DEVELOPING THE ECONOMIES OF SOUTH-EASTERN EUROPE

*Harry Cohen**

NATO Parliamentary Assembly, Sub-Committee on East-West Economic Cooperation and Convergence, Chairman (United Kingdom)

Last year's conflict in Kosovo has had a plethora of strategic and political ramifications which are recasting the very purpose of key institutions governing European political and economic life. The conflict was an unfortunate consequence of long-standing and worsening regional instability and, more specifically, of the hideous policies of the Milosovic regime which have done so much to exacerbate regional tensions. Yet, it has also served as a wake up call to the trans-Atlantic Community and a blaring reminder that flitting attention to the problems of South-Eastern Europe's transition has been a self-defeating policy. The continent is too small, borders are too porous, and economic forces and technology have galvanized the process of integration to such an extent as to make it impossible to contemplate the notion that what happens in the Balkans does not really matter. All of this seems perfectly self evident today. But until recently, the Western approach to the region was largely one of crisis management and short-term measures designed to quell overt violence, but inadequate to the task of promoting the kind of integration that will bring long-term peace and stability to the region.

Throughout most of this decade, the European Union was largely consumed with ensuring the successful adoption of the Euro, extending membership to the Union to a limited number of states, and undertaking the kinds of institutional reform that would allow the Union to manage that process. In the wake of the conflict in Kosovo, it has placed the development of a much sharpened foreign policy and security identity squarely at the centre of its agenda. Coping with the emergency situation in much of South-Eastern Europe and ultimately fitting that region into the institutional and economic life of the continent has accordingly emerged as one of the top priorities for Europe. By virtue of its distance and the already considerable sum it has expended in fostering a higher degree of regional security, the United States has happily conceded the lead to Europe in this field, while nonetheless recognizing the importance of its own economic and security engagement there.

The economic, political and institutional challenges the region faces, however, are extraordinarily daunting, and those helping to meet these are girding themselves for a decades-long commitment and the likelihood of a fair share of setbacks along the way. Much of the Balkans never underwent free market oriented economic development, and thus the challenges lie not only in garnering resources, but fundamentally altering political practices, reorienting civil societies, building integrative infrastructure, and recasting legal structures. A comprehensive and fresh set of approaches to regional economic revitalization is therefore essential. In the past, the West tended to treat issues and countries in the region separately. By narrowing its collective imagination to such conceptual boxes, it was not sufficiently prepared to identify the broad region-wide challenges that have long demanded political attention. In this sense, Western policy itself was "balkanized". In the wake of the recent conflict, however, the trans-Atlantic community of nations has finally begun to articulate a broader regional approach in which security, democracy and economic reconstruction are organically linked.

Before examining the region wide challenges to economic development and integration, however, it is first essential to sketch out the critical economic circumstances several of the region's countries confront. The Balkan states are hardly homogenous; to the contrary, the economic and political landscape is so variegated as to make absolute generalizations of little use.

The Situation in Kosovo

Political stability is the handmaiden of economic development, and sustainable economic growth is impossible without a legitimate state capable of establishing the rule of law, coherent administration, economic rules of the game, and, even more fundamentally, civil peace. To varying degrees and in different ways, many of these fundamental conditions are not being met in any of the three regions of the FRY.

Although many pundits were tempted to characterize the end of the conflict in Kosovo as a new beginning, the situation in that strife weary province gives an almost false ring even to expressions of cautious optimism. That most of the hundreds of thousands of Kosovars who were expelled have returned home seems almost extraordinary. That there are emergency services in place granting the population the food, shelter and energy it needs to survive the winter reflects the rapid mobilization of governments, international organizations and NGO's to respond the dire situation as does the fact that repairs to basic infrastructure have begun. But for those looking at longer term prospects, the news is not good.

First of all, if military conflict in the province has been put to end, violence remains a serious problem. Nine years of grotesque repression at the hands of the Milosovic regime has left the Kosovar Albanian population, and particularly the younger people who have no real recollection of ethnic co-existence, in a vengeful frame of mind. In the oft-times lawless climate in certain parts of the province, dozens of innocent ethnic Serbs have been murdered, and thousands have felt that they had no alternative but to abandon the province or move to

Serb enclaves. Kosovar Albanians in predominantly Serb regions have also suffered terrible retribution. The capacity of KFOR troops and still under-manned police forces (only 2000 of an expected 6,000 international policemen have been deployed in Kosovo) to provide blanket protection to exposed minorities is obviously limited, but in certain areas, anything short of such protection invites ethnic attacks.

In this environment, the lofty goal of achieving ethnic reconciliation in Kosovo has given way to a much diminished aspiration to furnish basic protection to those living under threat of ethnic reprisal-ethnic Serbs, Slav Muslims and Roma, and in the Serb majority area, Kosovar Albanians.[1] Yet, even this is proving a genuine challenge. There is no effective justice system in place, and many of those arrested for criminal activities are invariably released. KFOR troops are under enormous pressure to contain ethnic hostility in areas like Mitrovica where grave tension gave way to serious violence in February.

The ethnic divide has critical economic consequences. Kosovo not only must recover from the horrible violence carried out by the Yugoslav army and military groups, but also it has to overcome the legacy of nine years of exploitative Serbian rule in which the Kosovar Albanian majority was denied a voice in government and utterly marginalized economically and socially. Kosovar Albanian schools were shut down, farmers were denied seed and other basic inputs and Kosovar Albanian workers were expelled from state-owned companies. The collective damage to basic physical and human capital as a result of these policies is almost incalculable.

Not surprisingly, the restoration of order and the creation of a working state apparatus represent key immediate priorities for the international community. The thinking is that once these are in place, the difficult task of fostering some degree of ethnic co-existence can begin. UNMIK has recently taken steps to rationalize Kosovo's administrative structures and to ensure some degree of domestic political control over it. The new governing body oversees 14 governmental departments which were previously operating without sufficient coordination.

As of January 31, 2000 a joint administrative structure has been in place, led by four members of UNMIK and three political representatives from Kosovar Albanian parties. The provisional government of Hashim Thacci and Ibrahim Rugova has had to merge into this structure.[2] Importantly, the Serb party, which was invited to participate, is boycotting the project, claiming that the new administrative system represents a step towards Kosovo's secession from the FRY.

The latest reports, however, suggests that these important steps have done little to improve the governability of the province. The stand-off in Mitrovica is only the most visible manifestation of the myriad problems besetting UNMIK, KFOR and the donor community. Bernard Kouchner has complained that despite significant aid pledges, he still lacks the resources to create a functioning government apparatus and is spending an increasing amount of time simply trying to secure needed funds. UNMIK requires $325 million to cover basic public services and government workers pay, and teachers and refuse collectors must be paid. Failure to cover those costs will only place greater burdens on KFOR troops,[3] and it is also creating a certain degree of trans-Atlantic friction which could erode much-needed Alliance solidarity as far as the approach to Kosovo is concerned.

The sources of Kosovo's economic crisis are not dissimilar to the roots of its great political predicament. Kosovo's banking system is virtually non-existent; the Serbs had simply eradicated all Kosovar Albanian credit institutions in 1990. Accordingly there are no solvent banks operating in Kosovo and no effective regulatory framework exists to facilitate their emergence. Not surprisingly, the few foreign investors attempting to conduct business in Kosovo face an array of barriers beyond the general instability. Corporate law is virtually non-existent and companies operate in a kind of legal limbo where what is permissible and what is not is a matter of guess work. The communications network is extremely unreliable; truck queues can last up to seven days on the borders and public financing is now secured with a prohibitively high import duty of 26%. Organized crime, the flip side of a weak state, poses a serious impediment to an economic take-off. Finally the agricultural system is seriously degraded. This has particularly serious consequences in a province where 70% of the population lives in the countryside and to varying degrees directly depends upon the farming sector. Direct Serbian rule resulted in a serious degradation of rural investment, and production fell 50-70% throughout the last decade. Land mines now litter the countryside and this too is makes a rapid agricultural recovery all but impossible.

Kosovo's woeful infrastructure poses another set of problems. According to one UNMIK official in January, the power supply for Kosovo has deteriorated over the course of the winter, and the province desperately needs new power generating capacity. The Serbian power industry has curtailed its daily supply of 75 megawatts of electricity, and in January, Pristina was enjoying only six hours a day of power.[4] Neither the telecommunication system nor the postal service were functioning at the war's end, and both were seriously degraded due to years of neglect and low or no investment. Water is in poor supply and of low quality, and pipe leakage's cause water supply losses of up to 50% in some towns. Finally, the basic public health system is in very poor condition-something made apparent in demographic statistics. The UN Population Fund and the World Health Organization recently reported that none of the maternity wards in Kosovo meet basic reproductive rights standards, and there are 54 deaths per 1000 births as opposed to 5.6 in the EU.[5]

The Aid Effort, Priorities and Problems

How to turn around this disastrous economic situation represents one of the great challenges facing the World Bank and the EU which are jointly leading the economic aid effort. A serious problems for donors to Kosovo has been the lack of a strategic framework and the many obstacles to coordinating aid particularly on the ground. Kosovo is highly unstable, and even to say it is now in a post-conflict phase is somewhat misleading. Moreover, the problems are not simply due to last year's conflict but can also be traced to a decade of purposeful economic neglect and political marginalization at the hands of the Milosevic regime, decades of inefficient Yugoslavian economic policy, as well as a history of underdevelopment. UNMIK and the long list of international organizations and NGO's operating in Kosovo today must cope with this fundamental reality, which not only burdens the economy but penetrates deeply into the fabric of Kosovar society. With KFOR providing overall security, the UN High Commission for Refugees dealing with resettling issues, UNMIK overseeing public administration, the OSCE in charge of elections and media and the EU coordinating the aid effort, the task of aid and development integration has proven extremely trying.

UNMIK itself is organized along four pillars covering humanitarian issues, civil administration, democratization, institution building and economic development, the last of which, the EU is managing. The immediate requirement has been to meet the basic needs of a population living in dire circumstances and to coordinate the efforts of various donors in this critical area. But over the long-term, the EU will seek to lay the foundations of a modern well functioning market economy supposedly by generating the resources needed for basic public institutions, the construction of a payments system, and well regulated financial, utility and telecommunications systems. The Commission has created an Agency for the Reconstruction of Kosovo to prepare and implement reconstruction programmes and to coordinate it own efforts with those of other organizations.

The modalities of underwriting and administering aid to Kosovo has generated no small amount of controversy within the EU. The Commission, for example, has earmarked Euro 500 million for Kosovo's reconstruction but has had to engage in some budgetary slight of hand to reach this number. The Council recently proposed an across the board cut in other external policy programmes to fund this initiative, but the European Parliament has strongly opposed this and even threatened to withhold funds for reconstruction to pressure EU Finance Ministers to increase overall funding for foreign policy initiatives. Parliamentarians are particularly irritated that the Commission had committed to multi-year financing at the Kosovo Donors' conference, but did not reflect these commitments in its budget proposals.[6] Agriculture Commissioner Franz Fischler has agreed to reduce his Directorate's budget for 2001 by 300 million Euro to underwrite the EU's Balkan initiatives, but the debate has given a sense of how difficult it is for the EU to shift resources from heartily defended internal budgets to fashionable but more politically exposed international programmes even though member governments have made CSFP a top institutional priority for the Union.

Although there has been a significant promise of aid to Kosovo, much of the money has yet to be spent. The Commission has encountered bureaucratic delays disbursing funds, and this is partly due to new and stricter spending procedures. On the Commission side, the problem not only involves cumbersome financial controls but also inter-Directorate rivalries and a shortage of personnel. The other half of the problem, of course, is that the quality of public administration in the region itself is not impressive, and financial controls are very lax.[7] Finally, aid distribution has become a critical source of political patronage in Kosovo, and control over these levers is granting some rather undemocratic figures growing political clout.[8] Concerns about aid misappropriation are therefore entirely justified, and close scrutiny is essential.

Nevertheless spending delays have fomented a certain degree of trans-Atlantic tension. Secretary of State Madeline Albright recently hinted at American frustration with the aid effort in Kosovo, saying, "Here, as with the region as a whole, it is vital that our partners join us not only in pledging generously, but also in disbursing promptly".[9] The Commission now recognizes the problem and has set up a special task force for the Balkans to cut through the red tape which heretofore had slowed up assistance payments. The Americans have welcomed this, but at the same time U.S. officials and members of Congress continually allude to a tacit *quid pro quo* by which the Americans, who shouldered the greatest share of the military burden, now expect the Europeans to take the lead in Kosovo's rehabilitation and economic construction effort.

Montenegro's Quest for Autonomy

Uncertainty regarding its sticky relationship with the FRY is complicating long-term economic development in Montenegro. The Republic's President, Milan Djukanovic has publicly flirted with putting Montenegro's status within the FRY to a referendum, but for the moment, his government appears to have shelved this risky course. The immediate goal now is to secure greater autonomy from federal authorities and to distance the Republic from the consequences of that regime's economic and political policies, but even this is fanning the flames, and many now speak of an almost inevitable military conflict between the two Republics.

The Montenegrin economy has declined substantially over the last decade and is beset by criminal activities like smuggling and trafficking in stolen goods.[10] Montenegro's uncertain status weakens its capacity to pursue autonomous economic policies, establish normal economic relations with the outside world and attract foreign investment. Moreover, there are few guarantees that economic aid to and commerce with Montenegro will not directly or indirectly benefit federal authorities. This poses a trying dilemma for Western leaders who must craft a policy which rewards Montenegro's apparent commitment to democratic freedoms and European integration but nonetheless continues to penalize Milosevic's

Yugoslavia. Moreover, Western governments prefer that Montenegro remain in the FRY and become a force for democracy within the Federation; secession opens a Pandora's box of potential horrors into which no Western government wants to peer.

The Montenegrin government, however, has only widened the gulf between itself and Serbia. On November 2, 1999, the government declared that the D-Mark would henceforth act as a parallel currency to the Dinar. A new central bank and monetary authority were established with price stability to constitute the central object of policy. This was not simply a play for independence; the Federal Republic of Yugoslavia has been struck by sky-rocketing inflation that price controls have yet to quell, and Djukanovic wants to insulate his Republic from the nefarious effects of hyper-inflation. Needless to say, the Milosevic regime strongly opposes the notion of Montenegrin monetary sovereignty, in part, because it means that Serbia can no longer purchase goods from Montenegro at artificially reduced prices. The FRY's Constitutional Court recently declared Djukanovic's monetary strategy illegal - a ruling which was made without the two Montenegrin judges on that court.[11] Belgrade is now holding up all payments to that Republic and denying it access to subsidized food. In March, Serbia imposed a full economic blockade on its fellow Republic and significantly tightened up border controls.[12]

Montenegro has been tightly integrated in the Serbian economy, which normally accounts for some 70% of its trade.[13] President Djukanovic is looking to Europe to compensate for the loss of trade with Serbia, and the EU has responded with Euro 14 million in aid this year.[14] The President also hopes to participate actively in the Stability Pact and even begin the long process of joining the EU. There is certainly scope for Montenegrin participation in Stability Pact programmes, but without sovereign status and given the fact that the federal government is now an international pariah, Montenegro's imminent participation in, for example, the Stability and Association Agreements, is highly unlikely.

In January 2000, the government outlined its immediate economic goals. Achieving price stability remains the cornerstone, and the government has vowed to launch a broad voucher-stye privatization in April 2000. The question here is whether institutions are sufficiently resilient to prevent the corruption of the sale of state-owned assets. The government has forecast a growth rate of 5% in 2000 and expects a sharp increase in exports, but both will be difficult to achieve in the current climate.[15]

Dealing with the FRY - Carrots and Sticks

The West confronts a particularly trying dilemma in forging a policy toward the FRY. Western imposed isolation alone will not solve the problem of that country's political and economic transformation. If anything, total isolation could strengthen Milosevic's hand, and in the minds of some Serbians, justify his claim that the West is the true enemy. Milosevic's family and cronies have managed to flourish despite and perhaps even because of the many sanctions regimes that have been imposed on that country over the last decade. Moreover, the longer Serbia remains in its current limbo, the greater the challenge will be to rehabilitate it politically, morally and economically.

The country is an economic disaster with inflation running at nearly 50% per month, very high unemployment, and pervasive corruption, all of which make it impossible to imagine positive change, particularly given the regime's economic policies and the resources it has at hand. At the same time, the West cannot carry out business as normal with a regime whose leader and chief lieutenants stand accused of war crimes. Thus efforts are being made to reach out directly to the democratic forces in the country and to use targeted, humanitarian assistance as a means to differentiate democratic from authoritarian political forces. The idea has been to prevent the total isolation of Serbia while nonetheless cutting off Milosovic.

The West must now mark out a path for the Serbian people toward participation in the institutional and economic life of Europe while conveying that the way will remain blocked as long as the current regime maintains its grip on power. Ideally, the policy should seek to encourage the highly fragmented opposition to make Europe both a political rallying point against the current government and a central feature of its agenda for change. In this sense, the Croatian case could be instructive. The fact that the doors to Europe are cracking open for Croatia demonstrates to the Serbian people that there is a pathway to a democratic future. The process will not be easy either for Croatia and especially for the FRY as both countries must achieve some reckoning with their grave responsibilities for the disasters and crimes which have beset the region. Finally, the Serbian people must understand that they will be left behind economically and in terms of European integration if they fail to undergo democratic change soon.

In the immediate term, efforts to differentiate democratic forces in Serbia are essential. Serbia remains ineligible for unilateral trade preferences and the Phare programme, and the EU will never consider a Milosovic-led Serbia to be eligible for a Stabilization and Association Agreement. EU co-operation is limited to humanitarian aid, to support for democratization and to certain assistance measures, like the Energy for Democracy Programme, that bypass central authorities.[16] That programme has been one of the more notable examples of this attempt to differentiate between the democratic and authoritarian strains of Serb political-culture. The FRY initially blocked consignments of heating oil at the border with the former Yugoslav Republic of Macedonia, but protests in the towns of Nis and Pirot compelled the government to relent. The EU is now looking to expand the programme to Novi Sad, Subotica, Sombor Kraljevo and Kraguijevac. Again, the virtue of such initiatives is that they make it more difficult for Milosovic to suggest that the West is to blame for the ills that have best the FRY. Indeed, they demonstrate that Europe is willing to assist the forces of democracy in Serbia and to play a defining role in the country's revitalization.

According to the UN, Serbia is spending $1 million dollars a day importing electrical power, and in January, the Serbian electricity debt was estimated to stand at Euro 10.2 million.[17] The regime recently struck a deal with Gazprom and has managed to import sufficient supplies of Russian oil and gas to stave off an energy panic. Serbian debt to Russia is mounting as a result. Nor is it clear how Serbia is financing its energy imports, although a $300 million Chinese loan extended with fairly generous repayment terms has certainly helped.

The Centre for European Policy Studies (CEPS) has advocated that the European Union begin to prepare itself to provide substantial support to a post-Milosevic FRY. Any new government there would simply not be able to generate the resources needed for reconstruction and transition. The CEPS study sees eventual Western support for rebuilding the bridges of the Danube as essential, but argues that no public funds should go into rebuilding large factories which were loss-makers and which would continue to draw away precious resources into unprofitable ventures. At best, it might provide some income support to those who have lost their jobs.[18]

The federal government has sought to put the best face on a dismal economic situation. Television news in Serbia focuses on successfully rebuilt roads and plants which have returned to production. But the regime cannot hide the economic disaster for which it is largely responsible. A decade of tyranny, corruption and war have only hastened economic decline.

The ruined bridges on the Danube continue to pose problems and not only in Serbia. Romania has paid a high price as a result of the river's closure, and many Bulgarian ships are also stranded north of the FRY. Thousands of river workers have been laid off and many private shipping companies stand on the threshold of bankruptcy. Russian and Ukrainian ships carrying fuel to Yugoslavia, however, have been allowed to bypass the blocked portions of the Danube though an extensive network of canals and waterways. For months, the government of Slobadon Milosevic has refused to allow a clean up without Western cash to rebuild the fallen bridges, and Yugoslav officials maintain that the clean-up alone will cost $33 million dollars. A provisional pontoon bridge has been erected in Novi Sad, but it will have to be removed if river traffic is to recommence. The 11 member Danube Commission has proposed that the EU underwrite a clean-up of the debris with a tender, upon which Yugoslav companies would be forbidden to bid.[19] After months of attaching conditions to proposed clean up projects, the FRY agreed to accept this proposal, but there are no guarantees at this juncture that it will go forward. The City of Vienna has offered a temporary bridge to Novi Sad, but even this would require an exemption on the current sanctions regime.[20]

Croatia

Croatia's recent elections results have injected a degree of optimism regarding its long-term prospects, suggesting to those who have despaired of democracy's shallow roots in the Balkans, that even those living under the region's more authoritarian states can find a way to build democratic and tolerant government. The lesson is particularly important for the Serbian people, who ultimately must decide if they will construct an alternative to the Milosevic regime.

The West has long said that improved relations with Croatia hinge on rapid dismantling of the county's anti-democratic structures, an end to Croatian interference in Bosnian internal affairs, a return of Serb refugees and cooperation with the International War Crimes Tribunal. Progress is now evident on all these fronts. The new Croatian President Stipe Mesic, whose inauguration was attended by 12 European heads of state and the American Secretary of State, has been quick to make overtures to the West, suggesting that his country will henceforth be more cooperative with the International War Crimes Tribunal. That said, the government of Ivica Racan recently unannounced its displeasure at the Tribunal's harsh sentence of Bosnian Croat General Tihomir Blaskic and may sponsor an appeal. On the positive side, members of the Croatian Parliament are looking at ways to end the unlawful financing of Bosnian Croats, and governing party leaders have stated that henceforth assistance will flow through normal channels.[21]

Croatia's new spirit of cooperation has been duly noted in Western circles, and a sea change is underway in Western policy toward Croatia. The EU has already begun an important political dialogue.[22] But it wants to see better compliance with the Dayton peace, improved cooperation with the International Criminal Tribunal for the former Yugoslavia, and greater willingness to allow a return of Serb refugees who left during the war before it makes important concessions like opening the Phare programme to Croatia and considering it for Stability on Association talks.[23]

The new government is also moving promptly to implement much needed liberalization measures. The Tudjman regime had long avoided serious restructuring and thereby bequeathed the current government a series of structural problems that will likely consume a great deal of political energy over the coming years. The former government's profligate spending has resulted in serious budget and current account deficits, both of which were exacerbated by last year's security related tourism collapse. The current account deficit for 1999 alone will approached $2 billion. Although the D-Mark is now acting as a parallel currency in Croatia, external deficits have sparked a currency depreciation which, in turn, has fueled inflation. One of the first measures of the new government of Ivica Racan was to cut official salaries by 40%, a move which both marks an important symbolic break with the style of the previous government and sends a signal that fiscal rectitude will be a priority for the new government.

Unemployment stands at 20%; yet even this rather daunting figure does not adequately reflect real unemployment levels.[24]

The state's critical need for financial resources to cover debt service has advanced the pace of privatization, and the new government is committed to moving quickly on this front. Croatia's most important insurance company and its three largest banks are all on the auction block.[25] Mesic has also promised to investigate past privatizations which many analysts believe were rigged to reward Tudjman's cronies - a practice which has likely cost Croat tax payers billions of dollars and left the economy in the hands of a number of unworthy managers.[26] Some arrests have already been made.

Croatia appears to have turned a political corner. The new leadership seems generally committed to undertaking the kinds of reforms that will make possible its eventual integration into Europe. Indeed, President Mesic has promised to bring Croatia into the European Union within five years - a rather optimistic prognostication, but one which nevertheless reveals a strong Croatian aspiration for integration in European institutions. Its possible future participation in NATO's EAPC should not be discounted either. The key will lie in the leadership's capacity to manage a tough economic transition while engaging in an historical reckoning that may not be popular but will nonetheless be a *sina qua non* for participation in the institutional life of Europe.

Bosnia-Herzegovina

The Bosnian economy stands at an important cross roads. Last year's conflict was particularly unsettling given the country's delicately poised ethnic balances, and the still fundamental institutional problems that need to be sorted out. Bosnia-Herzegovina is still plagued by the lack of consensus regarding a common state structure, very weak state institutions, organized criminal networks which have flourished in the absence of effective state institutions, and a civil society which is not highly articulated and remains splintered by ethnic tension. The country's ultimate economic situation will hinge, in part, on the degree to which the current political stalemate can be transcended, deeper cooperation among the republics secured and the government's capacity to wean itself from foreign aid reinforced. Foreign aid levels to the country are slated to fall. All of this challenges its divided political and economic leadership to move hastily from a condition of aid dependence to one of economic self sufficiency. That will not prove easy, but as the High Commissioner Wolfgang Petrisch has repeatedly warned, the huge influx of aid money and the construction boom associated with national rebuilding simply cannot persist indefinitely.

On the bright side, progress in refugee return and legislation on judicial and economic reform is moving ahead. The currency board, which pegs the Marka to D-Mark, has kept the lid on inflation, and the federal authorities have managed to enact important budgetary cuts. But state finances continue to depend on foreign aid which is also underwriting an imposing trade deficit. That deficit, in turn, has been exacerbated by recently imposed Croatian tariffs and, course, by the utterly degraded Yugoslav market.

At the micro-level, voucher privatization began in September 1999, and one-third of state owned companies are slated for sale in 2000. The rest are to be disposed of through cash privatization. These sell-offs began in the Republika Srpska in July, but by mid-September, only 10 of the initial 350 firms had been purchased. The prospects are rather poor at this juncture that banking privatization will proceed as planned.[27]

The lesson of Bosnia have been particularly instructive to the international community as it cobbles together a general development and integration framework for South-Eastern Europe. The aid effort in Bosnia has demonstrated that genuine development cannot be achieved in a geographical and conceptual vacuum. The countries of the region are simply too small and isolated. That ties throughout the region must be reinforced is now generally understood to be a precondition for genuine economic, infrastructural, cultural, and institutional transformation. The Bosnian case also stands as a warning against the hazards of aid dependency. Simply funneling assistance through underdeveloped state institutions has increased the scope for corruption and clearly worked at cross purposes with the goal of building market economies. As a result, Europe now appears committed to making regional assistance conditional both on internal political and economic reforms as well as deeper regional integration.[28] It is presently recognized that until coherent state structures and efficient and reasonably uncorrupted financial practices are in place, and only after the myriad barriers to trans-border commercial flows are torn down and access to European markets extended, will private foreign investment, the most powerful agent of economic development, begin to flow into the region.

The Stability Pact

All of this is more easily said than done. The Balkan region is utterly fragmented politically, institutionally and economically and is characterized by enormous insecurity. Moreover, there are powerfully entrenched groups that have managed to profit from this situation and thus tended to defend a status quo which has been immiserizing for the great majority of the region's peoples. The great challenge for the international community and particularly for the European Union, which has a high stake in a positive outcome, is to quell the great fears that have militated against regional integration and to do so through the promise of deeper economic and ultimately political integration with Europe.

The Stability Pact is the organization charged with coordinating various assistance programmes to South-Eastern Europe. It seeks as its primary goals to develop existing economic and trade relations with and within the region; build upon existing economic and financial assistance to buttress democratization, civil society, education and institution building; foster greater cooperation in the area of justice and home affairs; advance inter-regional political dialogue and deepen the relationship between the European Union and the region.[29] The work of the Stability Pact's three round tables consequently reflects a recognition that political and economic reform in the context of greater overall regional security are all interdependent phenomena and that no strategy will be successful if not region-wide in scope. It is worth noting as well that while the FRY has not been invited to participate, there are efforts nonetheless to reach out both to the democratic government of Montenegro and to democratic forces in Serbia itself.

The Stability Pact is actually an umbrella organization in which regional aid initiatives in political, economic and security sphere are coordinated but not funded. Its own staff is skeletal and works with few financial resources and characterizes their mission as being a catalyst to action by other organizations and states. Indeed, the Special Coordinator, Bodo Hombach, has recently found himself prodding participating states to grant more generous financial concessions to the region. He has urged both the United States and the EU, for example, to raise export credit guarantees to South-Eastern Europe, arguing that such schemes will encourage private capital to flow into a region where risk premiums have been very high over the last decade. At the same time, Mr. Hombach has promulgated the idea of establishing a revolving fund that would collect debt repayments on behalf of the Paris Club of official creditors and use the moneys to finance projects in the region.[30] None of these initiatives will be administered by the Pact itself; yet, each will nonetheless fit into the broad panoply of initiatives it is coordinating.

Twenty-nine states are currently engaged in the Pact including EU member states, nine countries from South-Eastern Europe excluding the FRY, the United States and Russia and a number of international organizations. The current division of labour seeks to assign to various institutions tasks in which they enjoy a comparative advantage.

The World Bank, for example, has developed a credit programme, the Public Finance Structural Adjustment Programme, which will underwrite the development of public financial institutions like autonomous national auditing agencies, while undertaking initiatives to strengthen tax collection methods, enhance the capacity of regional actors to disburse public funds in an efficient and transparent manner, support central government's ability to manage and structure external debt as well as develop efficiently managed, low cost, social safety nets. This credit will total $91 million which the Swiss and Dutch government are helping to underwrite.

The EBRD is concentrating on private sector development and particularly guarantee facilities for trade finance, credit for small and medium enterprises, micro-finance, equity funds, risk guarantee funds, and financial support facilities for local contractors. It is also exploring the feasibility of underwriting infrastructure projects in the areas of transportation, energy and environment.

The OECD has worked with the governments of the United Kingdom and the United States to develop an Investment Charter to create common rules of the game and standards that will ultimately help foreign investors to operate in the region's markets. The countries of the region, with the exception of the FRY, have signed the Charter and see it as a means to encourage inward investment. The effort is supported by a Business Advisory Council of business leaders from the region and participating countries.

The Role of the EU

Of all the partner states and organizations supporting the Stability Pact, the European Union is clearly playing the most pivotal role. It is providing the bulk of development assistance, and for the period 2000-2006, it envisions 5.5 billion Euro of spending on regional programmes, although where these funds will come from is not yet clear. When development, macro-economic and humanitarian assistance as well as bilateral contributions from member states are counted, the EU has pumped in an estimated Euro 17 billion to the region since 1991.[31] The Union has now made the ultimate integration of the region into Europe a guiding principal in its regional strategy, and with that lofty goal, it has set upon its most ambitious and high stakes foray into the conduct of a common foreign policy.

The inauguration of the EU's Stability and Association Agreements makes explicit the link between the current endeavour to stabilize the region and the longer-term goal of ensconcing it safely in the heart of Europe's economic and institutional life. The link is a natural one insofar as laying the economic, political, institutional and security based foundations for sustainable development, regional integration and international openness will invariably also move the countries of South-Eastern Europe closer to meeting the criteria for joining the Union.

The problem is that even securing agreement on these fundamental principals will be difficult. In fact, the Commission currently maintains that much of the region is not even prepared to begin this negotiation process.[32] The one exception at this juncture is the former Yugoslav Republic of Macedonia which will begin talks in March - a testament to the great sacrifices that country has shouldered in recent years and its impressive contributions to regional security and inter-ethnic reconciliation in a period of grave crisis. It should be noted as well that Romania and Bulgaria are not part of this initiative even though their stakes in the process are very high. Both of these countries, in fact, are already part of the club of 10 countries engaged in the pre-accession process.

At present, 60-90% of exports from the countries which were part of the old Yugoslavia go to the EU. And according to the Union, more than 80% of exports from Albania, Bosnia and Herzegovina, Croatia and the former Yugoslav Republic of Macedonia enter the EU duty free. The EU estimates the value of preferential trade concessions at Euro 100 million Euro per annum. But many analysts believe that the barriers to more open trade, including the dearth of export credit finance, poor transportation infrastructure, restricted access to Europe's agriculture markets, and regional border controls continue to make it very difficult to sell in the central markets of Europe. For its part, the Clinton Adminstration has sent draft legislation to Congress both to grant $398 million in bilateral and regional funding (excluding Kosovo which will falls under a separate appropriation) and to provide unilateral duty free access to the US market for goods from South-Eastern Europe over five years. These concession would include imports of sensitive products like footwear, iron and steel. Madeline Albright has urged the EU to move in this direction as well.[33]

The EU is apparently looking at ways to link further opening to European markets to progress in breaking down regional barriers to trade and transportation. The Commission has announced that the Stabilization and Association Agreements will contain the objective of concluding regional cooperation conventions that would establish a free trade area with other countries that have signed such agreements with the European Union. This is makes very explicit the link between liberalization and integration at the regional level and integration at the pan-European level. The European Union is the largest integrated market in the world, and granting the Balkans more liberal access to its market will be critical to the development of the region's economies. The combined GDP of Albania, Bosnia, Bulgaria, Croatia, Yugoslavia, the former Yugoslav Republic of Macedonia and Romania is roughly $108 billion or 1% of the that of the EU.[34] As a point of departure, therefore, granting that kind of access to European markets is unlikely to have a dramatic impact in the EU itself.

Most economists agree that as a first measure, a free trade area should be established among the successor states of the old Yugoslavia which would eradicate all tariff barriers among them. Once this is in place, and that will hardly be an easy task, the effort could turn toward building a customs union with a common external tariff, an arrangement which might make it easier to forge a common economic area with the European Union.[35] Currently high barriers to regional commerce are grossly complicating the immediate reconstruction effort as well as long-term development.

The CEPS study advocates an even more drastic approach by which Balkan states would be rapidly integrated into a customs union with the EU. The EU, in turn, would compensate the region for the foregone tariff revenues because tariffs are currently a primary source of public finance throughout the region. The rational here is that the Balkans are so poor, that regional integration alone will not be sufficient to generate any kind of momentum for economic development. To ease the impact of increased competition, the Union should also provide some income supports, but not funds which could be used to subsidize loss-making industries. When it is politically and diplomatically tenable, this programme could be extended to Serbia as well. Finally, the CEPS study suggests that because of border corruption and administrative delays, once a free trade area were in place, the countries in the region might be best off farming out customs controls to private international companies. Such proposals suggest that in an era of globalization, the countries of the region should be prepared to accommodate themselves to a more limited view of national sovereignty to facilitate their integration into European and global markets. The problem, of course, is that many of these countries have only just attained that sovereignty, and it is not always politically palatable to forgo newly acquired national powers after long struggles to secure them.

While it is obviously not feasible to extend the CAP into South-Eastern Europe, the EU could contribute greatly to regional development both by offering tariff free quotas for agricultural goods and even by allowing the region to impose countervailing duties on EU food imports that effectively mirror EU subsidies. The latter could thus become a means simultaneously of generating government revenue and mitigating the price distortions of EU subsidies. In this way, according to CEPS, EU agricultural export subsidies, which already have undercut South-Eastern Europe's vital agricultural sector, would become transfer payments. The EU now exports 20 times more food from region than it imports.

Obviously opening agriculture markets will be politically difficult to manage in Europe. Yet, South-Eastern Europe's agricultural capacity is far smaller than Europe's as a whole, and the impact upon West European farmers of granting such access consequently is not likely to be substantial. Moreover, there are already numerous political, budgetary and international pressures to liberalize the European agricultural system; granting South-Eastern Europe greater access to that market should be made part of the greater reform effort that Europe certainly needs to undertake.

The Monetary Dimension

Achieving monetary stability in the region is a fundamental precondition for sustainable growth and development. High inflation profoundly distorts business practices, skews inward investment and discourages foreign investors from entering local markets. A certain amount of progress has already been achieved on this front as the former Yugoslav Republic of Macedonia, Kosovo, Montenegro and Bosnia Herzegovina are using the D-Mark as a parallel currency. But there are questions as to whether current arrangements are sufficiently resilient to the kinds of shocks to which the region has been susceptible. It may be that an even tougher anchor systems is needed to prevent speculative attacks and to make the stand against inflation fully credible. The risk of a possible exchange peg collapse could well discourage investment flows, particularly after the recent

East-Asian experience in which so many international investors were scorched when the Thai Baht, previously thought to be tightly anchored to the dollar, collapsed.

There are many suggestions now that full monetary "Europeanization" may be the best way to counter this risk. This could be accomplished through the creation of currency boards like the one which has been set up in Bulgaria. Currency boards would effectively eradicate the most important features of monetary sovereignty and effectively make the European Central Bank the central bank for the region. Some analysts suggest that to ensure the complete invulnerability of a currency board to political intervention, they also seat non-national experts - yet another explicit suggestion that part of the solution to the region's economic crisis may lie in voluntarily suppressing certain traditional elements of national sovereignty. CEPS has proposed that the EU should back the board's reserves with a 0% interest loan that would equal the amount of currency in circulation (the amount of currency in circulation in any given economy is usually equal to 5-10% of GDP, and the region's GDP is very small relative to that of the European Union.) Bosnia-Herzegovina, the former Yugoslav Republic of Macedonia and Kosovo would accordingly require collectively Euro 3 billion in cash for Euro-backed currency boards. That loan could be raised on private capital markets, and the cost to the EU would lie in covering interest payments on the loan.

Once this system is in place, old cash could be exchanged for new notes and coins, and any seniorage, the earnings that accrue to the European Central Bank as a result of inflation, would invariably fall to the ECB. But the benefits of lower inflation and the inability of the political class to interfere in monetary matters would clearly outweigh the cost of lost seniorage. Finally, without a lender of last resort, banking reform would be an essential element of any such system. Full liberalization and privatization of the banking system would therefore have to follow. The expectation would be that large international banks would begin to enter the market either directly or through the acquisition of local banks. Either way, their presence would be instrumental to bringing in foreign capital.[36]

The Environmental Dimension

Environmental assistance to South-Eastern Europe is essential, particularly over the medium- to long-term. But there are also hot spots notably in Pancevo and Novi Sad, Serbia[37] which demand immediate attention regardless of the current sanctions regime. To neglect consideration of the environment in the construction and development process will only burden the region with long-term problems and costs. What has happened recently in the Tisza river clearly reveals existing deficiencies in the region's regulatory structure, the inherently international nature of environmental problems, and the huge costs that will accrue if an adequate, region-wide environmental regulatory framework is not established quickly. This demands Western financial and technical assistance to develop environmental policy tools and conduct environmental impact assessments. At the same time, cooperation among the states in the region will be essential to setting up this framework.[38] The Environmental Action Programme (EAP) Task Force, which engages environmental ministers from the OECD and Central and Eastern Europe countries is particularly well placed to assist in framing an environmental reconstruction strategy for the Balkans. Bilateral assistance can also help. Some of the more successful transition countries in Central Europe for example, are using their experience to assist the region's governments develop local environmental action plans, legal and institutional structures, investment strategies and tools for policy implementation.[39]

But civil society at large must feel that it too can participate in a meaningful way to ensure sustainable and environmentally friendly economic and political development. Environmental rehabilitation and the development of democratic institutions are closely intertwined, and the importance of this relationship has been recognized in the UN/ECE's Convention on access to information, public participation in decision-making and access to justice in environmental matters (the so-called Aarhus Convention). Environmental cooperation can foster international and inter-ethnic reconciliation particularly given the inherently shared set of interests at play. Obviously NGO's have a vital role to play in this regard, and they must insist on transparency in decision-making and on dialogue with governmental decision-makers and industry.

Fostering Infrastructure Links among Regional Actors

Another critical aspect of deepening regional integration will involve the very practical task of building trans-border infrastructure networks to solidify links among the region's actors. The state of South-Eastern Europe's transportation, communication, and energy infrastructure is currently very poor and has been degraded as a result of the old Yugoslavia's break-up and the Balkan wars that ensued. Improved transport and communications networks are virtually a precondition now to restoring economic ties among the region's states and to lowering the cost of conducting business across those borders. There are a number of initiatives under the guise of the UN/ECE, the South-Eastern Co-operative Initiative (SECI) and the EIB to assess the communications and transport infrastructure needs of the region. A coming donor's conference will seek to raise funds for the "Corridor 8" highway system across the Balkans - a project which includes modernization of the Albanian port of Durres.[40] In April, a Memorandum of Understanding was signed in Athens by the region's transport ministers, under the aegis of SECI, to liberalize regional road transport, harmonize procedures, rationalize charging policies, and upgrade information systems regarding these charges. Such initiatives must be followed up and funding should be made available to carry them to completion.

Restoring navigation on the Danube will also be vital, particularly to countries like Romania and Bulgaria, which see that waterway as key transportation link to Central Europe. The Stability Pact Special Coordinator, Bodo Hombach, played an important role in a mid February agreement between those two countries to construct a new bridge across the Danube, a project that could also be granted priority funding at the March donor's conference which is to select roughly 130 cross-border projects for funding.[41] Representatives from the former Yugoslav Republic of Macedonia, Montenegro and Albania have also agreed to cooperate more closely to plan road, rail, telecommunications and power links among themselves, again with an eye on gaining much support from the international community. Ultimately, however, there will be significant improvement to regional transportation links without Serbia. Its pariah status and the destruction of numerous road and rail bridges that traverse it have had a terribly adverse impact on trade among Balkan states, and with the rest of Europe. This obviously remains a delicate political problem that the West must navigate with great care.

Finally, the question of infrastructure cannot be separated from the anti-competitive practices of the region's utilities companies, many of which enjoy monopoly status. Eradicating these monopolies and driving prices downward can be most efficiently achieved through well-supervised privatization and by opening up the region's utilities to European energy grids. This is a priority area for a number of the organizations operating in South-East Europe, and the Greek government is now working with seven other countries to integrate the region's energy markets.

Conclusions

For all the good intentions of the West and despite the emergence of more liberal and dynamic governments in countries like Croatia, the Federal Republic of Macedonia and Bulgaria, as well as in Montenegro, great optimism as this juncture would be misplaced. The institutions of the Federal Republic of Yugoslavia, a country which sits astride the vital cross-roads of the Balkans, are still under the control of a regime whose leader has been indicted for war crimes and with whom cooperation is well nigh impossible. The security situation in Kosovo itself remains explosive, and this as well as the open question of its final status, its tattered social fabric, and the decimated condition of its infrastructure make it difficult to envision rapid and well entrenched economic progress. Persistent regional insecurity continues to run up against the economic and political imperative for deeper regional integration. Such integration demands a high degree of mutual trust, which at this juncture at least, is not in evidence. Weak state structures are everywhere apparent; criminal groups and black marketers have inevitably filled the void, and in some cases have permeated state structures. Finally, the machinery of Western support is hardly running smoothly and it is an open question whether Western funding will match the promises that have been made.

On the other hand, there is at least now a general recognition that aid and restructuring efforts need to be better coordinated, much better funded, region-wide, market-oriented, and contractual in nature. The terms of the region's ultimate membership in the Europe's economic and political institutions are being spelled out, and Europe has acknowledged its obligation to assist regional actors begin in meeting those terms. The EU can trace out a path leading to a higher degree of economic development and reduced ethnic tensions. Ultimately, it will have to do even more, and indeed both Europe and North America must quickly lower existing barriers to trade even in sensitive sectors like textiles and agriculture to help this region help itself.[42] In the short-term, however, more financial support is urgently needed, particularly to stabilize Kosovo and to ensure the day-to-day running of its public administration and basic social services. Continuing high profile Western and local efforts will be needed to foster inter-ethnic dialogue and reconciliation.

In the final analysis, there is no one-off solution to the great challenges the region faces. No single appropriation of aid funds or set of locally implemented policies will alone foster peace, democracy, a cleaner environment and prosperity. Rather, the Western community needs to think in terms of an ongoing process that engages not only the region's leaders, but also their shaken civil societies and the shattered institutions which have so eroded state authority. Above all, there will be no solutions unless some degree of societal consensus can be formed around a broadly shared vision for the future. Ultimate European integration, with all the political and economic choices implicit in that aim, should lie at the core of this consensus.

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** A longer version of this report will be presented to the NATO Parliamentary Assembly's Economic Committee at its May, 2000 Session in Budapest, Hungary.

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