THE BALKANS IN 2010: ECONOMIC SCENARIOS

Krassen Stanchev, Ph.D.
Institute for Market Economics, Sofia

I. Introduction and Objectives

1. This report is based upon the following: IME's own research into different aspects of Balkan economies, especially those in transition, conducted over the last four years; study of recent literature on these economies and relevant background political and economic developments; a survey of available concepts of postwar political order in South-eastern Europe; and interviews with economists from all Balkan countries. Questionnaires were especially designed for the purposes of this report. The methodology is described below, and a sample questionnaire is attached.

2. The immediate objective is to outline economic development scenarios for the Balkans for the period from 1999 to 2010. The task covers a span of eleven years, the starting point of which is still evolving; ways out of the crisis are difficult to foresee, and there is no possibility to quantify and weight political factors on which future developments will depend. Naturally, there is virtually no comprehensive data on how the war in Yugoslavia[1] is affecting its neighbor countries, so there is no basis for economic simulation and extrapolation. It is not a forecast but rather a future study, an undertaking which in today's circumstances is rather like science fiction. Respectively, the approach will be institutional or even constitutional, rather than quantitative. We believe these scenarios must have a more profound mission, namely:

- to initiate long-term thinking on the future of the Balkans, to reinforce attempts at such thinking currently taking place, and to sustain a debate on different development paths;
- to assess the probability of different scenarios, and describe factors that support one development or another;
- to provoke indigenous ideas on how to overcome past and current divisions and disparities; and
- to advocate approaches and policies that would prevent worst-case developments, help avoid the previous shortcomings of actions already taken, and support longer-term security and prosperity scenarios.

3. Six weeks after the NATO air-strikes on Yugoslavia started, Balkan governments claim great losses and deep impact on the political stability of Albania and Macedonia, but most of this should be taken with a grain of salt. International institutions – notably the IMF and the World Bank, DG II of the European Commission, the EBRD, the UN Economic Commission for Europe - judging from press reports, had promptly fixed their respective mechanisms for immediate remedies, and decided upon their own approaches to the Balkans. The Paris Club of official lenders is likely to reschedule Albania's and Macedonia's debt payments. There is intensive work being done by national governments, the media, public policy institutes and opinion leaders to assess current developments and propose solutions for postwar development. Profound deliberation is underway. It is likely that this time the international response to the conflict will not be victim to so many delays and inconsistencies as was the case in 1992-1995. The impression, however, is that lessons from the previous Balkan wars have not been learned, at least not to the desired extent, either by national or international agencies and opinion leaders. A key weakness of the postwar conceptions currently being debated is the lack of ideas for the integration of the Federal Republic of Yugoslavia (or what would left of today's federation). In working on scenarios, IME tried its best to take into account ideas and assessment suggested by others.

II. Methodology

[1] This report uses the phrase "the war in Yugoslavia" (or "the war") to indicate what international institutions refer to as "the Kosovo crisis."

4. In 1990-1995 the transition economies of Central and Eastern Europe were essentially economies of disequilibrium and uncertainty. Delays in political and economic reforms and the uneven progress of such reforms in many countries (notably Albania, Bulgaria, FR Yugoslavia, Romania and perhaps Croatia), as well as the war in Bosnia and Herzegovina, prolonged this painful period. In assessing long-term prospects for such economies, one should put more weight on political risk factors. In other words, from among the sets of typical country risk factors, those related to government policies and the external (geopolitical) environment are expected to play a decisive role and therefore deserve prime attention.

The war in Yugoslavia has shifted the accent from domestic onto international political risk factors. We assume that these factors fall into five categories, of which those related to international risk must be given priority:

a) international risk indicators: probabilities of war, external shocks, blocked trade routes, market protectionism, etc.

b) domestic political risk indicators: continuousness of reform and government commitment to reform, stability of the economic environment, entry and exit barriers, transaction costs, property rights and contract enforcement, etc.;

c) internal indicators: structure of investment, GDP per capita, inflation, etc.;

d) external indicators: current account as percent of GDP, import/export fluctuations; structure of exports, terms of trade, etc.;

e) debt indicators: debt/GDP ratio, debt service ratios, debt structure, secondary (country's) sovereign debt market, etc.

Good policies

5. The new situation also means that in the postwar order the "international governments" would have a decisive role to play. As the war in Bosnia demonstrated,[2] international institutions may have policies with long-term negative impacts. An assessment of long-term economic development scenarios for the Balkans must be based on a definition of what is "good" and what is "bad" and international government policy.

More concretely, a long-run successful economic transition policy should, at a minimum, include establishment of the following:

- a stable and convertible currency and stable financial and capital market institutions;
- rule of law, irrevocable private property rights and an entrepreneur-friendly environment;
- easy access to capital, and, broadly speaking, to factors of production, for foreign and domestic investors;
- broad-range and transparent privatization;
- a set of contract-enforcing institutions and equal access to justice – uncorrupted police, magistrates, courts and central and local government administration;
- a set of competitive and transparent conditions for the private provision of formerly public services in the fields of social safety nets, education, health care and infrastructure.

In many countries affected by the Yugoslav war, reforms have reached a turning point. In some of them (see below a detailed discussion of new divisions between economies in South-eastern Europe), reforms should be reassured or start anew, as an essential part of (and simultaneously to) the rebuilding of the entire region.

In assessing long-term scenarios for the Balkans, a "good economic policy" conducted by both national and international institutions means a region-wide approach which:

- rebuilds the war-torn countries and sets long-term prerequisites for growth and prosperity;
- minimizes the possibility of war, external shocks, blocked trade routes, or market protectionism; and
- promotes security via international and regional protection of human rights and dignity, cooperation, mutual dependence, cross-border clusters, and penetration and interweaving of economic structures.

We assume that there is a common denominator to these policies, a general criterion that is based on one key concept; namely, the interweaving (*die Verflechtung*) of economic and societal structures, based on rules and formal agreements to promote it.[3]

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[2] See a more detailed overview of these policies in: *Unfinished Peace*: Report of the International Commission on the Balkans, Foreword by Leo Tindemans, (Carnegie Endowment for International Peace, The Aspen Institute, 1996), especially on the role of IFIs (p. 26), and that of the UN, EU, and NATO (pp.: 4-9, 39-68), and the enumeration of the errors of Western policies (pp. 68-75).

[3] A counter-argument against the use of this criterion may cite the former-Yugoslav experience of dissolution in 1991-1992 (i.e., the period between the proclamation of Slovenian and Croatian independence on June 25, 1991, and the proclamation of independent Bosnia and Herzegovina on March 3, 1992) and the ensuing wars and violent splits of previously seemingly cemented structures of societal and economic coexistence. However, the key reason for the loss of viability of these structures was the failure of the leader

The questionnaires we use below to assess different scenarios rearrange recent statistics and require judgment to attempt to reflect interdependencies.

New divisions

6. We do not deal with the humanitarian crisis in the Balkan countries and the economic shocks of the war in Yugoslavia. We attempt a consideration of the long-term effects of current developments. We believe that March 24, 1999, is a date marking a turning point in history. The Balkans and the countries around them will hardly be the same as in the last ten years. The post-World War II international order, especially law-enforcement mechanisms, will be readjusted to new precedents and regional and global realities. The European Union, after failing to assimilate what used to be called South-eastern Europe,[4] is likely to develop some sort of Europe II legal status for the most damaged countries (such as Albania, Macedonia and perhaps Montenegro and Kosovo). International Financial Institutions (IFIs) will soon have a coordinating role and later a facility – say, a "Balkan Recovery Program" -- similar to the roles IMF and the World Bank played during the Persian Gulf War and the UN embargo on FR Yugoslavia (not similar to the European Recovery Program of 1948).

7. We foresee that the war will enforce new economic divisions on the Balkan peninsula. It is likely that geographic location, proximity and availability of traditional (pre-1999) trade routes and markets will have a predominant importance in the short and medium term. Companies from and economies in the Balkan countries will naturally seek diversity and alternatives to their pre-war links and routes. The governments' philosophy here is that nations (not companies) compete; seeking rents from others is a norm. Given the underdevelopment of the region's capital markets and poor competitiveness, the war puts a physical constraint on both intra- and extra-regional trade links. Influxes of refugees, lowered custom and transit revenues and other immediate impacts of the war will cause budget, current- and capital account deficits in the most affected countries. It is realistic to expect balance of payments gaps in 1999, 2000 and 2001. The competitive position of their companies will further deteriorate and their economies will be delayed in meeting EU single market challenges, and most would probably fail to contribute to rebuilding the war-torn Balkans. Weathering these impacts depends on administrative capacities and reform support from the IFIs. More concretely, we believe following new divisions are relevant:

1. In the group of countries suffering the most, which would require a restoration period that goes beyond the 2010 horizon, we identify: FR Yugoslavia (including Kosovo and Montenegro, either within or out of the federation), Albania and Macedonia; these are most "endangered economies" -- whatever the constitutional form of postwar Yugoslavia, its role remains crucial.
2. In the group of neighboring countries with fair prospects of swift (2000-2001) compensation and recovery of war impact, we find Croatia and Romania, and perhaps also Hungary; these are "troubled economies."
3. And in the group of countries that could fall into either category (especially if by 2001, a proper postwar order is not established and initiatives for rebuilding the Balkans are not adequately undertaken and implemented), we can put Bulgaria and Bosnia-Herzegovina. These are "troubled but not yet endangered" economies.

The troubled economies of Croatia and Romania, besides neighboring the conflict in Yugoslavia, also fall into another group of countries: along with Slovenia, Greece and Turkey they comprise something like a "Balkan Fence." Companies and economies surrounding the war in Yugoslavia are expected to play a key role during the conflict and in the postwar period. They are in a position to either impose additional burdens on exchange with external markets, or to facilitate it.

8. In all of the above-mentioned countries, domestic policies have been a key factor in delayed reforms. The war simply doubled country risks, aggravated the illness of pre-war lack of institution-building, rule of law and competitiveness. But with the exception of the leaders in Belgrade, governments could not do anything to prevent the current crisis. Temporary reform failures were common in Albania, Bulgaria and Romania. Albania's domestic policies today are of considerably less importance than those of Bulgaria or Romania,

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of the former-Yugoslav republics to agree on looser confederation, and especially the refusal of the federal government in Belgrade to adopt such rules.

[4] The name "Balkans" has been perceived as politically incorrect; in this report it means the same as "South-eastern Europe."

for the success or failure of current reform plans. The less affected an economy is by the immediate impact of the war, the greater the role of domestic economic policies. In the postwar period the most endangered economies of the first group are likely rather to depend on external political and financial support. Economies of the second and third groups are geared toward domestic policy factors, and for them external support is rather a supplementary leverage. Respectively, in international affairs, the responsibility of the political leaders of the latter group for economic and political developments in the Balkans is a new factor to contend with.

If, in the long run, postwar political and economic orders fail to compensate for currently emerging divisions, there will be a foundation for further disparities and conflicts.

In the endangered economies, including those of FR Yugoslavia (Montenegro and Kosovo), reforms must start anew. In the troubled ones, for different reasons (election of reformist government, better prospects for EU accession, etc.), reforms have recently gained momentum. The immediate need of these countries would be for secured access to external financing to overcome adverse macroeconomic impacts when and if they occur, on the precondition that they occur for reasons and factors beyond their control. Rebuilding the region and prompt international agreements that secure mobility of capital, labor, goods and services is of vital importance to all countries and must serve as an economic *conditio sine qua non* for long-term peace.

Legacy risk

9. All Balkan countries are exposed to a sort of legacy risk, when postwar realities reproduce the heritage of the 1990s or when postwar initiatives, opportunities, policies and instruments are rejected by local or Western democracies, and fail to behave in an economically rational manner. An example might be failure to meet the criteria for "good" policies outlined above, but rather institution of policy benefiting a particular group at the expense of others. It is difficult to quantify these risks, as there are a wide variety of development options. In general, such risks are highly probable.

The war in Yugoslavia has had an unintended impact on future policy choices: it has made it necessary for them to be clearer, of an "either-or" type. The countries of the Balkans and the other international players will either maintain legacies or embark on the path of development, integration and cooperation. Below we consider two major scenarios based on this clarity, while a third scenario is based on the reaction-pattern of the EU to the emerging democracies and market economies over the last ten years. In addition, we discuss approaches that may prevent or support the worst-case scenario.

II. ECONOMIC SCENARIOS FOR THE BALKANS IN THE NEXT TEN YEARS

A. Monumental economic disasters

10. The first scenario is a repeat of the fundamental features of Balkan history over the last ten years. FR Yugoslavia remains a part of the Balkan problem. If this happens, it will be a scenario of monumental economic disasters for both most of the individual countries in the region and in the Balkans as such.

Monumental disasters are extraordinary institutional constraints to economic freedom, growth and prosperity. We borrow this term from Thrainn Eggertsson,[5] who uses it to describe why Iceland failed to develop a fishing industry for about a thousand years. In the case of Iceland there were external powers and shocks that between the 9th and 19th centuries restricted Icelanders from fishing in the open sea. We believe, however, there are also domestic (and in the case of Balkans, intra-regional) factors that may impose institutional barriers to growth and hamper the prospects for prosperity in the long run.

External factors of possible support for this scenario are as follows:

- war legacies and divisions established by them;
- failure of international players (namely: the UN, NATO, IFIs, EU, G8 and the United States) to agree on rules and cost-sharing patterns for rebuilding Balkans, or agreement on an inappropriate plan; and
- commitment on the part of the above-mentioned Balkan Fence countries to seek rents from war-established divisions within South-eastern Europe.

[5] See: Thrainn Eggertsson, "No Experiments, Monumental Disasters: Why It Took a Thousand Years to Develop a Specialized Fishing Industry in Iceland," (Workshop on Political Theory and Policy Analysis, Indiana University, 1994).

Domestic (and in the case of Balkans, intra-regional) factors of possible support for this scenario are as follows:

- consistent failure of Balkan countries and leaders to agree on long-lasting peace agreements and constitutional order;
- discrepancies in economic development within the region[6] and different paces of market and democratic reforms; and
- aspirations to build nation-states at the expense of others, lack of respect for human and minority rights.

Main features

11. The probability of a longer war or coexistence on the brink of war seems significant. It well may be that there is a war that continues with interruptions over a period of 6 months to 2-4 years, and that despite the efforts of international communities there will be another war on the eve of 2010. The inter-war periods could be periods of delayed wars, when the parties prepare for the next step of a "desired" solution with milder or harsher practices of ethnic cleansing, and renewed claims on others' territories, symbols and heritage from once-common, or at least not divided, historic endeavors.

The background driving force of a long-lasting war must be found in the formation of nation-states in the region, a process which in other parts of Europe occurred between the 17th and 19th centuries, and in intra-regional economic disparities.

- Albanians in Kosovo are undergoing such nation-state formation.
- Led by Milosevic and backed by the Serbian identity, FR Yugoslavia is "defending" its national pride and territory.
- Macedonia, with its recently-gained independence, faces the challenge of defending its status quo.
- Montenegro is likely to embark on the nation-state path in the nearest future.
- Many constitutions in the region prevent flexibility on ethnic issues in their concept of statehood, envisage a constituent nation,[7] ban autonomy,[8] restrict foreigners from owning land,[9] or prohibit political representation of ethnic and religious minorities.[10]
- In the 20th century most countries have used some form of "soft" ethnic cleansing; e.g., the last pre-Yugoslavian case was the expulsion of Bulgarian ethnic Turks in May-June 1989 to neighboring Turkey (after they were deprived of their property rights).

12. Even if we assume that there is no pan-Balkan tendency for ethnically clean nation-states and take for granted that such states are virtually impossible, the dissolution of the former Yugoslavia (and the drafting of the newly independent states' respective constitutions) and the current war over Kosovo set a precedent with long-lasting consequences.[11] A country's national and ethnic self-determination is theoretically and ethically accepted to be a just aspiration. Civil society structures that may counteract chauvinist minds and movements are rare, weak and disliked by political leaders. It seems that there is some underlying mental mood that was summarized by the economist Vlado Gligorov, who is familiar with the region: "Why I should be a minority in your state, when you can be a minority in mine?" There is no currently-employed legal instrument that can ensure that an ethnic group or nation, seeking liberation from another group or

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[6] See: Krassen Stanchev, "Market Reforms in the Balkans: Barriers and Challenges," *Balkan Transitions*, edited by Ivailo Dichev, (Sofia, ACCESS, 1997).

[7] E.g., the Croatian Constitution says: "Croatia, the nation-state of the Croatian people and the state of other nationalities and minorities which are its citizens"; the Macedonian Constitution contains quite a similar statement: "Macedonia, the national state of the Macedonian people, which guarantees the complete civic equality and permanent cohabitation of the Macedonian people with the Albanians, Turks, Roma, and other nationalities living there." The Bulgarian Constitution states that "the official language … is Bulgarian" (Article 3), with no legal definition of what "an official language" is.

[8] E.g., Article 2.1 of the Bulgarian Constitution.

[9] E.g., Article 22.1 of the Bulgarian Constitution, Article 41.2 of the Romanian Constitution. In both cases, legal tricks help to get around the ban; but the point is that constitutional thinking is counter-productive in terms of international economic cooperation. There are similar provisions in other Balkan constitutions.

[10] E.g., in the Constitution of Bulgaria one may find the statement that "the traditional religion [in the country] is the Orthodox Christian congregation" (Article 13.2), and that political parties established on "ethnic, racial or religious lines" are not allowed (Article 11.4), while such parties exist *de facto* and it is almost impossible to implement this provision *de jure*.

[11] For further details see: Krassen Stanchev, "The Balkan Map in 2010: A Futuristic Attempt," *Sotziologicheski Problemi*, No 4, 1995 (in Bulgarian); *Unfinished Peace*: *Report of the International Commission on the Balkans*, pp. 28-36.

nation, will not eventually turn into an oppressor of a third group or nation.[12] If this mood prevails, by the year 2010 we will need to deal with conflicts over the dissolution of Bosnia-Herzegovina and Macedonia.

13. Except for Albania (in 1997, 3.8% of its imports were from Bulgaria) and Macedonia (in 1998, 20% of exports and 12% of imports were to and from FR Yugoslavia, and Bulgaria is a partner), the core Balkan countries have little exchange with neighboring transition economies but large trade with surrounding economies. Countries at the center and to the south of the peninsula have several times greater trade with Greece and Turkey. Aside from that direction, most countries' major trading partners are to the northwest; over 60% of the region's exports and imports are to and from EU, CEFTA and EFTA countries. A longer war or threat of war and interruption of those trade routes will put all these volumes at risk. If this scenario dominates in Balkan economies over the long term, the countries will run huge trade deficits. A monumental disaster would mean failure to develop those few competitive advantages the countries' respective private sectors succeeded in identifying, in tourism, wines, delicacy canning, knitwear, and some high-tech and service industries.

14. Economies and company structures are not well positioned to prevent external constraints to regional and indigenous development.

- Although most economies are led by private sectors and services (the average share of the private sector in GDP is about 60%), they are rarely competitive.
- Foreign direct investment is negligible in absolute and in per-capita terms. Countries have small economic "lobbies," due to limited foreign ownership.
- The level of foreign ownership in the Spanish economy is 42%, in Poland 12%, and in Romania 6%.[13]
- Mutual activities of economic agents (besides Croatia in Bosnia-Herzegovina) is no factor for integration and cooperation.
- Mutual penetration of neighboring bank sectors is close to zero, with the exception of some Turkish and Greek banks. Foreign ownership in banking sectors is a rare phenomenon in the Balkan transition economies.
- While Bulgaria and Romania (and to some extent Croatia) are exceptions, the foreign share is 2.5 times smaller than in Hungarian banking sector.

A common practice when transferring payments to a company in a neighboring country is for companies to use the services of international correspondent banks.

- Domestic, not to mention regional (or of regional significance) commodity exchanges, do not exist or function badly. Links between capital markets are at the level of irregular correspondence between the heads of the stock exchanges.

We do not have precise data on cross-border clusters in the Balkans. When we tried to identify examples of Bulgarian-Macedonian cooperation, the Chamber of Commerce in Sofia found 23 companies with mixed ownership, but all except one were in the trade sector. The debate about a second bridge between Romania and Bulgaria is an old story. The project has been around since 1886. In fact, capital and trade flows go about equally north and south of Danube; over the last 10 years trade has never gone above two percent on either side. Delays on ferries, bridges and border-crossings occur in 80% of cases, for both logistical and procedural reasons.

15. The war in FR Yugoslavia has exacerbated these hurdles. Any postwar settlement that fails to eliminate them would mean:

- the "endangered economies" of Albania, Yugoslavia, Kosovo, Macedonia, and Montenegro would further deteriorate or remain at high risk;
- the economies of Bulgaria and Bosnia-Herzegovina would fall into the same category as those "endangered species"; and
- the "troubled economies" of Croatia and Romania would remain at risk in the medium term, but perhaps fail to benefit from larger markets to the southeast.

B. Balkan Valleys

[12]See discussion of this phenomenon in relation to Balkans in: *Unfinished Peace*: *Report of the International Commission on the Balkans*, pp.: 28-32.
[13] Source: Heriot-Watt University, UK, quoted by: Francis Harris, "Join at your Peril," *Business Central Europe*, March, 1999, 12.

16. This scenario would be the aftermath of the best practices, which besides the errors and failures have been taking place in the economies of the region. This scenario has more to do with a vision than with indigenous legacies. It should allow for incremental development, a piecemeal approach to cooperation and investment, and a secured (perhaps internationally underwritten) economic and peace order. Balkan wars hit each of the region's economies in a different manner. Within the next ten years, we will have more Balkan countries. Each of them, no matter how small, should follow certain policies of entering the marketplace and/or adjusting to external shocks. Eventually, incremental development and a piecemeal approach would bring about individual routes to integration and prosperity.

Coveted features

17. This is a "neighbor-success" scenario. FR Yugoslavia, and accordingly Kosovo and Montenegro, could be a provisionally indispensable part of the solution to the problems. The peculiarity here is that this could not take place in a neighborhood of countries and economies isolated by war and buried in old conflicts. In the abstract terms of science fiction, it would require:

- low tariff barriers;
- a competitive market environment;
- free exchange of goods, services, capital and ideas;
- market potential of about 58 million (not including Turkey);
- a well-functioning infrastructure;
- easy accessibility to all the sights and corners of the Balkan peninsula; and
- stable and transparent exchange rate mechanisms (preferably, currency board regimes) and transparent and stable prices.

18. To achieve this, a joint strategy is needed to strengthen competitiveness, involve Turkey and other countries of the Balkan Fence group, and promote infrastructure projects on mutually beneficial grounds.
This scenario is not at all rooted in the political and historical backgrounds of the countries in the region, and for this reason is rather unlikely. However, it is worthwhile to attempt such policies. There is a chance of success, depending on two factors:

1. support from the international community for peace and institution-building, and
2. rebuilding the region and development of the regional infrastructure.

Such efforts should aim at facilitated access to outside markets and that of outside capital to local markets, as well as at cross-country cooperation between businesses and specific industry sub-sectors, and need to progress through the following stages:

- securing of regional and individual countries political stability;
- agreement upon joint strategies to strengthen regional economic order;
- negotiation and removal of "national" preferences for selected sectors;
- enforcement of open public procurement procedures; and
- facilitation of trade via lowering tariff and non-tariff barriers.

Feasibility

19. It is hardly possible that Western companies will invest in individual countries of the region, especially in FR Yugoslavia, unless there is substantial political and investment risk coverage or an effort at rebuilding the region. Combined London and Paris club claims on the former Yugoslavia (prior to 1991) total US $16 billion. Despite the efforts of Croatia, Macedonia and Slovenia, the debt has yet to be settled -- mostly due to obstructions from Belgrade's central bank and government. The successor-states of the former Yugoslavia also have claims one against another. Similar is the issue of restitution and/or compensation for refugees deprived of their property rights. All of these problems put a big question mark over the enforcement of property and creditor rights and increase the risk and costs of investment in FR Yugoslavia, but not only this. As soon as peace and political stability (i.e., a democratically-elected government committed to peace and international cooperation) are achieved in FR Yugoslavia, it should be granted appropriate debt forgiveness in order to ensure its swifter re-entry into the postwar reconstruction of South-eastern Europe.

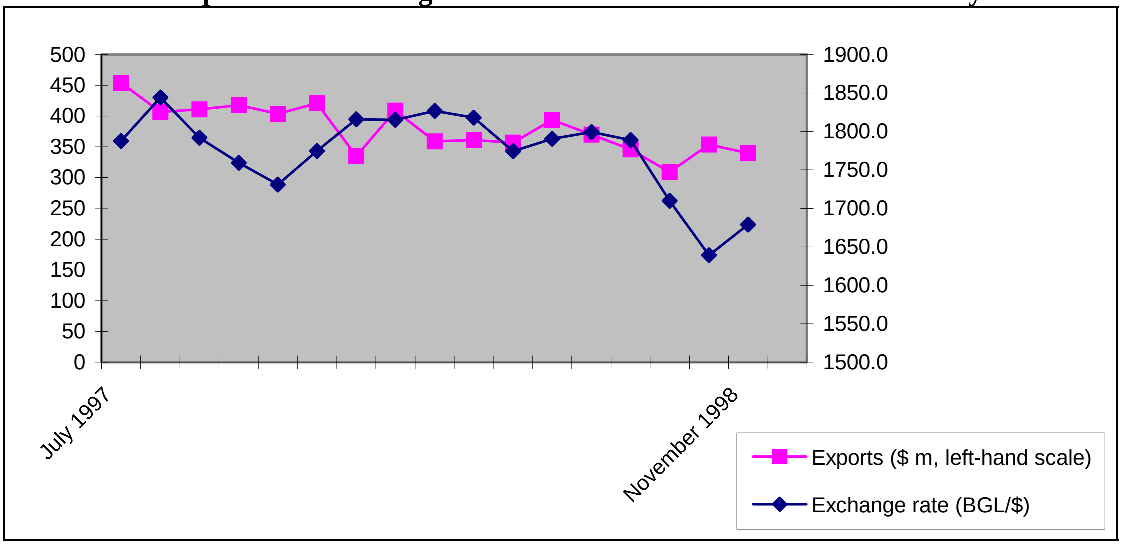
A postwar settlement of the former Yugoslavia's debts would diminish prospects for the debt reduction of other Balkan countries. Only those directly affected (Albania and Macedonia) are likely to negotiate favorable repayment schedules with the Paris club.

20. Despite all of the barriers to foreign investment, there are investors that already have a stake in the region. They vary for different countries, but they are likely to stick around and be prepared to use any business opportunities as soon as they occur. Disrupted trade may be cured by free trade agreements with EU, following the example of Turkey (believed not to be very positive), or via other policy instruments. At the end of the day, different parts of the Balkans might be rather different in terms of dominating foreign investment, payment and customs agreements and competitive advantages.

21. The financial infrastructure in most of the region's countries is in *status nascendi*. It is likely that opening their economies and keeping on track with their market reforms would result in privatization of their baking sectors and deeper links with international and financial markets. This is a likely development for the groups of "troubled" and "troubled but not yet endangered" countries, provided they keep up profound reform efforts.

22. The monetary systems in the region look more diverse than they actually are. Large segments of Balkan markets use the Deutschemark as a reference currency, in many countries the domestic currency is substitutable (though not legally), and people save (often outside banks) in D-marks or U.S. dollars. The currency board arrangements (CBA) in Bulgaria and Bosnia-Herzegovina proved to be a major tool for macroeconomic stability and imposed hard budget constraints in politically uncertain environments. Similar results have been experienced Lithuania and Estonia, which have even older currency boards. The latter managed to weather the 1998 Russian crisis with its two economic (institutional) instruments: its CBA and the flexibility of its economic and business structures. Since early 1999 both Balkan CBAs are pegged to the Euro. In Bulgaria, it does not seem to have hampered exports.

Merchandise exports and exchange rate after the introduction of the currency board



The graph shows that in the period between the currency board's introduction (effectively March-April 1997) and the beginning of the air-strikes on FR Yugoslavia, there was no direct link between exports and exchange rate. It is likely that periods of lower exports resulted from institutional and structural reasons, from the economy's lack of flexibility. A provisional postwar situation would be similar in all Balkan countries.

Another similarity to some postwar situation is demonstrated by the current economy in Bosnia-Herzegovina: foreign aid in the country amounted to 70% of GDP in 1998, a significant improvement. At least the most-affected Balkan economies would resemble the Bosnia-Herzegovina of 1997 and 1998, and to some extent the Bulgaria of early 1997 (though there was no war), where the CBA's created financial stability in impoverished countries.

CBA's limit the government monopoly on money supply. Thus, they lead to price stability and provide the financial system with transparency, which will be extremely desirable in the postwar Balkans.

23. Poor physical infrastructure in roads and railroads, telecommunications, transport and utilities has been a major economic reality for all Balkan transition economies. The war just made things even worse.[14] Three years ago, The International Commission on the Balkans suggested a solution that is equally important today and in the postwar period: it recommended "the creation of a Transport and Infrastructure Association for the entire Balkan space. This would not conflict with EU regulations, and it could be of considerable value to provide a framework not only for raising funds from the World Bank and the EBRD but also for planning major rail, road, and telecommunications investments and ensuring the rational development of air transport."[15]

24. Public opinion, voters and government leaders still have to accept the necessities of this scenario. Once practiced, genocide and ethnic cleansing constitute a legacy for ensuing generations. It is difficult to eradicate memories of past violence when there is no shared vision of a common future and prosperity. None of the available concepts of the future of the region thus far (neither those of political leaders, nor of the general public, business, and younger generations)[16] seem to have been inspired or committed to intra-regional cooperation and exchange. The governments of EU-associated countries are focused on bilateral agreements with the EU. They do not usually pay attention to issues of regional cooperation, other than ordinary trade and other agreements, while this scenario would require greater commitment and compromise.

Sticks and carrots

25. In 1991 the IMF and the World Bank insisted on the preservation of the economic powers of the federal Yugoslav government. Currently they undertake an individual approach to the needs of the affected (and eligible) countries, depending on the current status of their relations with the IMF and the IBRD. They have announced they are ready to play a coordinating role in international financial efforts to cure Balkan illnesses. They can also play an important role through policy advice. However, in the circulated communiqй on the principles for the provision of external financing, there is not a single word about any "regional" approach. "Regional" means the provision of external financing upon the pre-condition of implementing rules of the game for regional cooperation, institutional design and transparency. Such policy could mean politics, so it should made transparent form the very outset.

26. The underlying principle of the international players' attitude should be an approach related to individual country circumstances, with provision of funding on the condition of implementing policies that benefit the region and its links to international markets. A similar "political" approach is desirable on the part of all institutional payers in the postwar Balkans. "Troubled but not yet endangered economies" could have a "priority" position in IFI's cooperation, provided deteriorated performance is really due to external

[14] War damage in FR Yugoslavia is still yet to be estimated. Before the war, 65 kilometers of gas pipeline on Serbian territory and 40 kilometers on Bulgarian territory were lacking to connect Bulgaria's natural gas network with that of Yugoslavia; there is no gasoline pipeline between the two countries; there is a natural gas pipeline with Macedonia, Greece and Turkey, going to Skopje, Athens and Istanbul, respectively; a natural gas pipeline is lacking to link Bulgaria's network with the Greek port of Kavala; and gasoline lines are largely missing. Highways are interrupted on Bulgarian and Yugoslav territory, if we consider the Belgrade-Istanbul (West-East) route (highway is lacking between Nis and Sofia, and is unfinished between the Northern Thracian city of Plovdiv and Turkey's border town of Kapu-Kule); North-South and Black Sea-Adriatic highways do not exist at all, nor parts of the Macedonian road network. Virtually any kind of infrastructure is lacking on Albanian territory. There is no connection between Romanian and Bulgarian natural gas pipelines, nor between Macedonian and Yugoslavian ones; a natural gas pipeline goes from Belgrade to Bosnia but there is no link to Croatia (Croatia is supplied from the Adriatic via Slovenia). Electricity supply networks were established according to the COMECON "division of labor," and are attached to Russia and Central Europe, but not as part of intra-Balkan infrastructure. Meanwhile, in 1992 Poland, the Czech Republic, Hungary and Slovakia established an inter-government coalition to link themselves to the Western European electricity transmission network, which was accomplished two years ago. Balkan countries have hardly tested the waters for negotiations on electricity transmission reorientation and intra-Balkan links. Besides cable networks between Bulgaria and all neighboring countries that were established in 1996 and 1997, and similar links in Croatia, Slovenia and to some extent Romania, communications are slow and inefficient.

[15] *Unfinished Peace*, p.144.

[16] In early 1997, the Economic Development Institute of the World Bank conducted the only recent representative survey, coordinated by Djordjija Petkoski, on how Albania, Bosnia-Herzegovina, Bulgaria, Macedonia and Romania reflect their future, both as nations and neighbors in the Balkans; a cohesive vision on the region is visually missing in all countries.

factors. The principles of the EU single market do not contradict policies that would be good for the postwar Balkans. There is no conflict with the declared policies of the IFIs, either.

C. Balkan basement

27. This scenario is a realization of ideas about Second Europe. Intentions and procedures behind such efforts could either convert the Balkans into a garden within ten-fifteen years, or push it back onto the path of monumental disasters. Its major feature is the implementation of the easiest approaches and policies currently employed by the structures of the EU and the governments of the Balkan countries. It would be easy for this scenario to evolve because it utilizes approaches that are readily available and responds to requests that are apparent in the region. It may not be a problem to achieve political consensus on the major stages of this scenario, in a situation in which prompt solutions are desired. The general metaphor of this scenario is that it may establish foundations for postwar economic and political order, but if poorly implemented it may preserve the "under-qualified" status of the economies and countries it is intended to integrate.

We live in a situation of boiling imagination about the Balkans. Most ideas need still to be debated and revised. Often speakers use the same words but mean different postwar realities.

Early flyers of this scenario are the preliminary draft discussion ideas of a Postwar Stability Treaty expressed by representatives of the German government and of a System for Postwar South-East Europe (a shadow green draft paper from the Center for European Policy Studies in Brussels), and repeated general references to provisional Marshall plans for the Balkans made by politicians and the media in the affected countries and EU-member states.

The common denominator of these ideas is that they amend current institutional legacies, provide administrative continuity and do not create fancy realities out of the ashes of the war.

The Monumental Economic Disasters scenario is a continuation of rather spontaneous (societal) institutions that were sanctified into formality and tradition by the practices of the last ten years and reinforced by individual countries' constitutions.

The Balkan Basement is a scenario to be initiated by legacies of national and international administrations and government leaders. It is a case of political and administrative engineering, typical for *Realpolitik* but difficult to swallow when ideas materialize.

The Balkan Valleys scenario is somewhere in between; its background is more complicated, it lacks many of both the societal and bureaucratic legacies, and it has more political problems to solve.

Europe II

28. The political dimension of this sub-scenario consists in the creation of new relationships between the European Union and the war-torn Balkan countries. The merits of this approach are:

- it realizes a regional approach that is largely lacking in most of the Balkan initiatives from 1991 to date;
- it immediately establishes an international "government," responsible for the affairs on the spot, and solves the problem of the postwar constitution of Yugoslavia, Kosovo and perhaps other states that may emerge in the region or elsewhere;
- it mobilizes resources to conduct real pre-accession processes in previously "hopeless" accession countries (e.g., Croatia, Macedonia, Albania) whose governments insisted for years on a softer approach; it streamlines Brussels' administration in dealing with the region and saves implementation costs of other less-articulated blueprints;
- it really may bolster the process of joining the single market of the Union and shorten the distance between EU accession laggers and front-runners;
- it may speed up the reconstruction of EU structures in order to accommodate countries "hopeful" of accession; and
- it establishes more-or-less clear incentive-treats mechanisms, with an underlying message that not joining Europe II would have a high political price.

29. The concrete forms of Europe II legal foundations would be manifold and problematic; they include different versions of the EU's existing "four-pillar" policies (the fourth pillar being EU-non-EU bureaucratic coalitions) and implementation vehicles. One precondition is some sort of peace and stability treaty in the aftermath of the war in Yugoslavia. Next come different vehicles for getting EU enlargement through current procedures. Presumably, immediate autonomous membership would be restricted to Kosovo and other endangered countries and economies. Parallel to these, there should be a process of NATO enlargement to ensure security and peace-keeping in the region. Economic agreements are discussed separately in the next paragraph. Their major role, after immediate relief and reconstruction needs are covered, would be to make possible in the more distant future the mobility of capital, goods and services, labor and people. It would challenge the current motivation for Schengen-like rules if freedom of movement rights were the same for autonomous members as for "actual" EU-citizens, and challenge the feasibility of the entire plan if the rules "are not quite the same." Acceptance of a general principle of multi-ethnic and religious coexistence is believed to be a crucial foundation for any postwar treaty. How to judge whether this principle is profound, is not clear. The implementation vehicles will be most of the current programs of the EU. They are expected to support civil society structures in the endangered and neighboring countries.

30. <u>The economic cornerstone</u> is the creation of CBAs or CBA-like regimes, pegging local currencies to the Euro (or substituting them with the Euro), and signing a multilateral trade agreement with countries granted the status of semi-members of the EU. As in the case with Bosnia-Herzegovina, in the new aftermath of the crisis the FR Yugoslavia, and respectively Kosovo and Montenegro, would probably implement rebuilding and stabilization programs.
The stability treaty for others will have features already formulated in different forums (EU finance ministers, the IMF and the World Bank, EBRD Annual Meeting, G-8, UN ECE, etc.):

- political and investment guarantee schemes;
- financing infrastructure;
- support for the balance of payments;
- debt forgiveness; and
- structural reforms and development programs.

These measures are natural, and have already been tested in Bosnia-Herzegovina and other countries. They seem to constitute no problem and are the same as the economic steps outlined in the previous scenario. Perhaps the only difference is that in Europe II, the government structures of Brussels take over administrative and political responsibility.

31. <u>The key problem the Europe II sub-scenario fails to solve is</u> <u>justice</u>.
From the point of view of international law and political attitudes, it would not be fair to give Yugoslavia an equal start along with the other affected countries. From a philosophical point of view, it may not be justifiable to punish a nation for the actions of the government it elects, and, as Zarko Puhovski put it, "it is impossible to punish a government in warfare without punishing the nation." But this is a war. The argument could have different formulations: from that of a tacit intention to punish Yugoslavia to that of an honest reward for those who "have tried hard for a long time." However, if there is no equal start for FR Yugoslavia, there is a preferential treatment for those who suffered most, the Albanian people of Kosovo. If Kosovars get the status of an autonomous entity within the EU and Montenegro secedes, there will be an incentive for other groups to break away from Serbia. At the end of the decay or even earlier, the EU would create an ethnically clean Serbia.
In these circumstances, the EU-accession front-runners may feel they are treated unfairly. Advanced reforms, better economic performance and institutional development and greater competitiveness may turn out not to be the proper limousine to enter the club. The chart of the poorer would be welcome under advantageous terms. The principle of "the most affected served first" would be used, instead of the "first come first served" principle.
In order to avoid such opportunism, the EU would be forced to initiate special association treaties and partnerships with the newly autonomous states and regions. These treaties would obviously have lower status than ordinary associated membership. In order to stop regions and countries from rushing in the open door, from the very outset it would made clear that the new status is of limited applicability to selected newcomers. <u>To the extent that this happens, the Union would be preserving the existing discrepancies in the region.</u> Front-runners will remain front-runners, laggers will remain laggers, and autonomous members will remain autonomous.

32. Another problem is logistics. In a natural but fairly difficult-to-predict manner, FR Yugoslavia is setting both the time schedule and the political benchmark for all postwar plans. If it fails to elect a legitimate government committed to integration, the entire house of postwar Europe will be built on shaky foundations. A likely development is that Kosovo Albanians will not be in a position to return home by the fall of 1999, as expected in most EU reports on the refugee situation. The reasons are simple: destruction is at the rates of Bosnia (i.e. 60%); houses around the country must be reconstructed but domestic resources are limited; construction materials are expensive imports because roads and railroads have been destroyed at a rate of at least 30% (according to NATO headquarters reports); and if people do not return fairly soon they will have no possibility to plant and harvest this year, in which case they would starve during the winter in the open air of their homeland.
If the Kosovars do not return in the near future (as seems to be the case), all of the plans for special membership status and peace treaties based on legitimate representation must be postponed. Albania and Macedonia, who host the refugees, would be in a position only to receive aid, spending enormous energy on keeping their societies together. If the result is a receivership from the EU and other international institutions, why should it be called enlargement of the Union.
If the Europe II plans go into effect, the likeliest beneficiaries will be the Balkan Fence countries, rather than those in the name of whom the plans were conceived. As an observer put it bluntly: "we do not need an iron curtain, we need an iron fence or a wall to separate us from the Balkans."

Marshall plans revisited

33. When Western and Eastern European political leaders and opinion-makers talk about a South-eastern European "Marshall plan," they mean different Marshall plans. In the East, this a vague notion. It expresses an expectation of a lump sum of hard currency which government can spend to boost investment and growth. The message of this attractive name is: "give us the money on soft terms, we know how to spend it." In the West, this notion denotes a set of institution-building measures, similar to those described in paragraphs 16-23 and 30. The two visions still have to become explicit.

34. In the West, Marshall plan proponents recall the realities of post-World War II Europe, which had a level of destruction much more massive than that in Bosnia and FR Yugoslavia. In the East, proponents of the Marshall plan began referring to it immediately after the political changes of 1989-1990, during the war in Bosnia-Herzegovina and the first UN embargo on FR Yugoslavia, after the embargo, before the current war in FR Yugoslavia, and now they repeat the same *schlager* again. Before the current war they continually missed one point: Europe was destroyed by war, and Eastern Europe by central planners. A *quid pro quo* effect of the current war is the following attitude: "Yes, we were right, the plan is the only solution." But they again miss a crucial point: the destruction in both wars in the former Yugoslavia took place in only one country, during two wars led in the name of one and the same idea: an ethnically clean nation-state. It was shameful, it was unjust. But it was and is, so far, of marginal importance to the global economy.

35. Recently, in February-March 1999, the greater-than-expected current account deficit of Hungary had to be taken into consideration by 350 hedge funds, pension funds and institutional investors related only to Merrill Lynch, and was a signal for them to re-channel investment from European to other emerging markets. Such re-direction may be applied to the annual US $45 billion in emerging market investment. In the context of the debate on a provisional Marshall plan for South-eastern Europe, this so-far isolated case tells a story of mobility, investment volumes and significance. A South- eastern European "Marshall plan" could make sense for the economies of the region, but not for the global economy.

36. In order to have a Marshall Plan, Balkan governments should realize what the original story was. By no means it is a financing facility that grants some amounts to a government to spend during a four-five year mandate and then get reelected. The original Marshall Plan, or the European Recovery Program (ERP), had no direct influence on economic growth. Vigorous growth was already present in 1947 (before the introduction of the Plan), and industrial output was exceeding the pre-war level; without the Plan Europe's economies might have grown at a slower pace but would not have declined.[17] The real aftermath of the ERP was unintended but long-lasting institution building, starting from a prototype organization of today's

[17] Alan S. Milward, *The Reconstruction of Western Europe: 1945-1951*, London, Mathuen & Co., 1984, pp.: 7-13, 113.

OECD, setting the rules of multilateral trade and the customs union, the advent of the European payment union, respectively, the Schuman Plan, and reaching the Common Market. The Marshall Plan cannot be repeated in this form. A similar form would be a coordinated and supported effort to build or join the institutions (i.e., rules) of the global economy. But this is exactly what the Balkan transition economies (at least most of them) pretend to be doing. If it is a plan to finance government investments, or a plan to rebuild the region, it should be called and executed differently.
The governments of the Balkans must not be expected to achieve similar institutions in the immediate aftermath of the Yugoslav war. The nature of the war is different, and the nature of the world economy is different. Currently, most of them do not even have the information and statistics to facilitate some sort of "Balkan Recovery Program" resembling the original ERP. They are not to be expected to have such institutions even in the medium term; this is a trial-and-error process which takes time. But they can start working this direction, securing a consensus for their successors to continue.
<u>A rent-seeking attitude is the most harmful one for such efforts.</u> But rent-seeking may be supported by poorly designed, wrongly perceived and blindly implemented ideas of "Europe II" and a "Marshall Plan" as a substitute for central planning.

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