect effects of reduced imports of inputs, disrupted contracts, etc.

The actual losses in trade incurred by individual countries, however, are difficult to assess because of the lag in customs reporting and also because of the lack of precise and up-to-date information on trade flows by different modes of transport. For instance, Bulgaria's dependency on inland water transport (Danube river) and transit routes (railway and roads) via Yugoslavia is widely acknowledged and discussed; however, according to one source of transport statistics, nearly 70 per cent of internationally loaded goods (in tonnes) were carried by maritime transport in 1995, and of those shipped along the Danube 75 per cent went down the river to Ukraine.[41] Neither of these transport routes were directly affected by the conflict in Yugoslavia unless most of the ships were blocked in the Danube above Novi Sad. However, it has to be borne in mind that the geographical pattern of Bulgaria's exports has changed since 1995. The share of north European markets (see table 1.3.1), generally accessed via Yugoslavia and/or the Danube, increased by some 3-5 percentage points. In Romania, too, the bulk of internationally loaded goods used to be transported by maritime transport (40-45 per cent) with Danube shipments accounting for 6-7 per cent.

As noted already, a number of south-east European countries were facing large financing gaps even before the conflict in Yugoslavia.[42] In several cases shortfalls in privatization revenues and/or private capital financing have threatened to lead to the depletion of international reserves or even to default on debt repayments. It is against this background that the impact of the conflict on financing the balance of payments needs to be viewed. The IMF has estimated the incremental effects of the conflict on six south-east European countries in 1999 at some $1.1-$1.7 billion, of which $0.7-$0.9 billion represents a larger current account gap.[43] At the time of the publication's release in May, $591 million had been pledged by the international community. Of this $175 million was in grants and $70 million and $326 million in concessional and non-concessional loans, respectively.

Although, as mentioned above, the precise measurement of the conflict-related economic damage is necessarily uncertain at this stage, it is still useful to quote some of the estimates prepared by official government agencies in some of the other affected countries.[44] In the early phase of the conflict Bulgarian officials estimated the direct export losses due to the conflict at $1.0-$1.5 million a day.[45] Ten weeks after the start of the conflict the direct losses reported to the standing ad hoc government commission monitoring the war-related economic damage amounted to $73 million.[46] At the same time it was estimated that the total negative impact of the war on the current account might be as high as $70 million per month.[47] In addition, an earlier forecast of a $1 billion inflow of FDI in 1999 was reduced by one half in the wake of the Kosovo conflict; if this revised forecast proves correct it will obviously intensify the problems of filling the financing gap.[48] Government departments in Romania have estimated that it might lose some 15 per cent of its exports to Austria, Germany and Hungary (that is, more than 3 per cent of its total exports) as a result of the conflict.[49] According to other official estimates, the first two months of the Kosovo conflict resulted in total damage to the Romanian economy amounting to $803 million.[50]

Tourism throughout the region, but especially in Croatia where tourism is a key sector of the economy,[51] is likely to be badly affected in 1999. The estimates of the losses of the tourist industry in Croatia range from 10 to 50 per cent in terms of revenue.[52]

The spillover costs of the conflict are equivalent to another external shock for the affected countries, the strength of which depends on the degree of penetration of the shock waves through the different transmission channels mentioned above and, in general, on the distance from the conflict zone (naturally, the closest

[41] UN/ECE, *Annual Bulletin of Transport Statistics for Europe and North America*, 1997 (United Nations publication, Sales No. E/F/R.98.II.E.11), pp. 44, 104, 163 and 164.

[42] UN/ECE, *Economic Survey of Europe, 1999 No. 1*, pp. 178-179.

[43] IMF and the World Bank, "The economic consequences of the Kosovo crisis: an updated assessment", 25 May 1999 (IMF internet website). The estimates are for two scenarios, and exclude refugee costs. Including the latter the additional burden is some 1.8-3.0 per cent of the combined GDP of the six countries.

[44] The governments of some countries (such as Bulgaria) established special bodies with the task of monitoring and assessing the economic damage incurred as a result of the Kosovo conflict.

[45] Statement by Deputy Prime Minister Alexander Bozhkov, *Reuters*, 19 April 1999.

[46] *Pari Daily* (Sofia), 9 June 1999.

[47] Statement by Trade Minister Valentin Vassilev, *Reuters*, 27 April 1999.

[48] Statement by Deputy Prime Minister Alexander Bozhkov, *Reuters*, 19 April 1999.

[49] Statement by Romania's Ministry of Industry, *Reuters*, 20 April 1999.

[50] *Romanian Business Journal*, No. 20 (Bucharest), 21-27 May 1999. However, this estimate appears to contain some double counting since foregone imports and exports are added together.

[51] According to the national balance of payments statistics, in 1998 Croatia earned over $2.7 billion in foreign exchange from tourism (equivalent to 12.7 per cent of the country's GDP). UN/ECE secretariat computations.

[52] According to a statement by the Governor of the National Bank of Croatia, Marko Skreb, Croatia could expect a drop in tourism revenues by some 10-15 per cent in 1999. *Wall Street Journal Europe*, 16 April 1999. However, according to Tourism Minister Ivan Herak, the expected losses might reach as much as 50 per cent of the 1998 tourism revenues. *RFE/RL*, "Newsline", 27 April 1999.

neighbours are the worst affected). As all the south-east European transition economies were already in a precarious state before the conflict, due to their grave domestic problems, they are extremely vulnerable to any additional external disturbances. There is therefore a considerable risk that unless timely and comprehensive measures (supported by adequate resources) are taken by the international community to offset the negative impact of the Kosovo conflict, some of these economies will soon be facing a new round of severe economic crises. There is therefore an urgent need for coherent strategies to address not only the immediate consequences of the conflict but also the chronic structural weaknesses of the south-east European economies which leaves them in such a vulnerable state.

1.4 Postwar recovery strategies

The paramount economic issues arising from the consequences of the war are related first of all to the repair of the damage caused by military action and the reconstruction of the economies directly involved in the conflict; but, more fundamentally, the key task is to bring about the economic regeneration of the whole south-east European region in order to establish economic stability and economic growth and to lay the basis for future economic prosperity and so reduce the risks to security in the future.

The scale of the economic damage and the implications of the Kosovo conflict for the whole of south-eastern Europe (which will continue to have a negative impact long after the end of military operations) demand an urgent response by the international community. It is becoming increasingly evident (and this judgement seems to be shared by a growing number of experts) that a new approach, different from that pursued in the past, is needed to address these problems. It is important to emphasize that the issue is not simply a matter of providing assistance for rebuilding the assets and infrastructure destroyed in the course of the conflict or of trying to re-start economic transformation using the old paradigms. The key element of a new approach must be to find ways and means to revitalize and rehabilitate a large European region, encompassing several sovereign states; it must include a comprehensive programme of economic measures that would allow these countries to embark on a path of macroeconomic stability and sustained economic growth and to ensure its eventual reintegration into the wider European economy. Over the years, the UN/ECE secretariat has been advocating the adoption of alternative approaches and strategies of reform, especially as regards the region of south-eastern Europe, with much greater emphasis on the building and the development of institutions and market infrastructures, and, because such institution building is complex and takes time, it has persistently advocated a much higher level of external support for these economies. They need a much longer breathing space than is currently provided for by the main sources of international assistance.

In addressing the whole issue of postwar reconstruction and recovery in south-east Europe, careful consideration must be given to the role of Yugoslavia which occupies a special position in the south-eastern region of Europe. Being one of the relatively large economies and strategically located on the main routes to western Europe, it is both an important market for neighbouring countries and an important transit country. As such, it must be central to any plans for reviving the economies of the region. It needs to be stressed that if the Yugoslav economy remains in shatters, if the Danube is not cleared so that navigation can resume, if the bridges are not rebuilt and the roads and railroads repaired to enable normal merchandise traffic between south-east Europe and the rest of the continent to be re-established, it is inconceivable that any attempts to revive the economies of the neighbouring countries will bring about the expected results. Moreover, if the Yugoslav economy remains in dire straits for a long time, it will not only impede the economic recovery of the region but will remain a threat to the economic and political security of Europe as a whole. A core of instability in the heart of the Balkans will not only continue to deter private investment, domestic and foreign, in the south-east European region but also to generate political and social tensions throughout the continent. Hence, a comprehensive programme for reconstruction and recovery in south-eastern Europe must, almost by definition, include as a key element the rebuilding of Yugoslavia and the revitalization of its economy.

At the moment of writing this *Survey* the bombing of Yugoslavia had just come to an end and it was too early to assess with any pretence of accuracy the final extent of the war-related damage and its consequences for the future, but it seems safe to say that the economy is in ruins and will be in a disastrous state for a long time to come. Even the partial estimates quoted above indicate that Yugoslavia has lost a major share of its economic assets and in terms of economic development the country has been set back decades. Indeed the war appears to have relegated Yugoslavia to one of the poorest states in Europe. The task of rebuilding the damaged economic infrastructure alone is likely to run into tens of billions of dollars and will take years to complete. Clearly, this is not a task that Yugoslavia can accomplish on its own in the foreseeable future, even if it mobilizes all domestically available resources. Moreover, addressing such a task will require considerable amounts of official assistance to get the process started – even after a political settlement has been reached over Kosovo there is unlikely to be any significant inflow of foreign private capital to Yugoslavia in the short run.

In the postwar period Yugoslavia will be facing a myriad of complex economic problems. *First*, will be the rebuilding of the physical capital stock and the economic infrastructure. This will be a major task and will have to be sequenced over an appropriate time period, starting with emergency measures to restore basic services and then perhaps giving priority to the repair of the transport system, including clearance of the obstacles to traffic on the Danube. For the region as a whole, the reconstruction of the transport system is of primary importance for improving the economic situation.

Secondly, economic activity – and economic policy – have to be switched from military to peacetime objectives. This will also imply the need for a major reform in public finances, an area of economic policy that has been a persistent source of problems and an issue that Yugoslavia would have had to face anyway. *Thirdly*, and in parallel, the transition process will have to get underway, almost certainly with the transformation of the ownership and managerial structures into a private property-based market economy if foreign capital is to be attracted into the country. And *fourthly*, progress with reconstruction and reform will also depend on a reasonable degree of macroeconomic stability being maintained and, especially, on avoiding the risk of a severe inflation arising from the bottlenecks that will be inevitable in the short run.

The economic problems that lie ahead for Yugoslavia are daunting. In fact the population has yet to come to grips with the new economic realities and with the poverty that the outcome of the conflict implies for the foreseeable future. It is difficult to see how an agenda such as the one outlined above can be implemented effectively, and within a reasonable time so as to preserve social stability, without a major programme of long-term assistance from abroad.

The economic implications of the Kosovo conflict for the rest of the south-east European transition countries are not as grave as in the case of Yugoslavia but they still need to be addressed urgently in order to avoid a dangerous economic destabilization of the whole region and, more importantly, to create the foundations of future economic prosperity in this part of Europe. Indeed, the rebuilding of the destroyed infrastructure and the provision of short-term relief are by no means the only matters on which the peoples of the whole south-east European region deserve a response from the international community.

In fact, short-term assistance (or at least pledges of such) has not been missing since the outbreak of the Kosovo conflict. In April-May several rounds of extraordinary meetings of official donors took place bringing about pledges for supplementary donor support to Albania, Bosnia and Herzegovina, Bulgaria and The former Yugoslav Republic of Macedonia.[53] The International Monetary Fund and the World Bank published their own assessment (subsequently revised and updated) of the economic consequences of the Kosovo crisis, apparently preparing for additional contingency balance of payment support to the most affected countries.[54] However, even if this additional assistance helps the affected countries to get through the most difficult period in the short-term (which in itself is far from certain), this type of support does not even address the fundamental issue of reversing the unfavourable economic trends of the last decade and revitalizing the economies of the region.

This is not to say that these questions have been ignored in the public debates on the future of south-east Europe which have emerged since the outbreak of the Kosovo conflict; on the contrary, there have been intensive policy discussions and consultations, including at the highest political level. The EU together with the World Bank have taken the lead in this debate and have come up with several policy initiatives. The most important outcome has been the preparation of the so called "Stability Pact for South-Eastern Europe", the draft of which was discussed at a preparatory meeting of the foreign ministers of the EU member states and the south-eastern European countries in Petersberg, Germany on 27 May and which was adopted at a similar conference in Cologne on 10 June. This document outlines a broad framework for international cooperation with the south-east European countries but focusing mainly on the political dimension of the process. The economic dimension of the Stability Pact, however, is still to be spelled out substantively and only when that is done will it be possible to determine whether and to what extent this programme will respond to the needs and expectations of the peoples in south-east Europe.

During the policy debates on the future of south-east Europe reference has often been made to the Marshall Plan and indeed some of the policy suggestions have made direct reference to the need for a "new Marshall Plan for south-east Europe". Insofar as they recognize the need to support fundamental and time-consuming reforms and to promote economic regeneration across the entire region of south-eastern Europe, such suggestions are highly relevant and welcome. However it is worth mentioning that such

[53] Further official assistance to Romania was blocked by the lack of an operational agreement with the IMF. In May Romania finalized the preliminary negotiations for a new $475 million IMF standby credit, but at the moment of writing this *Survey*, this agreement was still awaiting approval by the Fund's board of directors.

[54] IMF and the World Bank, "The economic consequences of the Kosovo crisis: a preliminary assessment of external financing needs and the role of the Fund and the World Bank in the international response", 16 April 1999, and "The economic consequences of the Kosovo crisis: an updated assessment", 25 May 1999 (IMF internet website).

suggestions are often made as though the Marshall Plan was simply a synonym for providing large amounts of financial assistance to solve large problems, preferably on the generous terms provided to western Europe by the United States in 1948. Financial assistance *is* very important – and the reconstruction of Yugoslavia and the rehabilitation of south-east Europe in general will require large amounts of it; but the UN/ECE secretariat has long emphasized a number of features of the Marshall Plan which make a similar approach appropriate for the transition economies, and especially those of south-east Europe:

- The programme must be set in a realistic time frame, i.e. assistance must be maintained long enough to create a high probability of success – "Le succès de la plupart des choses dépend de l'appréciation exacte du temps qu'il faudra pour les réussir" (Montesquieu);
- Assistance should be provided in the framework of national programmes for recovery and reconstruction, containing targets for the main economic variables and for major institutional changes, together with an account of how each government proposes to achieve its objectives;
- These programmes should be drawn up by the relevant national policy makers and should take into account national sensibilities, values and history rather than be driven by a standard international model, "one policy fitting all"; it is, of course, understood that the broad objective is to create a market economy, of which there are many varieties, within a political framework of democratic institutions;
- A regional framework might be created to coordinate national actions and international assistance in areas where there are public goods, significant externalities, economies of scale, etc. Transport infrastructures, transboundary environmental issues and the diffusion of international norms and standards, for example, are areas where such coordination can be highly productive;
- The various national programmes could be peer-reviewed, preferably in the same regional framework, in order to provide national policy makers with a broader regional perspective. This could help to avoid inconsistent national decisions being made and encourage further cooperation among the participating countries, not least in clarifying their own preferences and priorities for the benefit of those providing assistance. Such a regional framework might also help to improve coordination between at least twenty-four potential donor countries and the plethora of international organizations involved in various, largely, bilateral, forms of assistance;
- The continued release of funds should be conditional on intermediate targets being met – the removal of such programmes from the traditional Bretton Woods framework does not imply a release from conditionality;
- Assistance needs to be delivered promptly at the start of the programme in order to create a momentum for change and create positive expectations for the recovery of output and fixed investment.

One prominent feature of the Marshall Plan, which is often overlooked at the present time when the term "assistance" is loosely used to cover everything from gifts to loans made at market (or even higher) rates of interest, is that it consisted for the most part of grants accompanied by a relatively small proportion of technical assistance. Most of the financial "assistance" provided to the transition economies since 1989 has consisted of loans, some at concessional but most at market rates of interest. This pattern appears to be continuing in the discussions of reconstruction in Kosovo: of the $591 million pledged by the international community to compensate for the incremental effects of the Kosovo crisis on six south-east European economies, over two thirds consists of loans (see above). It might be questioned, however, whether increasing the foreign debt of these countries is really the best way to provide them with assistance. Some of them – Bulgaria, Bosnia and Herzegovina, and Yugoslavia – are already regarded as "heavily indebted countries" and some of the others could fall into this category if their prospects for economic growth and exports continue to deteriorate sharply.

One of the underlying themes of this chapter is that the economies of south-east Europe are beset with chronic and deep-seated structural problems which will not disappear simply by repairing the damage caused by the Kosovo conflict. They are burdened with a large proportion of the capital stock which is economically non-viable but which requires very large amounts of investment to replace. At the same time, the institutional framework required to support large-scale structural adjustments, both economic and social, in a market economy environment are either missing or incomplete. Both sets of problems – economic restructuring and institution building – are complex and will require a longer time for their solution than is normally provided for in the standard prescription of rapid liberalization and stabilization. In this situation the danger is that debt servicing obligations will run ahead of sustained improvements in debt servicing capacity with the result that foreign direct investment will continue to hold back and there will be an increased probability that the transformation process will be checked by the tightening of macroeconomic policies designed to release resources for debt servicing.

A generous supply of grant aid, conditional on the recipient countries presenting coherent programmes for deep structural and institutional reform, can help the south-east European economies to escape from the threat of this stagnation trap – and the sooner this is perceived to be the case, the more rapidly will be the recovery in fixed investment, both domestic and foreign. There are also other arguments for significant amounts of grant aid rather than loans, particularly in the early stages of the transformation process. One of the major lessons of the Marshall Plan was the importance of prompt assistance at the very start of the recovery process. It is much easier to meet this requirement with grants than with loans which are subject to long and complex legal negotiations. If speedily delivered grants are successful in creating positive expectations and a forward momentum for change then they will provide a much better "return" to the donor countries than many of the loans provided to most of the transition economies since 1989.

The Marshall Plan as a model for a regional and cooperative programme has been stressed because this dimension is highly relevant to the condition of south-eastern Europe today. Regional cooperation is generally very weak in the Balkan and Danubian countries. This is not just a result of the violent breakup of the former SFR of Yugoslavia: it is of long standing and reflects the region's relative economic backwardness, the weak trade and other economic links among the countries of the region, and their political marginalization from the main currents of postwar integration in western Europe, a marginalization which if anything has increased in the 1990s. Although most countries in the region are seeking to strengthen their ties with the EU and NATO, increased regional cooperation could nevertheless prove essential for helping to boost the economic recovery of the countries in the region and to improve their general security not only from armed conflict but also from the risks of crime (especially drugs and arms trafficking), illegal immigration, transboundary environmental threats and so on. Cross-border cooperation in opening borders and improving regional transport infrastructures can, in a context of increasing confidence about economic recovery, help to significantly lower tension in the region and increase its attractiveness as a location for fixed investment.

Although regional cooperation is generally weak it is not entirely absent and it has recently been encouraged by initiatives such as the EU's Royaumont Process and the South-East European Cooperation Initiative (SECI). The latter[55] is a step forward in the process of building a framework for regional cooperation in which the UN/ECE has been actively involved.[56] It has already shown tangible results in harmonizing and simplifying procedures related to border crossing and has demonstrated the capacity and the will of the participating states to address collectively problems of common interest. The south-east European transition economies, however, need to be encouraged to undertake much bolder steps towards regional economic cooperation, liberalization and promotion of regional trade, and eventually for an increased regional economic integration which can support the way for their future integration into a larger and more united Europe. But in whatever form a regional framework develops it is important to stress once again that Yugoslavia is of central importance for any improvement in the regional economy; most of the region's problems are unlikely to be solved without its cooperation and it must therefore play a major role in any institutional arrangements.

One of the problems facing the implementation of a Marshall Plan type of development programme in south-east Europe is likely to be the low absorptive capacity of the recipient countries which may limit the efficiency and the speed of employing productively the inflow of resources. In fact, one of the key points of such a programme would be to target specific measures to create or expand the local absorptive capacity. The building and strengthening of the institutional environment is obviously one of the factors that not only enhances economic reforms but also increases the absorptive capacity of an economy. Hence the emphasis on institution building should occupy a central place in the rehabilitation programme. This in turn implies that if the programme is seriously

[55] Launched by the United States, it has now received the support of the EU and the Russian Federation, which makes it a potentially useful tool for developing a much bigger programme for the task of political and economic reconstruction and development in the region: this will require, as suggested above, large amounts of financial assistance, but also a major and long-term political commitment by the major donors to the region over many years.

[56] Although the details of national and regional programmes should be drawn up by the countries themselves, as emphasized above, some of the areas where the United Nations Economic Commission for Europe has been active in SECI and can deploy special expertise are almost certain to figure among the national and regional priorities. These include: water and health, air pollution abatement and soil decontamination, *environmental problems* where there is both a need for urgent action in the short term and for greater regional cooperation for longer-term solutions; *transport*, where the regional system suffers from both inadequate infrastructure and from insufficient regulations and associated institutions to ensure the safe, efficient and rapid movement of goods and people within and between countries; in the *energy* sector there are acute problems of basic supply and distribution which impinge heavily on the prospects for economic growth in the region and on the environment; the provision of a strong institutional framework for *human settlements*, including land administration, to support the clarification of property rights, urban renewal etc. In addition, the UN/ECE has programmes for *enterprise development*, for particular industries such as *forests and forest products,* and for specific public sector activities such as *statistics*. In all these areas there is a well-developed framework for intergovernmental cooperation, to which all the south-east European countries already belong, and which can be used to focus quickly on the urgent issues facing member countries.

committed to the rehabilitation of the south-east European economies, then it needs to be a joint, long-term cooperative effort by both the donors and the recipient countries. Thus it should set specific and concrete long-term targets and these targets should be backed by sufficient resources. Consequently the programme should contain a comprehensive financial component specifying how the necessary resources will be raised as well as the success criteria for their disbursement at each stage of the programme. In view of the extremely difficult situation in these countries, the importance of the availability of non-debt finance is again underlined.

The emphasis on the need for a long-term programme does not of course diminish the importance or the urgency of measures that must be carried out in the short and medium term. Rather, the longer-term perspective emphasizes the importance of sequencing and provides a context for the more urgent measures, many of which will have a long-term influence. Thus, an urgent task in Kosovo is the reconstruction of civil authority and, *inter alia*, the establishment of an effective authority for land administration to re-establish clarity in the property rights of thousands of refugees. Similarly, capacity building can also be helped in the short run by encouraging, for example, the creation or expansion of small enterprises to assist in the reconstruction of the housing stock in Kosovo[57] or by encouraging imports of food from neighbouring countries[58] to meet the domestic shortfall rather than meeting it from the surplus food stocks of the richer European countries. Through such initiatives effective demand can be injected into the local and regional economies and they are consistent with the objectives of promoting enterprise and the development of intraregional trade.

One conclusion that should also be clear, however, both from the experience of the Marshall Plan and from the transition process in south-east Europe since 1989, is that there are no easy answers and no short cuts. The experience of Bosnia and Herzegovina since the Dayton Accord is also a reminder that although the military parts of a settlement can be agreed fairly quickly, economic reconstruction, even when funds are provided, can be an extremely slow process if the various parties are unwilling to cooperate. Nevertheless, in other circumstances, generous assistance can improve the chances of greater cooperation simply by increasing the opportunity cost of non-cooperation.

A final lesson to be drawn from the Marshall Plan is for the potential donor countries of western Europe. Essentially the Marshall Plan represented a realistic and far-sighted appraisal of what was required to ensure long-term economic and political stability in western Europe – and, as it turned out, the intelligent pursuit of self-interest proved to be compatible with generosity towards the less fortunate and more vulnerable. West European leaders will need to demonstrate a similar degree of farsightedness and commitment now that the bombs have stopped falling in Serbia and Kosovo. If they do not, economic backwardness and stagnation in south-eastern Europe will simply preserve an environment in which threats to the security of Europe as a whole will continue to recur.

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[57] For example, small-scale, labour-intensive sawmills can be set up quite quickly and cheaply. Since there will be little or no harvest in Kosovo in 1999 these could help to absorb some rural unemployment or underemployment.

[58] As noted above, exports of foodstuffs from countries such as Bulgaria have been especially hard hit by the effects of the conflict.