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Transition in Southeast Europe

Understanding Economic Development and Institutional Change

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Abstract

The paper analyses the 20-year experience with transition in the SEE countries in a comparative framework, illustrating how these countries encountered difficulties in its implementation, despite having some of the best starting conditions in 1989 to implement a swift transition to a market economy. The paper recalls the initial conditions in the SEE region in 1989, macroeconomic performance and progress achieved in the various transition-related economic reforms. The international issues are also addressed related to the post-2000 integration of the SEE countries with the EU and among themselves. The paper also reflects on the main factors that are responsible for delays in transition in SEE related to political instability, delayed integration with the EU, and inappropriate economic policies.

Keywords: economic transition, Southeast Europe, economic development, institutional change, EU integration

JEL classification: P20, P27, P30, P33, O10

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Acronyms

CARDS	Community Assistance to Reconstruction, Development and Stabilization
CEE	Central and Eastern Europe
CEFTA	Central European Free Trade Agreement
CMEA	Council for Mutual Economic Assistance
EBRD	European Bank for Reconstruction and Development
EC	European Community
EIU	Economist Intelligence Unit
EU	European Union
FDI	foreign direct investment
FTA	bilateral free trade agreements
FYR	former Yugoslav Republic
IPA	Instrument of Pre-Accession Assistance
LFS	labour force surveys
UNMIK	United Nations Mission in Kosovo
PPP	purchasing power parity
PPS	purchasing power standards
SEE	Southeast European countries
SFR	Socialist Federal Republic
SSA	Stabilization and Association Agreements

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1 Introduction

Southeast Europe (SEE) is a region where the transition to a market economy and multiparty democracy has evolved under particularly difficult conditions. In comparison with the more advanced countries in Central and Eastern Europe (CEE), most SEE countries today are lagging behind in their level of economic development, economic and institutional reforms, and integration with the European Union (EU). In this paper, the SEE region is considered in its narrow definition of the Western Balkan states—Albania, Bosnia and Herzegovina, Croatia, former Yugoslav Republic (FYR) of Macedonia, Montenegro, Serbia, and Kosovo under the UN Security Council Resolution 1244 (the last three were part of the same country until June 2006).[1] In discussing the initial conditions of 1989, however, reference will also be made to the other three countries in the SEE region—Bulgaria, Romania, and Slovenia.[2]

The paper analyses the 20-year experience with transition in the SEE countries in a comparative framework, illustrating how these countries—most of which had some of the best starting conditions in 1989 for implementing a swift transition to a market economy—encountered difficulties in its implementation. The paper first recalls the initial conditions in the SEE region in 1989 (section 2). It proceeds to analyse macroeconomic performance of the SEE countries (section 3) and the progress achieved in the various transition-related economic and institutional reforms (section 4). International issues are also addressed, related to the post-2000 integration of the SEE countries with the EU and among themselves (section 5). The paper ends by reflecting on the principal factors that are responsible for delays in transition in SEE (section 6). A few concluding remarks are drawn at the end (section 7).

2 Historical background: initial conditions in SEE

When the Berlin Wall fell in November 1989, the SEE region consisted of four countries: Albania, Bulgaria, Romania and the Socialist Federal Republic (SFR) of Yugoslavia. All four countries started implementing transition-related economic reforms and held their first democratic multiparty elections in 1989-90, in SFR Yugoslavia at the level of the single republics. At that time, the general situation in SEE was very different from what it is today.

In 1989, SFR Yugoslavia was the most developed and largest country in SEE, both in terms of territory and population. There were major differences among the SEE countries regarding their international relations and trade orientation (Uvalic 2001).

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1 The Federal Republic (FR) of Yugoslavia was constituted in April 1992 and consisted of Serbia with its two provinces, Voivodina and Kosovo, and Montenegro. The country changed its name to the State Union of Serbia and Montenegro on 4 February 2003. Following the May 2006 referendum on independence in Montenegro, Serbia and Montenegro became two independent states in mid-June 2006. According to the UN Security Council Resolution 1244 adopted in mid-1999 Kosovo officially remained part of Serbia, though thereafter it has effectively been governed by UNMIK. In February 2008, Kosovo unilaterally declared its independence, but at the time of writing has still not been recognized by the United Nations and three EU member states (Cyprus, Romania and Spain). All statistical data after 1999 on FR Yugoslavia/Serbia do not include Kosovo.

2 Although Slovenia is more frequently classified among the CEE countries, since it was part of the Yugoslav federation it is appropriate to consider it as well.

SFR Yugoslavia in the late 1980s traded mainly with the European Community (EC), as it was not a member of the Council for Mutual Economic Assistance (CMEA) and had concluded several trade agreements with the EC, the first dating back to the early 1970s (Uvalic 1992). Bulgaria and Romania had been members of the CMEA for several decades, which naturally determined their main trade orientation in line with the 'socialist division of labour', and therefore had a much higher proportion of trade with the other socialist countries. Albania was the most closed economy in Europe: after having abandoned the CMEA in the early 1960s, it had followed its own autarkic development strategy for many years and had limited economic links with the rest of the world, including its closest neighbours.

In 1989 the institutional framework in the SEE countries was also very different. In comparison with other communist countries, SFR Yugoslavia had a longer tradition with market-oriented economic reforms, which started already in the early 1950s. A unique system of workers' self-management was introduced, along with opening up to the outside world and the gradual decentralization of the economy, particularly in the 1970s. Nevertheless, also in Yugoslavia, some of the main features of the communist economic system were not abandoned until the late 1980s (Uvalic 1992), including the commitment to non-private property and 'state paternalism' (Kornai 1980).[3]

More radical economic reforms, also in SFR Yugoslavia, started only at the end of the 1980s. The amendments to the Constitution adopted in 1988 raised the limits on private property and encouraged foreign direct investment. In December 1989, the last Yugoslav government launched a bold macroeconomic stabilization programme based on the 'shock therapy' (the first of this kind),[4] together with a privatization law aimed at changing the property regime in the bulk of the economy. The stabilization programme was initially successful in halting inflation, but by mid-1990 the mounting political crisis, which led soon after to Yugoslavia's break-up, impeded its further implementation.

In 1989, therefore, the overall initial conditions in SFR Yugoslavia were somewhat different than in the other former communist countries, primarily due to its longer experience with market-oriented economic reforms, greater openness of its economy and the country's specific international relations. At the time of the break-up of Yugoslavia in mid-June 1991, all its successor states generally had less distorted economies than the centrally planned economies in CEE (Estrin and Uvalic 2008). Unlike the Yugoslav successor states that in 1991 inherited some elements of the market mechanism, there had been no previous experience of a market economy in Albania; Romania had one of the most centralized economies among all CMEA countries, while only very limited reforms had been implemented in Bulgaria.

3 Kornai (1980) uses the term 'state paternalism' to describe one of the most fundamental features of the socialist system, namely the paternalistic relationship between the state and the firm, whereby the firm is constantly protected and supported by the state. State paternalism is at the basis of 'soft-budget constraints', typical of the traditional socialist economy, namely soft terms set in the tax and credit system and toleration by the political authorities of enterprise financial indiscipline (see Kornai 1980).

4 As a response to hyperinflation, the 'shock therapy' was based on the pegging of the exchange rate to the German mark, introduction of resident convertibility, freezing of money wages, strict monetary control, liberalization of 75 per cent of prices (except for public utilities, some metals and pharmaceuticals) and liberalization of 95 per cent of imports.

Kekic (1996) has calculated an index of initial conditions in all communist countries in 1989, based on various economic indicators and institutional characteristics (including the extent of previous market-based economic reforms, exports to the CMEA, external debt, energy intensity, economic structure, etc.). The index suggests that all the Yugoslav republics had better overall conditions than the other SEE (but also many CEE) countries. The index of initial conditions was lower for Bulgaria (13), Albania (15) and Romania (15) than for the Yugoslav republics, where it ranged from 19 for Serbia and Montenegro to 24 for Slovenia.

The economic transition in the SEE region was interrupted by the disintegration of the Yugoslav federation in mid-1991 into five independent states: Bosnia and Herzegovina, Croatia, FYR Macedonia, Slovenia and FR Yugoslavia (Montenegro and Serbia, with its two provinces Kosovo and Voivodina). After 1991, there was a notable divergence in the transition paths of the single countries, with some countries progressing much faster than others.

Slovenia has had a much smoother transition than the other countries. It was the most developed post-communist country with probably the best overall starting conditions, and it was only briefly involved in the Balkan military conflicts.[5] Soon after its independence in June 1991, Slovenia implemented major transition-related economic reforms, and was able to sign an Association Agreement with the European Union in 1996, to benefit from the PHARE programme and later from pre-accession funds, which prepared the ground for its entry into the EU in May 2004, together with the other seven CEE countries.

Bulgaria and Romania have had a slower pace of economic transition and have experienced major economic instability. Both countries went through a severe economic crisis also in the second half of the 1990s, which brought negative growth in Romania during 1997-99 and in Bulgaria during 1996-97. Nevertheless, similarly to Slovenia, they were able to benefit from EU support from the early 1990s. Bulgaria and Romania signed Association Agreements with the EU already in 1993, and benefited from PHARE and substantial pre-accession funding, which facilitated their joining the EU in January 2007.

The remaining SEE countries—or the Western Balkan states—have encountered much greater problems. The extreme political instability in the SEE region, which affected most countries for more than a decade, has left very profound and long-lasting economic consequences. The disintegration of the Yugoslav federation in mid-1991 and the military conflicts that accompanied it—in Slovenia (1991), Croatia (1990-91), Bosnia and Herzegovina (1992-95), Kosovo (1998-99) and FYR Macedonia (2001); the pursue of nationalistic and inward-oriented policies by the newly created states; the authoritarian regimes in some key SEE countries like FR Yugoslavia and Croatia; the eleven weeks NATO bombing of FR Yugoslavia in 1999; the severe UN sanctions against FR Yugoslavia during most of the decade; the Greek embargo against FYR Macedonia—are among the factors that have very negatively influenced economic performance of most SEE countries. The political events of the 1990s have also postponed many of the economic reforms required for the transition to market economy.

5 After Slovenia declared independence in June 1991, the Yugoslav army intervened to defend Yugoslavia's territorial integrity, but it withdrew after just ten days.

The way the legacies of the previous economic system were dealt with after the disintegration of Yugoslavia has had a fundamental impact on the course of the transition and economic performance of its successor states, resulting in very different outcomes (Estrin and Uvalic 2008).

As a result of unsettled political questions and/or postponed transition, these SEE countries have also substantially delayed their integration with the EU. It was only after the end of the Kosovo war in mid-1999 that the EU elaborated a more coherent and longer-term strategy for the integration of the Western Balkan states into the EU (see section 5 below).

3 Macroeconomic performance of the Southeast European countries

3.1 From hyperinflation to economic stabilization

The initial measures of transition, as elsewhere in Eastern Europe, had a number of negative economic consequences also in the SEE countries: high inflation, a substantial fall in real GDP, a rise in unemployment and worsening of other social indicators. In the SEE region, however, most of these problems have been of much greater scope than in the CEE countries, primarily because of the negative effects of the break-up of the Yugoslav federation, the military conflicts that accompanied it, and the United Nations embargo in the case of FR Yugoslavia (Uvalic 2003a).

Table 1
Inflation in SEE countries, 1992-2008
(Change in annual average retail/consumer price levels, %)

	Albania	Bosnia & Herzegovina	Federation	Republika Srpska	Croatia	Macedonia	FRY/S&M	Serbia	Montenegro	Kosovo
1992	226.0		73.1	7,461	665.5	1,664.4	9,237.0			
1993	85.0		44,069	2,233	1,517.5	338.4	116.5 trillion			
1994	22.6		780.0	1,061	97.6	126.5	3.3			
1995	7.8		-4.4	12.9	2.0	16.4	78.6			
1996	12.7		-24.5	16.9	3.5	2.3	94.3			
1997	33.2		14.0	-7.3	3.6	2.6	21.3	18.3	23.4	
1998	20.6		5.1	-14.0	5.7	-0.1	29.5	30.0	32.4	
1999	0.4		-0.9	14.1	4.0	-0.7	37.1	41.1	67.6	
2000	0.1		1.9	14.0	4.6	5.8	60.4	70.0	97.1	
2001	3.1	3.2	1.9	7.0	3.8	5.5	91.3	91.8	22.6	11.7
2002	5.2	0.4	-0.2	1.7	1.7	1.8	21.4	19.5	16.0	3.6
2003	2.4	0.6	0.1	1.8	1.8	1.2	11.3	11.7	6.7	1.2
2004	2.9	0.4	-0.3	1.9	2.1	-0.4	8.5	10.1	2.4	-1.1
2005	2.4	3.8	3.0	5.2	3.3	0.5	14.1	16.5	2.3	-1.4
2006	2.4	6.1	6.0	6.4	3.2	3.2	11.4	12.7	3.0	0.6
2007	2.9	4.9	1.9	1.1	2.9	2.3	-	6.7	4.2	4.4
2008 est.	3.4	8.5	8.5	8.0	6.1	8.3	-	11.7	7.4	9.4

Source: EBRD (various years) for all except Kosovo: Commission of the EU (2006) and (2009b).

In the early 1990s, all SEE countries except Albania registered hyperinflation (see Table 1). The successor states of former Yugoslavia experienced extreme macroeconomic instability as a consequence of the break-up of the Yugoslav political, economic and monetary union, further fuelled by expansionary economic policies and other country-specific factors.

Macroeconomic stabilization was attained the earliest in Croatia and FYR Macedonia. Thanks to very restrictive monetary policies, these two countries reduced inflationary pressures already in 1995-96. Thereafter, both countries continued applying restrictive monetary policy, Macedonia with the help of an IMF stand-by arrangement, which assured inflation rates usually well below 5 per cent. Macedonia even had disinflation in 1998-99 and again in 2004.

In Albania, the government introduced radical economic reforms in 1992, which were based on a shock therapy stabilization programme and backed by an IMF stand-by arrangement (Bartlett 2008: 31). Although inflation was brought down to a one-digit rate in 1995, the positive trend was interrupted by the 1997 financial crisis caused by pyramid schemes which deprived the Albanian population of life-long savings. Only after 1999 has Albania had a low inflation rate, usually well below 5 per cent.

Bosnia and Herzegovina experienced hyperinflation in the years immediately after the break-up of the Yugoslav federation and the war on its territory in 1992-95. A currency board was introduced in 1997 to facilitate monetary stability, with variable results for the two entities. In the Federation, inflation after 1995 has occasionally even been negative, but in the Republika Srpska, a one-digit inflation rate was achieved only after 2001.

The country that has had highest and longest inflationary pressures is FR Yugoslavia. In 1993, FR Yugoslavia had one of the highest hyperinflations ever recorded in economic history (an average rate of 116.5 trillion per cent). The monetary reconstruction programme in January 1994 based on a currency board, implemented by Dragoslav Avramovic, the central bank governor, succeeded in bringing down inflation to 3.3 per cent in 1994. The currency board could not be maintained due to insufficient foreign reserves to back up monetary policies, which had already in mid-1994 become expansionary (Uvalic 2010). Moreover, in the absence of more fundamental systemic changes, inflation remained in double-digits also in the second half of the 1990s. It was only after political changes in October 2000 that radical economic reforms also brought more permanent macroeconomic stabilization. Although price liberalization led to an average inflation rate of over 90 per cent in 2001, inflation was gradually reduced thereafter.

Within FR Yugoslavia, Serbia’s inflation rate has been similar to the one recorded for the whole country. After the split between Serbia and Montenegro in June 2006, inflation in Serbia has been at around 10 per cent or lower. In Montenegro, in order to escape from inflationary pressures within FR Yugoslavia, the government decided to introduce the German mark as legal tender already in 1998, which was replaced by the euro in 2002. This contributed to a substantial reduction of inflation, though only after 2003. In Kosovo, where the euro has also been used as legal tender after mid-1999, inflation remained relatively high but has also been reduced to low levels after 2002-03.

Table 2
Exchange rate regimes in the SEE countries

Country	Exchange arrangement	Period of adoption	Currency
Albania	Pegged	1990-91	Lek linked to the US$
	Independently floating	1992 onwards	Lek
Bosnia & Herzegovina	No unique regime	1992-96	BiH dinar, new BiH dinar, Croatian dinar (later kuna), Republika Srpska dinar and Yugoslav dinar
	BiH dinar pegged	After Aug. 1994	
	Currency board	1997 onwards	Convertible marka linked to the euro
Croatia	Pegged	1992	Croatian dinar, in 1993 replaced by the kuna
	Managed float	Oct. 1993 onwards	
FYR Macedonia	Pegged	1992-95	Coupons, later replaced by the Macedonian denar
	Conventional peg	1995 onwards	Macedonian denar
FR Yugoslavia	Pegged	1992-99	Yugoslav dinar
– Serbia	Pegged	1992	Yugoslav dinar
	Managed float	Dec. 2000	
– Montenegro	Euroization (euro *de jure* legal tender)	1998 onwards	Euro
– Kosovo	Euroization (euro *de jure* legal tender)	Mid-1999 onwards	Euro

Source: Daviddi and Uvalic (2006).

Table 3
General government balances in SEE countries (in % of GDP), 1994-2008

	Albania	Bosnia & Herzegovina	Croatia	Macedonia	FRY/S&M	Serbia	Montenegro	Kosovo
1995	-10.1	-0.3	-0.7	-1.0	-4.3			
1996	-9.7	-3.9	-0.4	-1.4	-3.8			
1997	-12.7	-0.4	-1.1	-0.4	-7.6			
1998	-12.1	-0.1	-3.0	-1.7	-5.4			
1999	-12.3	-4.0	-8.2	0.0	NA			
2000	-7.6	-4.7	-7.5	2.5	-0.9	-0.09	-4.0	
2001	-6.9	2.2	-6.8	-6.3	-1.3	-6.3	-2.0	3.7
2002	-6.1	-4.2	-4.9	-5.7	-4.5	-3.2	-1.9	4.4
2003	-4.9	2.3	-4.8	-0.6	-4.2	-1.1	-3.1	2.1
2004	-5.1	1.6	-4.0	0.4	-3.4	0.9	-1.9	-4.5
2005	-3.5	2.2	-3.5	0.3	0.9	1.0	2.1	-3.0
2006	-3.3	2.2	-3.1	-0.3	2.3	-1.6	4.2	2.4
2007	-3.5	-0.1	-2.5	0.6	-	-1.9	6.4	7.0
2008 est.	-5.7	-3.0	-1.4	-1.5	-	-2.4	1.5	0.0

Source: EBRD (various years) for all except Kosovo: Commission of the EU (2006) and (2009b).

The SEE countries have adopted a variety of exchange rate regimes in order to sustain their macroeconomic stabilization efforts, from floating regimes to much more rigid arrangements (see Table 2). Still, the choice of an exchange rate regime does not seem to have fundamentally influenced actual monetary policy. Even in countries with more flexible exchange rate regimes (Albania, Croatia, or Serbia), the objective of low inflation has led to restrictive monetary policies and real appreciation of national currencies, bearing close similarities with policies followed by countries under a more rigid regime—the currency board in Bosnia and Herzegovina, or the adoption of the euro in Montenegro and Kosovo (Daviddi and Uvalic 2006).

High fiscal deficits were characteristic of the 1990s, but there has been some fiscal consolidation after 2001 (see Table 3). Restrictive budgetary policies have led to fiscal surpluses, frequently for several years in a row—in Bosnia and Herzegovina during 2003-06, in FYR Macedonia in 2004-05 and again in 2007, in Montenegro throughout the 2005-08 period, in Serbia in 2004-05, in Kosovo in 2001-03 and in 2006-08. While the tax systems in all SEE countries have been subject to radical reforms, the structure of government expenditure has not changed much, confined to a large extent to wages, pensions and social transfers, with negligible capital investment. In 2008, the share of government expenditure in GDP was considered high particularly in Bosnia and Herzegovina (48 per cent), Montenegro (44 per cent), Serbia (40 per cent) and Croatia (39 per cent). The size of the government is smaller in Albania and FYR Macedonia, where public expenditure in 2008 accounted for only 27 per cent and 34 per cent of their respective GDPs.

By 2009, therefore, all the SEE countries had reached substantial monetary stability, though at different times—Croatia and FYR Macedonia earliest, while Serbia only recently. The conduct of monetary policy has been heavily constrained by the requirements of macroeconomic stabilization, in almost all cases codified in conditionality negotiated and agreed with the IMF. Macroeconomic stability has been supported by more restrictive budgetary policy, although weak tax collection and a large informal economy remain characteristic. If not addressed in a coherent way, fiscal problems could endanger longer-term stability (see Trumbic and Uvalic 2005).

3.2 From a deep recession towards economic recovery

The SEE countries went through a very deep recession in the early 1990s (see Table 4). Albania registered a strong drop in real GDP in 1991-92, but in 1993 it had a growth rate close to 10 per cent. In Yugoslavia, the economic reforms implemented by the last government in 1990-91 led to a strong fall in output, while the dissolution of the country further deepened its economic collapse (Bartlett 2008: 114). Consequently, the Yugoslav successor states registered a much stronger cumulative fall of output. During only three years, from 1991 to 1993, real GDP in Bosnia and Herzegovina fell by 12 per cent, 80 per cent and 10 per cent respectively, while dropping in FR Yugoslavia by 12 per cent, 28 per cent and 31 per cent. Industrial production fell even more, contributing to a rapid process of de-industrialization. In Bosnia and Herzegovina, the war brought a complete collapse of industrial capacity, in FR Yugoslavia the fall in industrial production was particularly hit by the introduction of UN sanctions in May 1992, but Albania suffered the most damaging transition shock. The Albanian government never managed to introduce effective structural policies capable of rebuilding the industrial capacity that had been lost in the 1990s by the decline of the old state-owned industries (Bartlett 2008: 120-1).

Table 4
Growth in real GDP in SEE countries, 1991-2008 (in %)

	Albania	Bosnia & Herzegovina	Croatia	Macedonia	FRY/S&M	Serbia	Montenegro	Kosovo	Avg. all transition countries
1990	-10.0	-23.2	-7.1	-9.9	-7.9				
1991	-28.0	-12.1	-21.1	-7.0	-11.6				-7.9
1992	-7.2	-80.0	-11.7	-8.0	-27.9				-9.2
1993	9.6	-10.0	-8.0	-9.1	-30.8				-4.9
1994	8.3	0.0	5.9	-1.8	2.5	2.5	0.7		-5.2
1995	13.3	20.8	6.8	-1.1	6.1	6.1	6.2		0.1
1996	9.1	86.0	5.9	1.2	7.8	7.8	13.9		0.2
1997	-10.9	37.0	6.8	1.4	10.1	10.1	4.2		3.5
1998	8.6	15.6	2.1	3.4	1.9	1.9	4.0		-0.1
1999	13.2	9.6	-1.5	4.3	-18.0	-18.0	-6.7		1.8
2000	6.5	5.5	3.0	4.5	5.0	5.2	3.1		6.3
2001	7.9	4.3	3.8	-4.5	5.5	5.1	1.1		1.8
2002	4.2	5.5	5.4	0.9	4.0	4.5	1.9	-2.4	4.5
2003	5.8	3.0	5.0	2.8	3.0	2.4	2.5	-0.1	5.8
2004	5.7	6.3	4.2	4.1	5.0	9.3	4.4	3.4	7.2
2005	5.7	3.9	4.2	4.1	5.0	6.3	4.2	3.8	6.3
2006	5.4	6.7	4.7	4.0	5.0	5.5	8.6	3.9	7.2
2007	6.0	6.8	5.5	5.9	-	6.9	10.7	5.0	7.0
2008 est.	6.8	5.4	2.4	4.9	-	5.4	7.5	5.4	4.2
GDP 2008 (1989=100)	163.0	84.0	111.0	102.0	NA	72.0	92.0	NA	140.0

Source: EBRD (various years) for all except Kosovo: Commission of the EU (2006) and (2009b).

Economic recovery from the deep recession took place at different times—already in 1993 in Albania, in 1994 in most other SEE countries, and only in 1996 in Macedonia, where the recession was milder but lasted longer. However, there was a reversal in the trend of economic recovery in the second half of the 1990s, for different reasons, in all countries except Bosnia and Herzegovina. Albania had a serious financial crisis in 1997 caused by the collapse of pyramid schemes. Croatia also experienced a financial crisis when several domestic banks collapsed in 1998, due to politically connected lending to unprofitable enterprises (Bartlett 2008). FR Yugoslavia registered an 18 per cent fall in GDP in 1999, caused by the NATO bombing. FYR Macedonia's economic recovery was interrupted in 2001 by the outbreak of civil war.

After unsatisfactory growth during much of the 1990s, 2008 has been the eight consecutive year of positive real GDP growth for most countries, on average close to or over 5 per cent. The only exceptions are FYR Macedonia, experiencing negative growth in 2001 due to the civil war, and Kosovo, where positive GDP growth rates were registered only after 2004. Kosovo has had a very slow economic recovery due to reduced international assistance and the failure of the UNMIK authorities and the provisional government to implement effective economic reforms (Bartlett 2008: 116-7). Strong domestic demand in recent years in the SEE countries has been fuelled by fast credit growth and by the revival of exports markets, contributing to their present high vulnerability to the 2008-09 global financial and economic crisis.

3.3 External imbalances and FDI

All SEE countries presently face serious external imbalances. After a decade of declining or stagnating exports, caused by the break-up of the Yugoslav federation, military conflicts and trade embargos, SEE countries' exports have been growing since 2001. However, imports have grown even faster, inducing rising foreign trade deficits. Restrictive monetary policies implemented to combat inflation have frequently led to strong real appreciation of the national currencies, facilitating in no way the expansion of exports. Despite the trade preferences granted by the EU to all SEE countries after 2000, many SEE products are not sufficiently competitive on foreign markets or face non-tariff barriers, limiting their capacity to increase exports further.

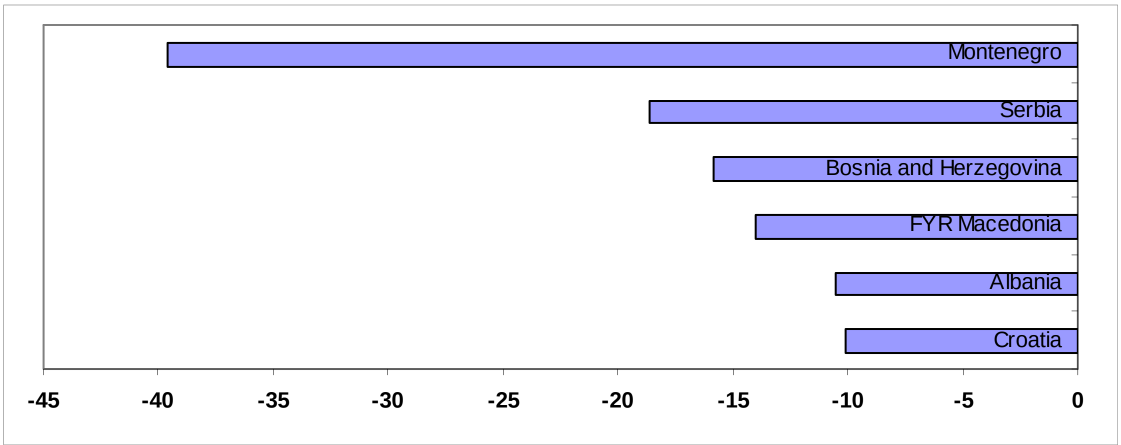
The actual outcomes of macroeconomic policies, also in this respect, have been strikingly similar across the SEE countries. Countries with more flexible exchange rate regimes have not used exchange rate policy to stimulate exports, rather on the contrary, currency appreciation has constrained export growth and stimulated increasing imports. The export capacity has been even lower in countries with a currency board or the euro, also due to additional structural deficiencies and country-specific problems. The main consequence in all cases has been a substantial increase in the trade deficit.

Due to an increasing trade deficit, all SEE countries have also had persistent current account deficits, which reached alarming levels in 2008 (see Figure 1). The high current account deficits have been covered by continuous inflows of capital from abroad—donors' assistance, emigrants' remittances, foreign loans, and foreign direct investment. By late 2008, most SEE countries also had extremely high levels of gross external debt, particularly Croatia (88 per cent of GDP), Montenegro (77 per cent) and Serbia (63 per cent).

Because of their large external financial needs, the SEE countries have been among the most exposed to the global credit crunch (see Uvalic 2009a). Several SEE countries turned to IMF for support late in 2008 and early 2009. IMF has already provided emergency loans to Serbia and Bosnia and Herzegovina, while Croatia, Montenegro, and FYR Macedonia are expected to follow (see IHS Global Insight 2009).

The high dependence of most SEE countries on foreign capital inflows is not of recent origin. In the 1990s, foreign assistance programmes helped economic recovery in

Figure 1
Current account deficits in the SEE, 2008 (in % of GDP)



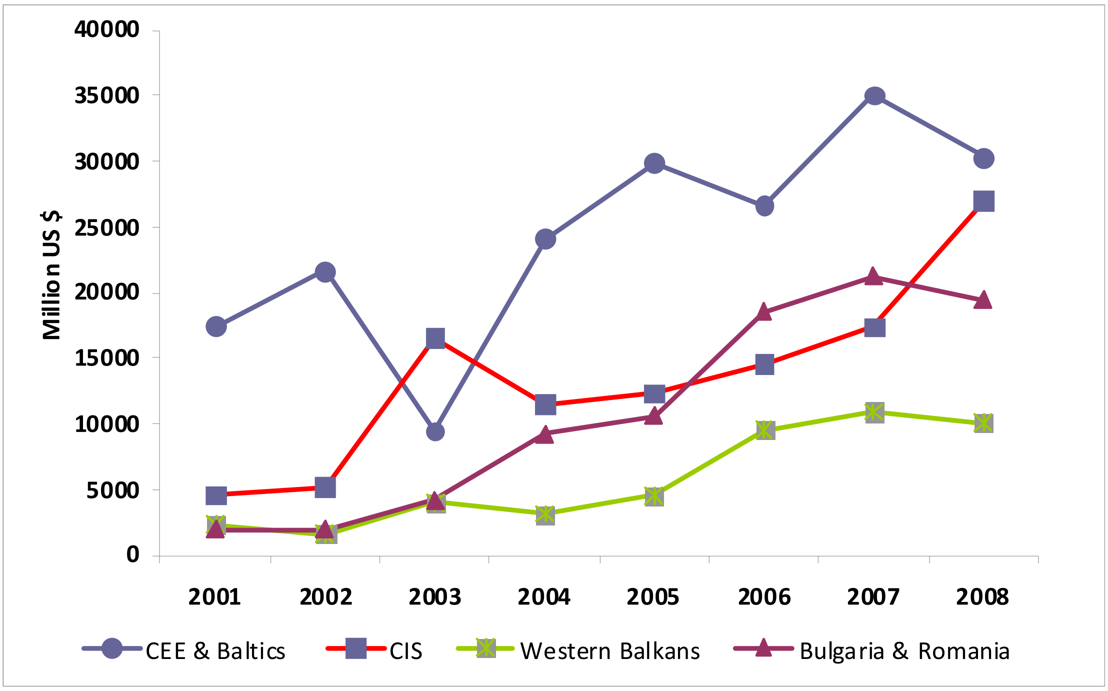
Source: IMF (2008).

Table 5
Net inflows of FDI in SEE countries, 1989-2008
(in millions US$)

	Albania	Bosnia & Herzegovina	Croatia	Macedonia	Montenegro	Serbia	Total FDI in SEE-6
2000	143	146	1,105	175	NA	50	1,619
2001	207	119	1,398	441	10	165	2,340
2002	135	266	552	105	84	475	1,617
2003	178	382	1,927	117	44	1,365	4,013
2004	324	708	732	322	63	966	3,115
2005	258	608	1,551	94	482	1,550	4,543
2006	315	718	3,194	424	585	4,264	9,500
2007	647	2,088	4,736	700	717	2,523	11,411
2008	844	1,003	4,576	612	805	2,717	10,557
Cumulative net inflows 1989-2008							
US$, million	3,505	6,228	23,164	3,226	2,791	15,040	53,954
Per head US$	1,101	1,639	5,215	1,570	4,229	2,005	-
FDI inflows 2008							
in % of GDP	6.6	5.3	6.6	6.4	16.7	5.3	-

Source: EBRD (various issues).

Figure 2
FDI in transition countries



Source: EBRD.

Bosnia and Herzegovina, and were accompanied by externally-imposed reform agendas and inappropriate aid policies. The phenomenon of 'aid addiction'—transfers of large amounts of international resources without the creation of sound conditions for more permanent economic recovery and self-sustaining growth—became an acute problem particularly in the international protectorates: Bosnia and Herzegovina and Kosovo (see Uvalic 2003b), but high dependence on external donor financial assistance was also present in FR Yugoslavia after the 2000 political changes (see Uvalic 2010). Throughout the 1990s, international assistance programmes have contributed little to creating conditions for self-sustaining growth in SEE. Until 2000, the prevalent part of foreign aid in the Western Balkans was not used for productive investment, but for emergency programmes, humanitarian assistance, and food aid (see Uvalic 2001).

Since 2001, the SEE countries have finally attracted increasing foreign direct investment (FDI), after a decade of extremely limited inflows. From 1989 to 1996, the cumulative FDI inflows into the four Western Balkan countries (without Bosnia) amounted to less than US$900 million, or 2 per cent of the total invested into the 27 transition countries (Uvalic 2003a). Even after 1997, FDI in the Western Balkans remained low, representing only 6 per cent of FDI into all 27 transition economies over 1989-2001. During this initial period, 60 per cent of total FDI in the Western Balkans was concentrated in Croatia.

Along with political stabilization after 2001 and the new EU policy for the Western Balkans launched in mid-1999, FDI has steadily increased, particularly after 2006 (see Table 5 and Figure 2). In 2006 Serbia attracted a record FDI of over US$4 billion, thanks to a few major privatization deals in telecommunications and banking. The recent increase in FDI inflows demonstrates a substantial improvement with respect to the 1990s, but the cumulative FDI of some 54 billion into the six Western Balkan countries during 1989-2008 is still fairly low, around 8.2 per cent of the total invested into all transition countries. The limited entry of FDI into the Western Balkan countries until recently, prevalently concentrated in services, is one of the main reasons for the inadequate restructuring of basic industries.

Over the whole 1989-2008 period, Croatia remained notably ahead of the other Western Balkan countries in terms of FDI stock, with US$23 billion, but this is still much less than the US$41 billion invested in Bulgaria or the US$58 billion invested in Romania. The second highest FDI stock is in Serbia (US$15 billion), followed by substantially lower amounts in Bosnia and Herzegovina (US$6.2 billion), Albania (US$3.5 billion), FYR Macedonia (US$3.2 billion) and Montenegro (US$2.8 billion). Regarding cumulative FDI inflows per capita, by 2008 Croatia was again ahead (US$5,215) followed by Montenegro (US$4,229), while the other SEE countries have attracted much less, ranging from US$1,100 in Albania to US$2,000 in Serbia.

The high political risk deriving from the military conflicts in SEE has undoubtedly been the main barrier for more FDI inflows in the 1990s, but political factors also remained important after 2000. Kosovo has so far attracted very little FDI—some 750 million euros over the 2004-07 period (see Commission 2009a). Limited inflows of FDI also stem from the smallness of markets of most SEE countries, from uncertain prospects of EU membership, and from the unsatisfactory regulatory environment.

3.4 Slow catching up and ‘jobless’ growth

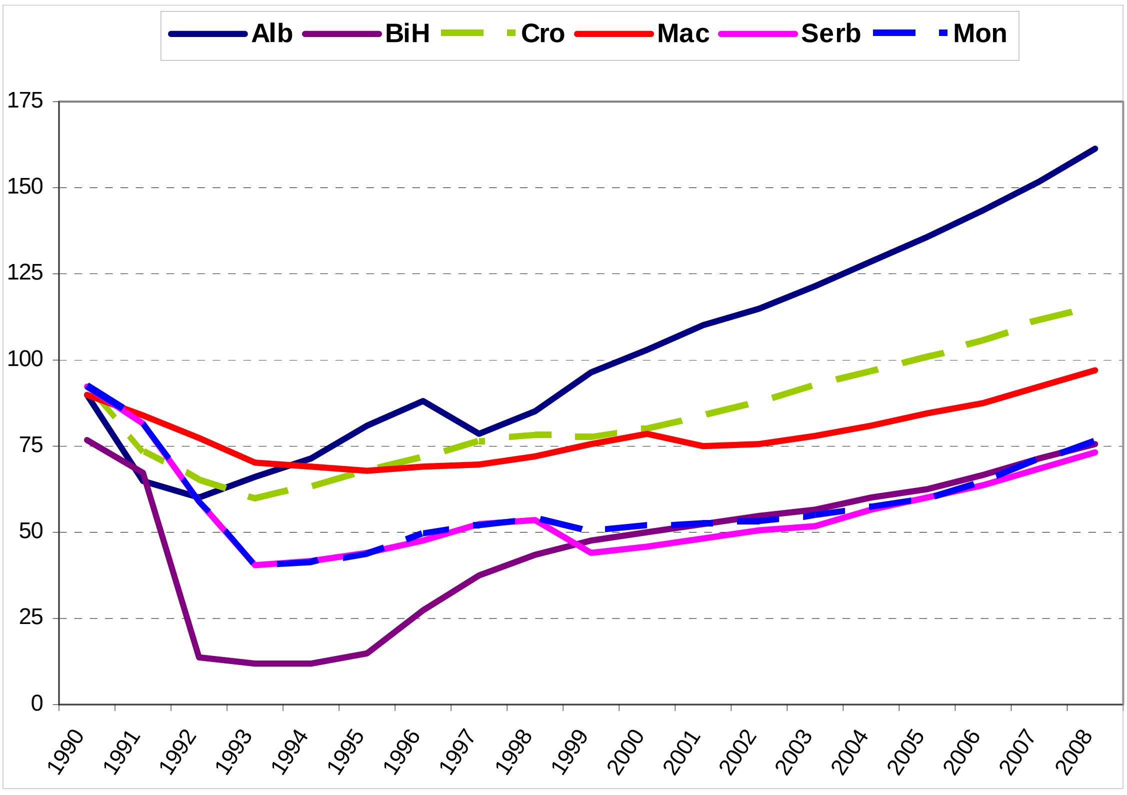
Despite strong growth in SEE in recent years, economic recovery has not been sufficient to compensate for the very substantial output drop of the 1990s. As late as 2005, Albania was the only SEE country that had surpassed its 1989 GDP level, thanks to exceptionally high growth rates throughout most of the 1990s and a very low starting point, while Croatia had just reached its 1989 GDP level. Although there was some further catching-up, the situation is still unfavourable for most countries, especially in comparison to the other countries in the transition region.

By 2008, the estimated real GDP in the nine more advanced countries (the five CEE countries, the three Baltics, and Croatia) was 156 per cent of the 1989 level. In all the 29 EBRD countries it was 140 per cent, while the situation was considerably worse in most Western Balkan countries. Only Albania, Croatia, and Macedonia had surpassed their 1989 GDP levels by 2008, while Montenegro was at 92 per cent, Bosnia and Herzegovina at 84 per cent, and Serbia at only 72 per cent of the GDP produced in 1989 (see Table 4 and Figure 3).

There are presently large differences among the SEE countries in the achieved level of economic development, larger than among the CEE countries (see Table 6). The richest country by far is Croatia, with a GDP per capita (at market exchange rates) in 2008 of over US$13,760; or of US$18,290 at purchasing power parity (PPP), according to estimates of the Economist Intelligence Unit (EIU). If we consider GDP per capita at PPP, the second most developed country is Serbia, but if we consider market exchange rates, it is Montenegro. The poorer SEE countries are Albania, Macedonia, Bosnia and Herzegovina, while the poorest is Kosovo. The EU Commission data show that in 2005 Kosovo had a GDP per capita of only €1,105 (at current prices), while it was €6,643 in Croatia (see Commission of the EC 2006).

Some catching-up has taken place over the past eight years with respect to the EU average GDP per capita, both because growth in the SEE countries has generally been higher than in the EU, and because the EU average has been lowered somewhat after the

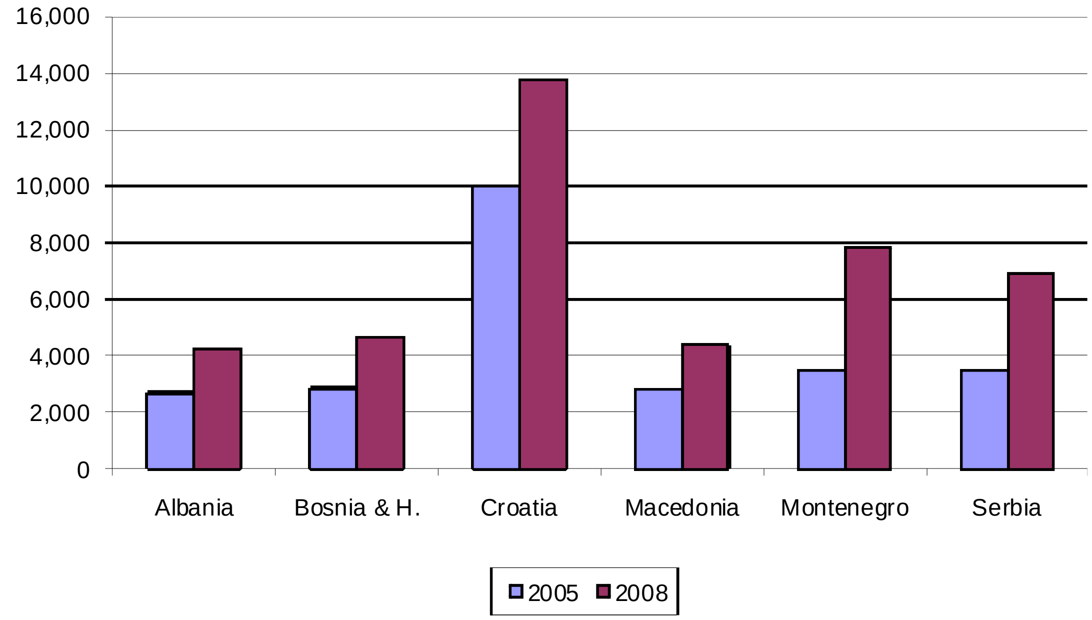
Figure 3
Real GDP growth (1989=100)



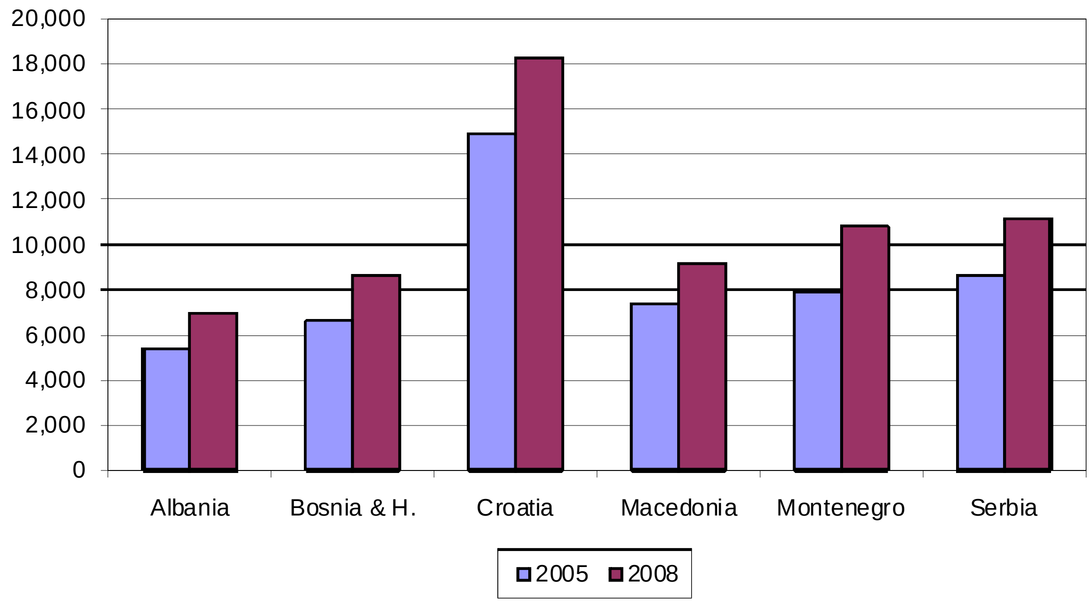
EU 2004-07 enlargements. In 2000, the SEE countries had a GDP per capita (at purchasing power standards, PPS) of only around 10-30 per cent of the EU-15 average (Uvalic 2003b). By 2008, Croatia had reached 63 per cent of the EU-27 GDP per head at PPS, but the other countries were still much further behind: Montenegro was at 43 per cent, Serbia at 36 per cent, Bosnia at 31 per cent and Albania at 26 per cent of the EU-27 average (see Commission of the EU 2009c).

Figure 4
Levels of development of the SEE countries, 2005 and 2008

AT MARKET EXCHANGE RATES



AT PURCHASING POWER PARITIES



Source: Economist Intelligence Unit.

The present relatively low level of development of the SEE countries is also reflected in the structure of their economies. Only in Albania does agriculture still contribute an important proportion of gross value added (21 per cent in 2005). The other SEE countries are less agricultural-oriented, the relative share of agriculture in gross value added had declined by 2006 to 12 per cent in FRY Macedonia, 11 per cent in Kosovo, 10 per cent in both Montenegro and in Serbia, and 7 per cent in Croatia. During 2000-07, these changes were accompanied by a decline in the relative share of industry in all countries except Albania, as well as a very strong increase in the role of services. The process of de-industrialization, which was most intense in the SEE countries in the early 1990s, has thus continued. By 2006-07, the contribution of services to gross value-added ranged from 57 per cent in FYR Macedonia to 69 per cent in Serbia (Commission of the EC 2009a: 61-2). In comparison with the 71.6 per cent share of services in the EU-27 in 2007, the SEE countries' shares seem rather high, considering their much lower level of economic development. Much of the recent growth in many SEE countries (Bosnia and Herzegovina, Montenegro, Serbia and Kosovo) has taken place in non-exportable services such as retail trade, banking and telecommunications, and not in the tradeable goods sector, which further explains the poor export performance of the SEE region.

The high GDP growth rates in most SEE countries have also been largely insufficient to alleviate the problem of very high unemployment. Though all governments have undertaken measures to create new jobs for laid-off workers to stimulate private sector development and to facilitate the entry of new private firms, the SEE unemployment rates are the highest in Europe (see Figure 5). The SEE has been badly hit by the phenomenon of 'jobless' growth, similarly to CEE countries in the first years of transition, but its proportions in most SEE countries have been much greater and there are no signs of improvement.

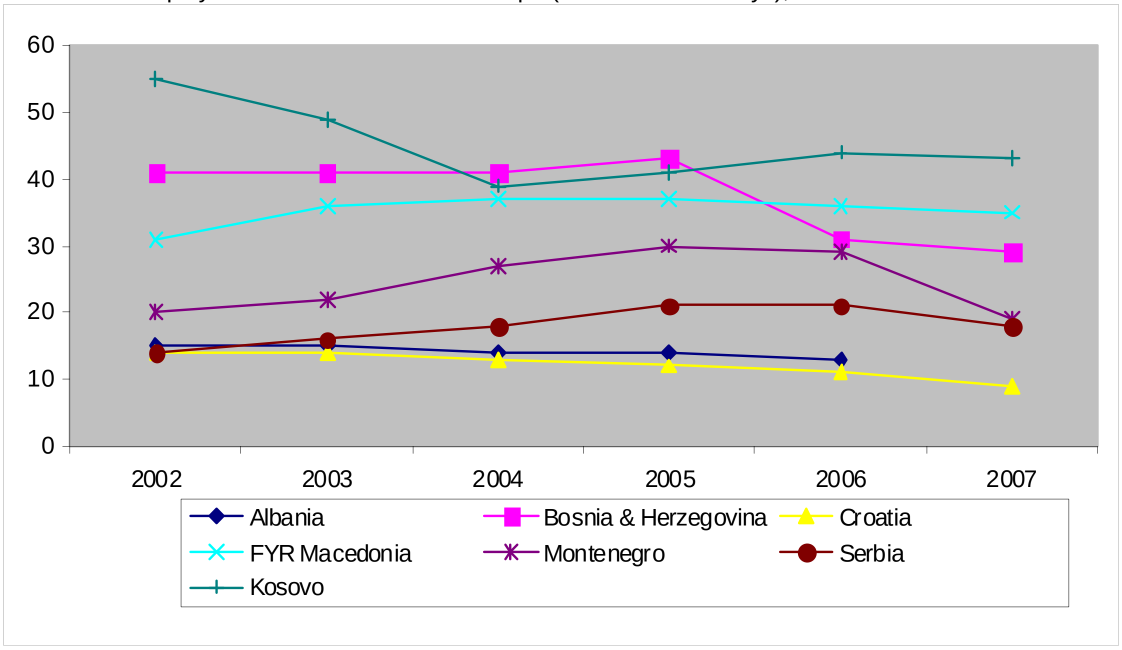
According to the more realistic labour force surveys (LFS), unemployment in SEE has also been extremely high, much higher than in CEE countries in the 1990s. The LFS unemployment rates in 2007 were particularly high in Bosnia and Herzegovina (29 per cent), FYR Macedonia (35 per cent), and Kosovo (44 per cent). Serbia and Montenegro have also had very high unemployment rates, close to 20 per cent or higher, which started declining in Serbia only in 2007. Also in Bosnia and Herzegovina, FYR Macedonia and Kosovo, unemployment rates have either increased or have remained very high over the last 5-6 years. Croatia is the only country that has rather substantially reduced its

Table 6
GDP per head in Southeast Europe, 2005 and 2008 (in US$)

	At market exchange rates		At purchasing power parities		GDP per capita in PPS EU 27= 100	
	2005	2008	2005	2008	2006	2008
Albania	2,690	4,260	5,400	6,920	23	26
Bosnia & Herzegovina	2,850	4,660	6,610	8,650	27	31
Croatia	9,970	13,760	14,940	18,290	57	63
Macedonia	2,820	4,370	7,350	9,140	29	33
Montenegro	3,480	7,850	7,880	10,800	36	43
Serbia	3,500	6,880	8,620	11,160	33	36

Source: Estimates of the Economist Intelligence Unit (June 2009), except for the last two columns which are Eurostat data (Commission of the EC 2009c).

Figure 5
Unemployment rates in southeast Europe (labour force surveys), in % of labour force



Source: Commission of the European Communities (2009a).

unemployment rate, from 15 per cent in 2002 to less than 10 per cent in 2007. Under the impact of the current global economic crisis which has hit all SEE countries, unemployment is likely to increase further.

These very high unemployment rates overestimate the effective number of unemployed workers, as they do not take into account persons having an activity in the informal economy. According to some estimates of the size of the informal economy in transition economies, in the SEE it is generally larger than in the CEE countries, ranging on average in 2002 from 32 per cent in Croatia to 45 per cent in Macedonia, but smaller than in many CIS countries (Schneider 2003). Other estimates suggest that the level of informal activity is the highest in Albania (52 per cent of household income), Kosovo and Macedonia (at 45 per cent and 39 per cent, respectively), while the Bosnian Federation, Serbia and Croatia have the lowest levels at 18-19 per cent (Bartlett 2008: 125).

4 Progress with transition-related economic and institutional reforms

The economic and institutional reforms needed for the transition to market economy have proceeded at variable speed in the individual SEE countries, and were in some of the countries notably delayed by unfavourable political circumstances. Albania, Croatia, and FYR Macedonia have implemented most reforms at a faster pace than the other SEE countries, and therefore have been labelled as the ‘early reformers’ (Bartlett 2008). Bosnia and Herzegovina and FR Yugoslavia (Serbia, Montenegro and Kosovo), in contrast, have postponed more radical economic reforms until fairly recently due to military conflicts and other political problems, and were thus referred to as the ‘late reformers’. FR Yugoslavia implemented radical economic reforms only after 2000, because at that time, the only areas where some results had been achieved were small-scale privatization and price liberalization. Bosnia and Herzegovina still has problems linked to the fragility of its institutions and malfunctioning of the state administration.

All the SEE countries have made substantial progress since 2001 in implementing the most important economic and institutional changes. We will consider the most recent transition indicators of the European Bank for Reconstruction and Development (EBRD), which evaluate progress in various areas of economic reform in all 29 countries in transition, on the basis of scores ranging from 1 (no or limited reform) to 4+ (comparable to a developed market economy). Thanks to the accelerated economic reforms in both FR Yugoslavia and Bosnia and Herzegovina over the last eight years, these two countries have also achieved excellent results in many areas of transition.

The EBRD transition indicators for 2009 show that there are no longer extreme differences between the 'early' and the 'late' SEE reformers (see Table 7), as was the case in 2001. Moreover, there are no major differences between the results achieved in CEE and SEE with respect to some of the easier-to-implement reforms, such as price liberalization, reforms of the trade and foreign exchange systems, or small-scale privatization, since these reforms have been completed by now also in the SEE countries.

All SEE countries have successfully implemented price liberalization and have opened up their economies through thorough reforms of the foreign trade regime, the elimination of quantitative restrictions and substantial lowering of tariff barriers. Small-scale privatization has also been practically completed in all countries except Bosnia and Herzegovina, whereas large-scale privatization, though slower, is well on its way in all the SEE countries (Albania is forging ahead of the other countries). In other areas, progress in the SEE countries has been slower. The most critical areas are enterprise governance and restructuring, competition policies, and the development of securities markets and non-bank institutions. In these three areas, far-reaching reforms have been much more difficult to implement, though these are the areas where changes have been more gradual also in the CEE countries.

Table 7
Transition indicator scores in SEE, mid-2009

	Albania	Bosnia & Herzegovina	Croatia	Macedonia	Montenegro	Serbia
Private sector share of GDP (in %) mid-2009	75	60	70	70	65	60
Enterprises						
– Large-scale privatization	4-↑	3	3+	3+	3 ↓	3-
– Small-scale privatization	4	3	4+	4	4-	4-
– Governance & enterprise restructuring	2+	2	3	3-	2	2+
Markets and trade						
– Price liberalization	4+	4	4	4+	4	4
– Trade and foreign exchange system	4+	4	4+	4+	4	4 ↑
– Competition policy	2	2	3 ↑	2+	2 ↑	2
Financial institutions						
– Banking reform & interest rate liberalization	3	3	4	3	3	3
– Securities markets & non-bank financial institutions	2-	2-	3	3- ↑	2-	2
Infrastructure reforms	2+	2+	3	2+	2+ ↑	2+

Source: EBRD (2009).

The private sector in 2009 accounted for 60-75 per cent of the SEE countries' GDP. Albania is the most privatized SEE economy, with a 75 per cent share of the private sector in GDP. Private sector has grown the least in Serbia and Bosnia and Herzegovina, where it contributes 60 per cent of GDP, thus placing these two countries among the six least privatized economies in the transition region. Privatization frequently has not been sufficient to improve corporate governance or lead to deep enterprise restructuring. In the privatized sector, microeconomic restructuring has often been delayed due to limited access to credit facilities and insufficient FDI in key industries, ineffective systems of corporate governance and lack of managerial skills. In many cases, enterprises were sold at privileged conditions to employed workers and managers, rather than outside owners or foreign investors having the resources and skills to invest in new technology and modernization. Enterprise restructuring and improved governance have taken place even to a lesser degree in the still non-privatized sector of the SEE economies, which is still fairly large in both Bosnia and Herzegovina and Serbia.

However, even less progress has been made in competition policy. Although most SEE countries have reduced subsidies to large non-privatized enterprises and have adopted laws promoting competition, there have been substantial delays in implementing existing legislation, the anti-trust authorities have been ineffective and monopolistic structures continue to dominate in a number of sectors. As a result, in the area of competition policy, all countries except Croatia were evaluated in 2009 by a modest score of 2 (with the addition of a plus or a minus). One of the main factors impeding more competition in all SEE countries is the inadequate regulatory business environment, also with regard to firm entry and exit. Although there have been major improvements in easing the conditions for firm entry, there are still substantial barriers in most SEE countries, as documented by the World Bank 'Doing Business Surveys'.

Another area where developments have been relatively slow is the financial sector. The SEE countries have implemented radical banking reforms, including privatization through the sale of majority shares to foreign banks, although with some delay in some countries like Serbia. By 2003, foreign ownership of the banking sector was already very high in Albania (over 95 per cent of total assets), Bosnia and Herzegovina (70 per cent) and Kosovo (61 per cent) (Commission of the EC 2004). In the meantime, foreign ownership of the banking sector has become dominant also in Serbia and Montenegro: in 2007, the asset share of foreign-owned banks in Montenegro was 79 per cent, and 75 per cent in Serbia (EBRD 2008: 162, 178). At the end of 2008, Serbia had only one bank (Komercijalna Banka) in which the Serbian government had a minority (43 per cent) ownership share (Uvalic 2010). Nevertheless, the loan-to-deposit ratios have generally been lower in the Western Balkans than in the CEE countries, while the net interest spread (the difference between lending and borrowing interest rates) is still relatively high, particularly in Serbia. Mainly as a consequence of delayed privatization, the stock exchange remains underdeveloped in all countries except Croatia, and little progress has been achieved in setting up non-bank financial institutions such as investment funds.

Infrastructure is another area where the SEE countries are still lagging behind the CEE countries, since economic reforms started to be implemented only fairly recently. By 2009, with the exception of only Croatia, the SEE countries were evaluated with a low 2 or 2+. These, however, are difficult areas to reform, and reform has taken place very gradually also in the most developed market economies and sometimes not even very successfully.

Although the progress achieved in transition-related economic reforms within the SEE region has been variable, the differences today are much less pronounced than eight years ago. Croatia, so far, has achieved the best results, in most areas evaluated by the EBRD as well as—or even better—than Bulgaria and Romania. Although the other SEE countries are lagging behind, even the ‘slow’ reformers (Bosnia and Herzegovina, Serbia, and Montenegro) have caught up in most areas of reform and are now approaching the more advanced countries. Thus there has been a major convergence among the SEE countries regarding their institutional framework.

5 International integration of the SEE countries

A decade of marked political and economic instability in the SEE region also delayed their economic integration with the outside world. The situation started to change after the end of the Kosovo conflict in mid-1999, when the EU launched the stabilization and association process (SAP) specifically for the Western Balkan countries. SAP included various measures to help the transition and integration of the SEE countries: generous trade preferences, the possibility to establish contractual relations with the EU through the signing of Stabilization and Association Agreements (SAA), and a new programme of financial assistance. Even more important, the Western Balkan countries were offered the prospect of future EU membership for the very first time since 1989. At the same time, in June 1999, the Stability Pact for South Eastern Europe was adopted by the EU and its member states, other developed countries and major international organizations, aimed at helping the economic reconstruction of the seven SEE countries affected by the 1999 military conflict, in addition to the then five Western Balkan countries, Bulgaria and Romania as well.

Privileged access to EU markets was assured already in 2000, through EU autonomous trade measures which established a uniform system of trade preferences for all Western Balkan countries (FR Yugoslavia was included somewhat later, on 1 November 2000). These trade preferences provided for the elimination of duties and quantitative restrictions for approximately 95 per cent of the goods from the Western Balkans entering the EU market, including agricultural and sensitive industrial products, with only a few exceptions. Privileged access to EU markets is provided even before a country concludes a SAA. The SEE-EU trade liberalization process is being implemented on an asymmetric basis, initially envisaging a greater opening of EU markets than those of the SEE countries. The EU also adopted a new programme of financial assistance specifically for the Western Balkans: the Community Assistance to Reconstruction, Development and Stabilization (CARDS), through which some €5 billion was to be provided over the 2000-06 period.

At the EU-Balkan Summit in June 2003 in Thessaloniki, the prospects of EU membership for the Western Balkans were reconfirmed and further steps were undertaken to strengthen the EU-Balkan integration process. One of the novelties is the introduction of European partnerships for the Western Balkan countries to identify the main priorities and checklists (similar to the earlier partnerships designed for the CEE countries). A new instrument of financial assistance was also adopted in July 2006, the Instrument of Pre-Accession Assistance (IPA), to replace all previous financial assistance programmes. It is through the IPA programme that EU assistance is now delivered to candidate and potential candidate countries—not only to the Western

Balkans, but also Turkey and recently Iceland. The total pre-accession funding within IPA for the current EU financial framework (2007-13) is €11.5 billion.

In the meantime, a more favourable climate was created also for increasing trade among the SEE countries. Thanks to the changed political climate after 2000, one of the most important regional cooperation initiatives of the Stability Pact for SEE is the process of trade liberalization. A Memorandum of Understanding on Trade Liberalization and Facilitation was signed on 27 June 2001 in Brussels by the foreign trade ministers of the-then seven SEE countries (the five Western Balkan countries plus Bulgaria and Romania); Kosovo participates as a separate entity, while Moldova has also joined the initiative in the meantime. The Memorandum led to the conclusion of bilateral free trade agreements (FTA) among the SEE countries, providing for a substantial reduction or elimination of tariff barriers. The process has effectively led to the creation of a free trade area in the SEE region (see Uvalic 2006; Bartlett 2007). After Bulgaria and Romania joined the EU early in 2007, EU trade regulations have superseded the FTAs signed with the other SEE countries.

Since these bilateral FTAs have been criticized as representing a ‘spaghetti bowl’ of differentiated trade relations, another important agreement was concluded in Bucharest in April 2006, when the SEE countries agreed to transform the FTAs into a single agreement, by enlarging and modernizing the current Central European Free Trade Agreement (CEFTA). Known as *CEFTA 2006*, the new single FTA is a modern trade agreement that harmonizes trade rules across the region and incorporates new provisions such as trade in services, intellectual property rights, public procurement and investment promotion.

The overall results of SEE countries’ trade liberalization, both with the EU and with other countries in the region, have been positive. Over the past eight years, the Western Balkan countries have become increasingly integrated with the EU economy (Uvalic 2007b). EU trade has increased faster with the SEE countries than with the rest of the world. The EU has become the main trading partner of all countries, accounting in 2008 for 55–80 per cent of the Western Balkan countries’ imports and exports. The positive trade effects are particularly evident for countries like FR Yugoslavia (Serbia and Montenegro) which had no or limited EU trade preferences before 2000. However, due to much larger imports than exports, the SEE countries have experienced growing trade deficits. Insufficient restructuring and modernization of key industries due to delayed privatization, limited FDI in the majority of SEE countries, and rigid exchange rate policies leading to the real appreciation of national currencies, are among the main reasons for the limited competitiveness of SEE products on EU markets.

The process of trade liberalization within the SEE region has also had a positive influence on regional trade. Most SEE countries have registered an increase in trade with other countries in the region, although the impact has been extremely uneven across countries (see Uvalic 2009b). The initiative has had very marginal effects in Albania, Bulgaria and Romania, where the EU’s much earlier trade liberalization measures have facilitated a major reorientation of trade primarily towards the Union. In contrast, regional trade for most countries of former Yugoslavia has remained an important part of their overall trade and intra-SEE trade liberalization has further stimulated its expansion.

In 1989, the most integrated part of the SEE region was the Yugoslav economy, and 18 years later the successor states of the former Yugoslavia are still the more integrated economies in the region—a paradox, since the break-up of the Yugoslav federation, the imposition of trade and non-trade barriers, the multiple military conflicts of the 1990s, and the economic sanctions imposed on some countries, have clearly pushed in the opposite direction. This reconfirms that historical trade links inherited from the past are of fundamental importance for the Western Balkans (see Uvalic 2006). Although all the SEE countries have made major efforts to reorient their exports primarily towards the EU countries, this has often given limited results. Thus, being able to find alternative, more liberalized markets in the SEE region has helped their exports grow more than otherwise would have been the case.

In addition to increasing trade, over the past eight years the SEE countries have become more integrated with the EU through other channels such as FDI and financial integration. The largest part, by far, of the recent FDI inflows to the SEE economies originates from EU countries. Western Balkan-EU integration has also taken place through increased integration of financial and capital markets, prompted further by privatization of the banking sector. As mentioned earlier, major EU multinational banks today own 60-95 per cent of the banking assets in Western Balkan countries. Foreign ownership of banks was a welcome feature in the process of bank restructuring and privatization, although it has recently rendered the Balkan countries more vulnerable to the current global economic crisis.

In contrast to the accelerated EU-SEE economic integration, the pace of establishing contractual relations with the EU has been disappointing. Only two countries were able to sign SAAs with the EU early on: FYR Macedonia in April 2001 and Croatia in October 2001 (see Table 8). For the other SEE countries the process has been substantially delayed, frequently due to very strict EU political conditionality. Albania concluded its SAA only in June 2006, and Montenegro in October 2007. The last two countries to sign an SAA were Serbia (April 2008), and Bosnia and Herzegovina (June 2008). In the case of Serbia, the ratification of the SAA and the application of the interim trade agreement were postponed for more than a year, due to its non-compliance with political conditions (insufficient collaboration with the International Criminal Tribunal for the former Yugoslavia); the process was unblocked only in late December 2009.

As a result, the SEE countries today are at very different stages of the EU integration process. Croatia is the only candidate presently negotiating EU membership with the objective of joining in 2012; FYR Macedonia is a candidate country but accession negotiations have not yet commenced; Montenegro and Albania have applied for candidate status which needs to be approved; Bosnia and Herzegovina and Serbia are still potential candidates, while Kosovo has a special status under the so-called 'tracking mechanism'.[6] With the exception of Croatia, the prospects of EU membership for the SEE countries are rather uncertain, despite promises regarding accession reconfirmed by the EU on various occasions.

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6 Since 2001, the Kosovo provisional authorities under UNSCR 1244 have prioritized the European agenda and committed to a long term European integration process. A permanent technical and political dialogue with Kosovo authorities, called the SAP tracking mechanism (STM), has been established to provide sound policy advice and guidance to Kosovo's reform efforts. Under the SAP tracking mechanism, regular meetings have been held to assess Kosovo's progress in realizing European partnership recommendations.

Table 8
Stabilization and Association Agreements signed by the EU and the SEE countries

Country	Date of signature	Date effective
FYR Macedonia	9 April 2001	1 April 2004
Croatia	29 October 2001	1 February 2005
Albania	12 June 2006	1 April 2009
Montenegro	15 October 2007	Ratification process not complete
Serbia	29 April 2008	Ratification process not complete
Bosnia and Herzegovina	16 June 2008	Ratification process not complete

6 Understanding delays in transition in SEE

The ongoing analysis of macroeconomic performance and transition-related economic reforms in the SEE countries suggests that there has been major convergence over the past eight years. Although some SEE countries had achieved the desired objectives much earlier, macroeconomic performance after 2001 has also improved in the 'late reformers' that were characterized by extreme economic instability in the 1990s. Similarly, many transition-related reforms have now been carried forward and implemented successfully in countries that were institutionally lagging behind in the 1990s: Bosnia and Herzegovina, Montenegro, Serbia. Today we observe a substantial reduction in the institutional differences not only among the individual SEE countries, but also with respect to the CEE countries.

Yet, most Western Balkan countries today still lag behind in certain aspects of economic reforms, in the level of economic development, and in the EU integration process. One might have expected that the extent of market-oriented reforms undertaken in the past, which provided all of the Yugoslav successor states with initial conditions that were among the best within the former socialist countries, would have been a substantial advantage, facilitating the transition. However, most SEE countries, instead of being leaders among the transition countries, have turned out to be laggards (Estrin and Uvalic 2008). Why has not the success of CEE been replicated in the Western Balkans?

There is an enormous empirical literature that tries to disentangle the role of various factors responsible for the diverging progress of the individual transition countries that considers the importance of initial conditions, policies such as privatization and liberalization, and institutions (see, for example, Godoy and Stiglitz 2007). Over the last 20 years, the SEE countries have experienced very different paths of transition, but it seems even harder in their case to establish the determinants of variable transition paths. This is because there are additional factors in the SEE region that have fundamentally influenced the different pace and contents of transition. Three groups of factors are primarily considered to be responsible for the delayed attainment of some transition objectives in SEE:

i) political events,

ii) delayed integration with the EU, and more arguably,

iii) inappropriate economic policies.

The *political events* of the early 1990s—primarily the break-up of the Yugoslav federation and the military conflicts accompanying it—interrupted the economic transition. These rendered other priorities, primarily the building of nation states, more important, even at the cost of military conflict, international isolation, and high economic instability. After the disintegration of former Yugoslavia, the pursue of political objectives rendered some of the objectives of the transition to market economy secondary. As a result, the overall political and economic conditions in the SEE region during the 1990s were fundamentally different than those in CEE. The legacy of the 1990s, a decade marked by extreme political instability, left a heavy burden on most SEE countries, including delicate problems relating to borders, status, return of refugees, and minority rights. In addition, the political events of the 1990s have had very profound and long-term economic consequences not only on those countries that had to bear major responsibility for them, but for the entire SEE region. Albania and FYR Macedonia, although not directly involved in the Balkan military conflicts in the 1990s,[7] also experienced the negative effects of political instability in the SEE region, as illustrated by the limited FDI inflows, or delayed association to the EU. Despite major improvements in macroeconomic performance and the fast implementation of transition in all SEE countries after 2001, these have not been sufficient to compensate fully for the negative trends of the 1990s. Even after 20 years, half of the countries still have not attained their 1989 GDP levels.

The second group of factors that explains the slower pace of economic transition in the Western Balkans is *delayed integration with the EU*. EU policies towards the Western Balkan region, particularly in the 1990s, were very different than those applied to the CEE countries or even other SEE countries (Bulgaria, Romania, or Slovenia). Due to the outbreak of war in SEE in the early 1990s, the EU failed to elaborate a longer-term strategy for the Western Balkans, which in turn substantially delayed their integration with the EU. In the early 1990s, in order to be offered substantial financial support through PHARE and other forms of assistance, it was sufficient for the CEE countries to declare their desire to implement the transition to multiparty democracy and market economy. Association Agreements with the EU were concluded soon thereafter, during 1993 to 1996. The Western Balkan countries, in contrast, were not offered more substantial financial assistance and the possibility to conclude Association Agreements with the EU until the year 2000, and the whole process has been extremely slow. The non-fulfilment of the required conditions that have become even more numerous for the Balkan countries than for the CEE states, together with very strict EU political conditionality, has delayed the EU-Balkan integration process quite substantially, so that the Stabilization and Association Agreement with the EU was not concluded by a few Western Balkan countries until 2008.

The third factor which accounts for the SEE countries' slower transition progress is *inappropriate economic policy*, although this is somewhat more controversial. Some SEE countries have postponed the attainment of transition-related economic objectives because of exceptional political circumstances (Bosnia and Herzegovina), or because of the deliberate choice of a 'gradualist' transition strategy (FR Yugoslavia). The economic policies implemented in Serbia in the 1990s were often reversals of progressive transition-related economic reforms implemented in 1989-91, or were even

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[7] The 2001 civil war additionally destabilized the Macedonian economy, but this happened only ten years after Yugoslavia's break-up.

a return to practices long abandoned in former Yugoslavia (Uvalic 2007a). Only more recently have these countries introduced more radical economic reforms, very similar to those implemented in the other SEE countries some years earlier.

While the timing of transition-related economic reforms was different in the single SEE countries, the contents were similar, designed on the lines of the orthodox transition policies implemented elsewhere in CEE, and based on the recommendations of the Washington consensus (see Williamson 1990). The SEE-country economic policies have focused on liberalization, macroeconomic stabilization, exchange rate stability, and privatization, often disregarding the negative effects of restrictive monetary policies for the real sector of the economy. The high monetary instability in the SEE region in the early 1990s, and the frequent presence of the IMF, fundamentally influenced the monetary policies intended to minimize inflation irrespective of the effects on growth. This type of policy was implemented in some SEE countries despite the fact that experience of excessively restrictive macroeconomic policies in certain transition countries, proposed as part of the 'post-Washington' consensus (Kolodko and Nuti 1997: 49-52), had already indicated very high costs in terms of slower growth.

Other important messages of the 'post-Washington' consensus were also mostly ignored in SEE (see Kolodko and Nuti 1997). The new consensus stressed the importance of the 'organic' growth of the private sector through the expansion of *de novo* enterprises rather than just privatization of existing firms; the importance of corporate governance as opposed to a mere transfer of property titles; and recognition of the negative consequences of neglect or discriminatory penalization of the state sector. At a time when the invisible hand of the market continued to be glorified, the post-Washington consensus stressed the new role of the state and active government policies, not just *less* government but *a different role* of the government. In particular, the importance of industrial policy was pointed out, for example, by promoting investment in certain sectors, improving access to credit for small and medium enterprises, encouraging innovation, or in introducing and protecting quality and technical standards.

It is precisely these areas of reform that were neglected in SEE countries. As a result, the process of industrial restructuring has been slow, contributing to limited competitiveness and insufficient export growth. Although the first decade of transition in CEE has produced many important lessons, mistakes from the early years were forgotten only too readily by the SEE countries that embarked on radical reforms much later, like Serbia (see Uvalic 2010). Despite strong growth since 2000, most SEE countries today are relatively underdeveloped: only three SEE countries had reached their 1989 GDP levels by 2008; they have Europe's highest unemployment rates; and due to the structural weaknesses of their economies, all face very serious external imbalances. This rendered the SEEs particularly vulnerable to the global financial and economic crisis.

In addition, there are a number of specific elements that could be criticized. The hyper-liberal policies applied in the early 1990s in Albania and FYR Macedonia, backed by the IMF-supported shock therapy programmes, contained a number of fatal flaws. The substantial cuts in government expenditure that reduced the role of the state to a bare minimum had adverse consequences for certain sectors such as education or health. There were even greater policy failures in international protectorates such as Bosnia and Herzegovina or Kosovo, where liberalization, stabilization and privatization brought highly disappointing results, stable currency being the only exception. Economic recovery of these war-devastated economies has been very slow, institution-building has taken much longer than expected, and many solutions imposed externally have been notorious failures; to mention one, the private pension fund in Kosovo, invested entirely in mutual investment funds outside the country (Bartlett 2008: 154). Judging by the low level of development in FR Yugoslavia (Serbia and Montenegro), acceleration of transition-related reforms since late 2000 and strong economic recovery have not been sufficient to alleviate the negative effects of the earlier decades. In Serbia, capacity restructuring constituted almost entirely of privatization, a process which has proceeded very slowly and has not been accompanied by other important measures, such as improving the regulatory environment for enterprise entry, or increasing competition through effective anti-trust policy (Uvalic 2010). Croatia has achieved better progress with regard to many reform objectives, and is the most developed among all SEE countries, but this is also due to its good initial position: it was the second most developed Yugoslav republic (after Slovenia) in 1991. Croatia still has a number of reforms to complete and its recent growth has been based on heavy borrowing from abroad, making it presently the most indebted SEE country and among those most severely hit by the global economic crisis.

Some of Popov's (2009) reflections about the lessons from the transition economies seem appropriate also for the SEE region. Optimal policies are context dependent: they depend on specific backgrounds and are different for each stage of economic development. There are no universal recipes, as there is more than one route to success. The reforms needed to stimulate growth are different and depend on the historical legacies. Indeed, path dependency and historical legacies have been very important for all the SEE countries, yet these facts have not been sufficiently taken into account in the policy advice offered to the region during the last 20 years.

7 Conclusions

By 2009, most SEE countries had successfully attained many of the economic objectives of the transition to market economy. The only possible exception is Kosovo, which is still in a rather difficult political and economic situation.[8] The SEE countries have become more open market economies with dominant private ownership, have reformed many key institutions, and have liberalized their trade with the EU and with their neighbours. Their financial sector is dominated by foreign-owned EU banks, and there is an emerging stock exchange in all capital cities. Over the past eight years, the SEE countries have been among the fastest growing transition economies. They have reached substantial macroeconomic stability, have had stable or slightly appreciating internally convertible national currencies, have accumulated substantial foreign exchange reserves reducing the risk of external insolvency; privatization opportunities still abound and FDI has been on the upward trend, at least until mid-2008. With respect to a mere eight years ago, the gap regarding transition-related economic reforms within the SEE region between the early and late reformers, as well as between the Western Balkans and the CEE countries, has been greatly reduced. Strong economic integration

8 Kosovo declared political independence in February 2008, but by late 2009 it was still not recognized by the United Nations and a number of countries, including three EU member states (Cyprus, Romania and Spain). It is the least developed of all the SEE economies. In May 2009, it has obtained membership in the IMF.

of the SEE countries with the EU has also taken place through increasing trade flows, FDI, and financial integration, even though the establishment of contractual relations has proceeded at a much slower pace.

During the last 20 years, the SEE countries have achieved many important transition objectives, but there have been a number of failures as well. Today's low level of output with respect to 1989 illustrates how deeply the recession of the 1990s (and the political events that greatly amplified it) has affected the SEE economies, since the impacts have only partly been alleviated by strong economic growth after 2000. The history of very high and persistent inflation has led all SEE countries, some earlier and some later, to subscribe to the safe recipe of very restrictive monetary policies. While these policies were successful in reducing inflation, they have not assured longer-term economic development and a fast catching-up with the more developed European countries. The limited restructuring of many industrial sectors in most SEE economies and the failure to establish an appropriate institutional, regulatory and legal framework have failed to generate the supply response necessary for reducing unemployment and generating sustained economic development (Daviddi and Uvalic 2006).

Although the EBRD in 1995 made a sharp distinction between the concepts of *transition* and *economic development*—with transition being defined as the process of establishing open market economies through institutional change, while development refers to the enhancement of living standards—it is clear that transition to a market economy has been largely motivated by the pursuit of economic development (Kekic 1996). The systemic changes necessitated by the transition to market economy should, therefore, also have been a major instrument for attaining longer-term economic development, but this has proved more difficult to achieve in the SEE countries. Transition-related institutional changes implemented in a particularly unstable political and economic environment have not favoured fast economic development.

There are still a number of economic tasks to be accomplished in the SEE countries, yet political challenges are just as important. The SEE countries need to make a major effort to resolve the remaining political issues, as this is in the interest of all. The EU should also reconfirm, in a credible way, the prospects of EU membership for the Western Balkan states. In order to accomplish permanent stability in the Western Balkans, it is essential to integrate all countries into the EU as soon as possible, not only economically but also politically.

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