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Desk editor: ***Krassen Stanchev***
English editor: ***Carolina de Ramos***

The Balkans in 2010: Economic Scenarios

Dr. Krassen Stanchev

I. Introduction and objectives

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

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

• to initiate long-term thinking on the future of the Balkans, to reinforce attempts at such thinking currently taking place, and to sustain a debate on different development paths;

• to assess the probability of different scenarios, and describe factors that support one development or another;

• to provoke indigenous ideas on how to overcome past and current divisions and disparities; and

• to advocate approaches and policies that would prevent worst-case developments, help avoid the previous shortcomings of actions already taken, and support longer-term security and prosperity scenarios.

3. Six weeks after the NATO air-strikes on Yugoslavia started, Balkan governments claim great losses and deep impact on the political stability of Albania and Macedonia, but most of this should be taken with a grain of salt. International institutions – notably the IMF and the World Bank, DG II of the European Commission, the EBRD, the UN Economic Commission for Europe - judging from press reports, had promptly fixed their respective mechanisms for immediate remedies, and decided upon their own approaches to the Balkans. The Paris Club of official lenders is likely to reschedule Albania's and Macedonia's debt payments. There is intensive work being done by national governments, the media, public policy institutes and opinion leaders to assess current developments and propose solutions for postwar development. Profound deliberation is underway. It is likely that this time the international response to the conflict will not be victim to so many delays and inconsisten-

Published by the *Institute for Market Economics,* P.O. Box 803, 1000 Sofia; 32, Patriarch Evtimii Blvd.
Tel.(+ + 3592) 981-29-75, 87-41-35; fax: (+ + 3592) 980-24-72.
E-Mail addresses: ime@omega.bg, ime@techno-link.com
Also at: **www.ime-bg.org**

cies as was the case in 1992-1995. The impression, however, is that lessons from the previous Balkan wars have not been learned, at least not to the desired extent, either by national or international agencies and opinion leaders. A key weakness of the postwar conceptions currently being debated is the lack of ideas for the integration of the Federal Republic of Yugoslavia (or what would left of today's federation). In working on scenarios, IME tried its best to take into account ideas and assessment suggested by others.

Methodology

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

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

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

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

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

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

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

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

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

Good policies

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

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

• a stable and convertible currency and stable financial and capital market institutions;

• rule of law, irrevocable private property rights and an entrepreneur-friendly environment;

• easy access to capital, and, broadly speaking, to factors of production, for foreign and domestic investors;

• broad-range and transparent privatization;

• a set of contract-enforcing institutions and equal access to justice – uncorrupted police, magistrates, courts and central and local government administration;

• a set of competitive and transparent conditions for the private provision of formerly public services in the fields of social safety nets, education, health care and infrastructure.

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

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

• rebuilds the war-torn countries and sets long-term prerequisites for growth and prosperity;

• minimizes the possibility of war, external shocks, blocked trade routes, or market protectionism; and

• promotes security via international and regional protection of human rights and dignity, cooperation, mutual dependence, cross-border clusters, and penetration and interweaving of economic structures.

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

The questionnaires we use below to assess different scenarios rearrange recent statistics and require judgment to attempt to reflect interdependencies.[4]

New divisions

6. We do not deal with the humanitarian crisis in the Balkan countries and the economic shocks of the war in Yugoslavia. We attempt a consideration of the long-term effects of current developments. We believe that March 24, 1999, is a date marking a turning point in history. The Balkans and the countries around them will hardly be the same as in the last ten years. The post-World War II international order, especially law-enforcement mechanisms, will be readjusted to new precedents and regional and global realities. The European Union, after failing to assimilate what used to be called South-eastern Europe[5], is likely to develop some sort of Europe II legal status for the most damaged countries (such as Albania, Macedonia and

perhaps Montenegro and Kosovo). International Financial Institutions (IFIs) will soon have a coordinating role and later a facility – say, a "Balkan Recovery Program" -- similar to the roles IMF and the World Bank played during the Persian Gulf War and the UN embargo on FR Yugoslavia (not similar to the European Recovery Program of 1948).

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

1. In the group of countries suffering the most, which would require a restoration period that goes beyond the 2010 horizon, we identify: FR Yugoslavia (including Kosovo and Montenegro, either within or out of the federation), Albania and Macedonia; these are most "endangered economies" -- whatever the constitutional form of postwar Yugoslavia, its role remains crucial.

2. In the group of neighboring countries with fair prospects of swift (2000-2001) compensation and recovery of war impact, we find Croatia and Romania, and perhaps also Hungary; these are "troubled economies."

3. And in the group of countries that could fall into either category (especially if by 2001, a proper postwar order is not established and initiatives for rebuilding the Balkans are not adequately undertaken and implemented), we can put Bulgaria and Bosnia-Herzegovina. These are "troubled but not yet endangered" economies.

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

8. In all of the above-mentioned countries, domestic policies have been a key factor in delayed reforms. The war simply doubled country risks, aggravated the illness of pre-war lack of institution-building, rule of law and competitiveness. But with the exception of the leaders in Belgrade, governments could not do anything to prevent the current crisis. Temporary reform failures were common in Albania, Bulgaria and Romania. Albania's domestic policies today are of considerably less importance than those of Bulgaria or Romania, for the success or failure of current reform plans. The less affected an economy is by the immediate impact of the war, the greater the role of domestic economic policies. In the postwar period the most endangered economies of the first group are likely rather to depend on external political and financial support. Economies of the second and third groups are geared toward domestic policy factors, and for them external support is rather a supplementary leverage. Respectively, in international affairs, the responsibility of the political leaders of the latter group for economic and political developments in the Balkans is a new factor to contend with.

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

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

Legacy risk

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

The war in Yugoslavia has had an unintended impact on future policy choices: it has made it necessary for them to be clearer, of an "either-or" type. The coun-

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

4. See a sample questionnaire in Attachment I to this report.

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

tries of the Balkans and the other international players will either maintain legacies or embark on the path of development, integration and cooperation. Below we consider two major scenarios based on this clarity, while a third scenario is based on the reaction-pattern of the EU to the emerging democracies and market economies over the last ten years. In addition, we discuss approaches that may prevent or support the worst-case scenario.

II. Economic scenarios for the Balkans in the next ten years

A. Monumental economic disasters

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

Monumental disasters are extraordinary institutional constraints to economic freedom, growth and prosperity. We borrow this term from Thrainn Eggertsson[6], who uses it to describe why Iceland failed to develop a fishing industry for about a thousand years. In the case of Iceland there were external powers and shocks that between the 9th and 19th centuries restricted Icelanders from fishing in the open sea. We believe, however, there are also domestic (and in the case of Balkans, intra-regional) factors that may impose institutional barriers to growth and hamper the prospects for prosperity in the long run.

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

• war legacies and divisions established by them;

• failure of international players (namely: the UN, NATO, IFIs, EU, G8 and the United States) to agree on rules and cost-sharing patterns for rebuilding Balkans, or agreement on an inappropriate plan; and

• commitment on the part of the above-mentioned Balkan Fence countries to seek rents from war-established divisions within South-eastern Europe.

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

• consistent failure of Balkan countries and leaders to agree on long-lasting peace agreements and constitutional order;

• discrepancies in economic development within the region[7] and different paces of market and democratic reforms; and

• aspirations to build nation-states at the expense of others, lack of respect for human and minority rights.

Main features

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

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

• Albanians in Kosovo are undergoing such nation-state formation.

• Led by Milosevic and backed by the Serbian identity, FR Yugoslavia is "defending" its national pride and territory.

• Macedonia, with its recently-gained independence, faces the challenge of defending its status quo.

• Montenegro is likely to embark on the nation-state path in the nearest future.

• Many constitutions in the region prevent flexibility on ethnic issues in their concept of statehood, envisage a constituent nation[8], ban autonomy[9], restrict foreigners from owning land[10], or prohibit political representation of ethnic and religious minorities.[11]

• In the 20th century most countries have used some form of "soft" ethnic cleansing; e.g., the last pre-Yugoslavian case was the expulsion of Bulgarian ethnic Turks in May-June 1989 to neighboring Turkey (after they were deprived of their property rights).

12. Even if we assume that there is no pan-Balkan tendency for ethnically clean nation-states and take for granted that such states are virtually impossible, the dissolution of the former Yugoslavia (and the drafting of the newly independent states' respective constitutions) and the current war over Kosovo set a precedent with long-lasting consequences.[12] A country's national and ethnic self-determination is theoretically and ethically accepted to be a just aspiration. Civil society structures that may counteract chauvinist minds and movements are rare, weak and disliked by political leaders. It seems that there is some underlying mental mood that was summarized by the economist Vlado Gligorov, who is familiar with the region: "Why I should be a minority in your state, when you can be a minority in mine?" There is no currently-employed legal instrument that can ensure that an ethnic group or nation, seeking liberation from another group or nation, will not eventually turn into an oppressor of a third group or nation.[13] If this mood prevails, by the year 2010 we will need to deal with conflicts over the dissolution of Bosnia-Herzegovina and Macedonia.

13. As country surveys show, (see Attachment I), except for Albania (in 1997, 3.8% of its imports were from Bulgaria) and Macedonia (in 1998, 20% of exports and 12% of imports were to and from FR Yugoslavia, and Bulgaria is a partner), the core Balkan countries have little exchange with neighboring transition economies but large trade with surrounding

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

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

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

9. E.g., Article 2.1 of the Bulgarian Constitution.

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

economies. Countries at the center and to the south of the peninsula have several times greater trade with Greece and Turkey. Aside from that direction, most countries' major trading partners are to the northwest; over 60% of the region's exports and imports are to and from EU, CEFTA and EFTA countries. A longer war or threat of war and interruption of those trade routes will put all these volumes at risk. If this scenario dominates in Balkan economies over the long term, the countries will run huge trade deficits. A monumental disaster would mean failure to develop those few competitive advantages the countries' respective private sectors succeeded in identifying, in tourism, wines, delicacy canning, knitwear, and some high-tech and service industries.

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

• Although most economies are led by private sectors and services (the average share of the private sector in GDP is about 60%), they are rarely competitive.

• Foreign direct investment is negligible in absolute and in per-capita terms. Countries have small economic "lobbies," due to limited foreign ownership.

• The level of foreign ownership in the Spanish economy is 42%, in Poland 12%, and in Romania 6%[14].

• Mutual activities of economic agents (besides Croatia in Bosnia-Herzegovina) is no factor for integration and cooperation.

• Mutual penetration of neighboring bank sectors is close to zero, with the exception of some Turkish and Greek banks. Foreign ownership in banking sectors is a rare phenomenon in the Balkan transition economies.

• While Bulgaria and Romania (and to some extent Croatia) are exceptions, the foreign share is 2.5 times smaller than in Hungarian banking sector.

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

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

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

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

• the "endangered economies" of Albania, Yugoslavia, Kosovo, Macedonia, and Montenegro would further deteriorate or remain at high risk;

• the economies of Bulgaria and Bosnia-Herzegovina would fall into the same category as those "endangered species"; and

• the "troubled economies" of Croatia and Romania would remain at risk in the medium term, but perhaps fail to benefit from larger markets to the southeast.

B. Balkan Valleys

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

Coveted features

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

• low tariff barriers;

• a competitive market environment;

• free exchange of goods, services, capital and ideas;

• market potential of about 58 million (not including Turkey);

• a well-functioning infrastructure;

• easy accessibility to all the sights and corners of the Balkan peninsula; and

• stable and transparent exchange rate mechanisms (preferably, currency board regimes) and transparent and stable prices.

18. To achieve this, a joint strategy is needed to strengthen competitiveness, involve Turkey and other countries of the Balkan Fence group, and promote infrastructure projects on mutually beneficial grounds.

This scenario is not at all rooted in the political and historical backgrounds of the countries in the region, and for this reason is rather unlikely. However, it is worthwhile to attempt such policies. There is a chance of success, depending on two factors:

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

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

13. See discussion of this phenomenon in relation to Balkans in: *Unfinished Peace*: Report of the International Commission on the Balkans, pp.: 28-32.

14. Source: Heriot-Watt University, UK, quoted by: Francis Harris, "*Join at your Peril*," Business Central Europe, March, 1999, 12.

1. support from the international community for peace and institution-building, and

2. rebuilding the region and development of the regional infrastructure.

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

• securing of regional and individual countries political stability;

• agreement upon joint strategies to strengthen regional economic order;

• negotiation and removal of "national" preferences for selected sectors;

• enforcement of open public procurement procedures; and

• facilitation of trade via lowering tariff and non-tariff barriers.

Feasibility

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

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

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

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

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

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

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

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

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

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

funds from the World Bank and the EBRD but also for planning major rail, road, and telecommunications investments and ensuring the rational development of air transport."[16]

24. Public opinion, voters and government leaders still have to accept the necessities of this scenario. Once practiced, genocide and ethnic cleansing constitute a legacy for ensuing generations.[17] It is difficult to eradicate memories of past violence when there is no shared vision of a common future and prosperity. None of the available concepts of the future of the region thus far (neither those of political leaders, nor of the general public, business, and younger generations) seem to have been inspired or committed to intra-regional cooperation and exchange. The governments of EU-associated countries are focused on bilateral agreements with the EU. They do not usually pay attention to issues of regional cooperation, other than ordinary trade and other agreements, while this scenario would require greater commitment and compromise.

Sticks and carrots

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

26. The underlying principle of the international players' attitude should be an approach related to individual country circumstances, with provision of funding on the condition of implementing policies that benefit the region and its links to international markets. A similar "political" approach is desirable on the part of all institutional payers in the postwar Balkans. "Troubled but not yet endangered economies" could have a "priority" position in IFI's cooperation, provided deteriorated performance is really due to external factors. The principles of the EU single market do not contradict policies that would be good for the postwar Balkans. There is no conflict with the declared policies of the IFIs, either.

C. Balkan basement

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

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

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

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

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

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

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

Europe II

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

• it realizes a regional approach that is largely lacking in most of the Balkan initiatives from 1991 to date;

• it immediately establishes an international "government," responsible for the affairs on the spot, and solves the problem of the postwar constitution of Yugoslavia, Kosovo and perhaps other states that may emerge in the region or elsewhere;

· it mobilizes resources to conduct real pre-accession processes in previously "hopeless" accession countries (e.g., Croatia, Macedonia, Albania) whose govern-

16. *Unfinished Peace*, p.144.

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

ments insisted for years on a softer approach; it streamlines Brussels' administration in dealing with the region and saves implementation costs of other less-articulated blueprints;

• it really may bolster the process of joining the single market of the Union and shorten the distance between EU accession laggers and front-runners;

• it may speed up the reconstruction of EU structures in order to accommodate countries "hopeful" of accession; and

• it establishes more-or-less clear incentive-treats mechanisms, with an underlying message that not joining Europe II would have a high political price.

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

30. The economic cornerstone is the creation of CBAs or CBA-like regimes, pegging local currencies to the Euro (or substituting them with the Euro), and signing a multilateral trade agreement with countries granted the status of semi-members of the EU. As in the case with Bosnia-Herzegovina, in the new aftermath of the crisis the FR Yugoslavia, and respectively Kosovo and Montenegro, would probably implement rebuilding and stabilization programs.

The stability treaty for others will have features already formulated in different forums (EU finance ministers, the IMF and the World Bank, EBRD Annual Meeting, G-8, UN ECE, etc.):

• political and investment guarantee schemes;

• financing infrastructure;

• support for the balance of payments;

• debt forgiveness; and

• structural reforms and development programs.

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

31. The key problem the Europe II sub-scenario fails to solve is justice.

From the point of view of international law and political attitudes, it would not be fair to give Yugoslavia an equal start along with the other affected countries. From a philosophical point of view, it may not be justifiable to punish a nation for the actions of the government it elects, and, as Zarko Puhovski put it, "it is impossible to punish a government in warfare without punishing the nation." But this is a war. The argument could have different formulations: from that of a tacit intention to punish Yugoslavia to that of an honest reward for those who "have tried hard for a long time." However, if there is no equal start for FR Yugoslavia, there is a preferential treatment for those who suffered most, the Albanian people of Kosovo. If Kosovars get the status of an autonomous entity within the EU and Montenegro secedes, there will be an incentive for other groups to break away from Serbia. At the end of the decay or even earlier, the EU would create an ethnically clean Serbia.

In these circumstances the EU-accession front-runners may feel they are treated unfairly. Advanced reforms, better economic performance and institutional development and greater competitiveness may turn out not to be the proper limousine to enter the club. The chart of the poorer would be welcome under advantageous terms. The principle of "the most affected served first" would be used, instead of the "first come first served" principle.

In order to avoid such opportunism, the EU would be forced to initiate special association treaties and partnerships with the newly autonomous states and regions. These treaties would obviously have lower status than ordinary associated membership. In order to stop regions and countries from rushing in the open door, from the very outset it would made clear that the new status is of limited applicability to selected newcomers. To the extent that this happens, the Union would be preserving the existing discrepancies in the region. Front-runners will remain front-runners, laggers will remain laggers, and autonomous members will remain autonomous.

32. Another problem is logistics. In a natural but fairly difficult-to-predict manner, FR Yugoslavia is setting both the time schedule and the political benchmark for all postwar plans. If it fails to elect a legitimate government committed to integration, the entire house of postwar Europe will be built on shaky foundations.

A likely development is that Kosovo Albanians will not be in a position to return home by the fall of 1999, as expected in most EU reports on the refugee situation. The reasons are simple: destruction is at the rates of Bosnia (i.e. 60%); houses around the country must be reconstructed but domestic resources are limited; construction materials are expensive imports because roads and railroads have been destroyed at a rate of at least 30% (according to NATO headquarters reports); and if people do not return fairly soon they will have no possibility to plant and harvest this year, in which case they would starve during the winter in the open air of their homeland.

If the Kosovars do not return in the near future (as seems to be the case), all of the plans for special membership status and peace treaties based on legitimate representation must be postponed. Albania and Macedonia, who host the refugees, would be in a position only to receive aid, spending enormous energy on keeping their societies together. If the result is a receivership from the EU and other international institutions, why should it be called enlargement of the Union.

If the Europe II plans go into effect, the likeliest beneficiaries will be the Balkan Fence countries, rather than those in the name of whom the plans were conceived. As an observer put it bluntly: "we do not need an iron curtain, we need an iron fence or a wall to separate us from the Balkans."

Marshall plans revisited

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

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

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

36. In order to have a Marshall Plan, Balkan governments should realize what the original story was. By no means it is a financing facility that grants some amounts to a government to spend during a four-five year mandate and then get reelected.[18] The original Marshall Plan, or the European Recovery Program (ERP), had no direct influence on economic growth. Vigorous growth was already present in 1947 (before the introduction of the Plan), and industrial output was exceeding the pre-war level; without the Plan Europe's economies might have grown at a slower pace but would not have declined. The real aftermath of the ERP was unintended but long-lasting institution building, starting from a prototype organization of today's OECD, setting the rules of multilateral trade and the customs union, the advent of the European payment union, respectively, the Schuman Plan, and reaching the Common Market. The Marshall Plan cannot be repeated in this form. A similar form would be a coordinated and supported effort to build or join the institutions (i.e., rules) of the global economy. But this is exactly what the Balkan transition economies (at least most of them) pretend to be doing. If it is a plan to finance government investments, or a plan to rebuild the region, it should be called and executed differently.

The governments of the Balkans must not be expected to achieve similar institutions in the immediate aftermath of the Yugoslav war. The nature of the war is different, and the nature of the world economy is different. Currently, most of them do not even have the information and statistics to facilitate some sort of "Balkan Recovery Program" resembling the original ERP. They are not to be expected to have such institutions even in the medium term; this is a trial-and-error process which takes time. But they can start working this direction, securing a consensus for their successors to continue.

A rent-seeking attitude is the most harmful one for such efforts. But rent-seeking may be supported by poorly designed, wrongly perceived and blindly implemented ideas of "Europe II" and a "Marshall Plan" as a substitute for central planning.

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Kosovo: A Monumental Disaster Caused by a Simplistic Vision

Dr. Andrey Ivanov, IME

The world would be a marvelous place to live in if everything was as simple as the broadly televised picture of the Balkan crisis makes it out to be. Unfortunately it is not.

The simplistic vision tells us the story of a conflict launched by Milosevic at the end of 1980s for the purpose of his own political survival. The truth is much more complicated: throughout the entire 20th century Kosovo was a point of Serbian-Albanian rivalry, where two nationalistic dreams clash.

The difference lies only in their points of departure. The Serbian nationalistic dream was already realised in 1918 when the Great Powers allowed Serbia to take the Slav-inhabited territories of Croatia, Slovenia, Vojovodina, parts of Bulgaria and the Albanian-dominated Kosovo. Of course, Croatia was a rather special case: for the Croats entering the new South Slav state represented a way to escape the Austro-Hungarian empire with the view that a Slav state would be easier to escape later. This they then attempted to do during the Second World War and later in 1970, during the "Croatian spring". However this does not change the fact that the Serbs' main motivation was completion of their nationalic project. The Albanian nationalist project, on the other hand, is still underway. Albania emerged as an independent state after the Balkan wars in 1912-13 as part of an attempt by the Great Powers to create a check against the neighboring Slav states in the peninsula. In fact, the emergence of Albania as an independent state was the beginning, rather than the end, of the Albanian nationalist project. Thanks to a number of events (Italian occupation during the World War II, communist rule afterwards) this was delayed for decades and only reemerged on the political agenda at the end of 1980s (for more details on Balkans nationalisms see Andrey Ivanov, *The Balkans Divided: Nationalism, Minorities and Security*, Hamburg, Wien, New York: Peter Lang, 1996).

That was why at the end of 1980s the Serbs, which had a nation-state, treated the integrity of the state and non-violation of its borders as a priority. The Albanians, on the other hand, began to work for the unification of "all kin in one state". Hence their priority was self-determination through secession, including revision of the existing borders.

These are two incompatible types of argument. Being part of different historical and political discourses, by definition they cannot meet. Both can be justified from their own points of view. Both are moral – though based on a different approach to morality. For some Serbs it is moral to kill civilians for the sake of the integrity of the State and Orthodox sanctuaries. For some Albanians it is moral to smuggle drugs in order to finance the fight of the Kosovo Liberation Army for self-determination through secession. And it is up to the external actors involved in the conflict, which approach to support.

Until the end of the "cold war" state integrity and non-violation of borders was a priority - and the Serbs could keep the province by using force. Things changed in the early 1990s but the Serbs did not (could not!) grasp this fact. Being a dominant republic in the Yugoslav federation, most of them perceived the federation, rather than the republic, as "their state".

National affiliation (in this case – belonging to the Serb nation) was one of the two criteria determining the pro-integrity and anti-integrity attitudes. The second one (of completely different type) was the political affiliation. The other group that perceived the federation as "their state" was the communists. Although both have very different types of affiliation criteria, at a certain point - in terms of determination – the two coincide. Most of the Serbs were for keeping the federation (no matter what their political affiliation was) – as well as most of the communists (no matter what their national affiliation was). When the representatives of the other nations (or those more liberally-minded, no matter what their national affiliation was) voted in favour of secession, these two (partially overlapping) groups – i.e. nationalist-minded Serbs and radical-minded communists - fought against it (frankly defending "their state"). Being better armed and no less motivated, they also committed more atrocities than their opponents and thus were doomed to find themselves represented as symbols of "universal evil".

Of course, to a certain extent the Serbs had bad luck. They were trying to enter old-style political deals, but a time when their old "partners" were either withdrawing or hiring better PR professionals. First, the Serbs fought a sham war with Slovenia because both sides felt they needed a small dose of military violence for their own reasons. The Yugoslav army did this in order to bolster its claim that it would take actions against any others wanting to secede. The Slovenes did so in order to create a powerful identity for their new state by portraying it as forged in the heart of battle. The world however was only aware of the "visible" part of the deal, the war against the Slovenes. The second case involved Croatia. In 1990 Milosevic and Tudjman met and agreed to divide Bosnia between them but disagreed over Vukovar. Tudjman was also smarter than his counterpart and very soon calculated that entering any agreement with Milosevic would be a bad move in the long term. What were broadly televised were the pictures of destroyed Vucovar, and not the agreed division.

In general the result of the first phase of the dissolution of Yugoslavia was to divide it into perpetrators of good and evil. The Serbs were identified as neo-communists, aggressors, criminals against humanity whilst all the others were perceived to be completely innocent. This simplification was not just far from the truth; it also opened the way for the West's moral relativism and double standards in its approach to the region. Thus a situation emerged in which expelling the Albanians from Kosovo deserved to be punished, while expelling the Kraina Serbs from Croatia did not (in 1995 over 250,000 Serbs were 'cleansed' in a few days).

This general context was not taken into consideration when the air strikes were planned. The plan itself was based on the fatally simplistic "good guys" versus "bad guys" version of reality which was largely painted by Western leaders keen to explain the conflict in easy terms, in the type of short catchy messages appropriate for the TV news. The complexity of the issue was difficult to explain in 100 words and as a result Milosevic (together with the Serbs in general) got painted as the "boogie man", whilst others (yesterday – Tudjman, today - the Kosovo Liberation Army) emerged painted "white". Since their involvement was built around this simplistic interpretation, the approach adopted was inevitably wrong. The results of the involvement – the diametric opposite of those anticipated – are evidence of this.

First, instead of bringing Milosevic to the negotiations table in few days and persuading him to adopt a civilized approach to ethnic issues, the West provided him with rational arguments for his barbarian policy. No matter how long ago his ethnic cleansing operation was planned, he (or his successor) will always use the air strikes as an argument to justify this decision. The air strikes provided him with a personified external enemy, with a "plot-scenario", with a reincarnation of the myth of the battle of Kosovo. Before the air strikes Milosevoch did not have internal support from the constituency for his "definitive solution" of the Kosovo case. After the air strikes the majority of the society is on his side.

Second, air strikes supported an 18th century-type of policy, agenda and approach at the end of the 20th century. They have encouraged farther a pre-modern type of affiliation based on primordial criteria (blood ties etc.). This will make the Balkan countries even more remote from Europe and common democratic values than they were before the war. After the strikes no Western-minded attitude and opposition will be viable in Serbia for decades. But these pre-modern attitudes may also gain popularity elsewhere in the Balkans, including Greece.

Third, the air strikes are contributing to further criminalization in the region. All the Balkan countries are concerned at the danger of a re-emergence of the "embargo tycoons" and money laundering practices which could threaten their fragile economic stability. Local mafias emerged during the first embargo against Yugoslavia and these countries have had to make enormous efforts to limit their area of control. From now on this task will become much more complicated and expensive. The whole region is likely to descend into further chaos and criminal activity.

Fourth, NATO directly "invited" Russia to make the Balkans a sphere of its "vital interests". The Yugoslav parliament voted unanimously to join the new USSR (the union between Russia and Belorus), and the Russian Duma adopted a similar declaration. While this is not binding, it was a strong expression of intentions. It is a situation, which will at least contribute to a second "cold war" with all the political and security consequences this entails.

Last but not least, from a procedural point of view the air strikes are in direct conflict with the existing system of international relations and replace the rule of law with that of moral imperative. This in fact not only means the clinical death of the Security Council of the UN, but also the end of all expectations that NATO can evolve towards a collective security structure. After its simplistic involvement in Yugoslavia it now has far less credibility in world affairs and is perceived more than ever as an instrument of the US foreign policy.

In light of this development, the direct economic losses, the cut transportation corridors and the impact on foreign investors of the apparent increased political risk are all of small regard.

What could be done instead? Many things. First, economic growth in the region should have been encouraged. People are susceptible to ethnic manipulation when they are poor and have nothing to lose. The war will impoverish them even further, thereby making them even more susceptible to ethnic radicalization. Now the Western countries are speaking of a Marshall Plan for the Balkans when it is too late. Probably the delay will itself be used once again some time in the future to explain why there will be no such plan.

Second, countries with a positive record in solving ethnic conflicts in the Balkans, like Bulgaria and Romania, should have been encouraged through investments (this would have been an incomparably cheaper option than a drawn out military conflict). Supra-national integration projects should have been treated as a top priority. Bulgarians, Macedonians, Albanians would greatly prefer to jointly operate a trans-regional pipe-line rather than quarreling over possession of territory without any resources, any infrastructure, anything except ancient-rooted historical myths.

Third, a civilized division of Kosovo should have been negotiated and moderated. Many Serbs in the 1980s realized that they cannot and need not hold Kosovo and were ready for its partition. The North-Western part (with the Orthodox monasteries) was supposed to remain in Serbia; the Southern part was to join Albania. Today the division seems inevitable anyhow but the humanitarian disaster could be avoided.

Fourth, "local voices" and Yugoslavia neighbors' concerns should have been taken into account. So far they are simply consuming the consequences of others' miscalculated decisions.

The Balkan countries have repeatedly articulated all the above possible steps. They were not listened to however. Instead the West acted in a typically 19th century "concert of powers" manner in which regional players are treated as no more than subjects in a bigger game. But having said "A", the West should now say "B", accept responsibility for its miscalculated approach and pay the price. After all, the Balkan disaster is not solely Milosevic's fault.

Do Small and Medium-Sized Enterprises in Bulgaria Present Employment and Growth Opportunities?

Andrey Ivanov, Ph.D.
Latchezar Bogdanov
Institute for Market Economics

Small and medium-sized enterprises are considered to be the backbone of every market economy. This is especially valid for a country in transition, with inherited structural unbalances and traditions in agriculture and the food-processing industry.

There is much empirical evidence, from both developed and developing countries, that clustering in certain areas and industries brings about external economies of scale and increases the efficiency of small and medium-sized enterprises (SME).[1] The impressive economic growth of "Third Italy" and other regions in Europe have inspired a lot of research on SMEs and competitive clusters.

Third Italy includes the northeastern and central parts of Italy. The region registered high real growth in the 1970s and per capita-consumption surpassed that in the wealthier north in 1981.[2] This impressive economic performance was associated with the concentration of small and medium-sized firms in particular sectors and localities in the region. The impressive economic growth of the Third Italy was presented to the English-language audience as of a model of industrial development economics, in which linkages between SMEs induced high real growth.

The natural units of a competitive cluster are small and medium-sized enterprises (SMEs). It is believed that the prospect of the emergence of competitive clusters in the Bulgarian economy is closely related to the establishment of SMEs.

SMEs are an important instrument in three dimensions: as a source of new employment opportunities, an impulse for dynamism and a potential for innovation.

Due to their flexibility, low start-up capital and proximity to direct consumers, SMEs can become an economic sector that plays a key role in the creation of new jobs. Thus, they can turn into a vehicle for the creation of a competitive economic environment in the country. On this basis SMEs can reach levels of effectiveness that can foster the economy's adjustment to competitive environments, and they have a significant place in the development of new markets.

The other, indirect economic, aspect of SMEs' role is connected with their role in the development of a new business culture and spirit of entrepreneurship. Promoting new opportunities and improvement of skills, they can produce skilful and experienced managers. This would have a positive impact not only on the development of competition, but also on various aspects of the economy and society.

Another effect is the way SMEs can influence the property structure of the economy. Large privatization deals can be source of income to the budget, but they do not significantly improve the structure of the Bulgarian economy. That can be sustainably achieved only through grass-roots development of initiative and entrepreneurship – which again means the expansion of the role of SMEs.

The general result of SME expansion could be to provide an engine for economic growth and coveted prosperity in Bulgaria. However, a number of barriers prevent SMEs from playing their natural role in Bulgarian society.

This paper will study the current stage of development of SMEs in Bulgaria, as well as their capacity to create jobs and induce economic growth.

SME development in Bulgaria

Before discussing the specific problems of small business, we should first sketch the general framework of private sector development in Bulgaria. The reason is simple: private companies having less than 100 employees account for almost all of the companies registered, and for more than 75% of private sector employment. Some history would be useful.

Businesses were started up against the backdrop of a dominant public sector frozen by delayed privatization and quasi-fiscal subsidies. There were no corporate clients or suppliers for the newly-born private businesses other than the existing state-owned enterprises. During the first years of reform, state manufacturers worked at fixed and low profit rates. This enabled high retail profit margins and actually led to the creation of private businesses. Businesses began to act as retailers or suppliers. Similarly, private financial institutions were established, with credits from state-owned banks.

1. The role of SMEs in creating competitive clusters is further investigated in an upcoming survey by IME and the Economic Development Institute of the World Bank.

2. John Humphrey & Hubert Schmitz, "Principles for Promoting Clusters and Networks of SMEs," Number 1, Paper Commissioned by the Small and Medium Enterprises Branch, October 1995.

Understandably, their credit policy was to provide "friendship" credits to their managers or shareholders, that would be never paid back. This fact is of ultimate importance in the overall picture of the emerging Bulgarian market. It became easier to siphon assets from public enterprises and financial institutions than to invest in a green field. This phenomenon affected all aspects of business practice, including the structure of expenses, that are examined in this study. It destroyed both the old state sector and emerging private business.

Why could the private sector be an engine for growth?

The reason is that it is already an engine for growth. The share of the private sector in Gross Value Added (GVA) has been increasing constantly throughout the years.

At the same time, the performance of large state-owned enterprises was on the decline. In 1998, a year of real GDP growth of probably 4-5%, sectors in which state companies dominated suffered severe declines in sales and profits. Sales in the oil-refining and chemical (basically fertilizer plants) industries shrank by some 27-28% in 1998 in comparison to 1997 levels, in the steel industry by about 10%, etc. Large state-owned enterprises continued to accumulate bad loans. The difference in 1998 is that the major lenders appear to be the government (through tax arrears) and energy suppliers (Bulgargas and the National Electric Company, or NEC), which are themselves state monopolies. Government estimates show the level of this kind of bad loans to be about DM 1.5 billion, or six times more than the structural reform funding planned in the 1999 Budget.

Labor productivity and efficiency

Other indicators for comparison could be labor productivity and capital efficiency in both private and public sectors. The table below presents data on the performance of the private sector, compared to that of public sector companies:

The productivity index measures the ratio of labor productivity in the private and public sector as being the value added per employee. It is obvious that private companies have consistently outperformed state-owned ones. Moreover, labor productivity (measured by the same indicator) in the public sector nominally decreased by 17% during the first half of 1998 (compared to the same period in 1997).

More evidence supporting this conclusion can be found when analyzing data on the economic performance of SMEs in the public and private sectors.

This comparison is based on a National Statistics Institute (NSI) sample of companies submitting their annual balances sheets. The sample is representative in terms of registration and sector distribution. The sample consists of 11,740 non-financial enterprises, 8,500 of them private and 3,240 public. A total of 8,836 of them, 5,805 private and 3,031 public, have reported their final results for the first quarter of 1998. A total of 5,788 of them qualify as small-sized enterprises employing less than 50 people (4,152 private and 1,636 public).

The aggregate financial result in private companies is positive. It is negative in the state sector. This proves that private firms generally perform better than state-owned ones. If we take into account the fact that privately-owned enterprises are motivated (mainly for tax reasons) to declare lower income and lower profits, the difference in performance should become more significant. Also, the average net profit per employee in private companies that employ fewer than 5 workers is 10 to 12 times higher than the average for the entire the sample. This might mean either that these enterprises are not able underreport, or that they really are the most efficient segment of the economy. The probable answer is that they are more effective, but as a result of their lower level of capitalization.

Average sales per employee in the private sector are highest for the smallest companies. Even taking into consideration the possible unreliability of the sample, it is likely that labor productivity increases relative to the decrease in the size of the enterprise, one of the reasons for this being the low level of capitalization of the sector. The other is probably that small companies do not always account all of their expenses.

Public enterprises with 11-15 employees show remarkably positive financial results compared to others in the public sector. One possible explanation is their size. They are quite small, and hence not interesting to decapitalize. At the same time they are big enough to go beyond a "craftsman" scale of production and management approach.

Table 1: Share of the private sector in Gross Value Added (GVA)

Year	1993	1994	1995	1996	1997	1998*
Share in GVA (%)	35.4	39.4	48.0	52.5	58.8	63.7

Source: National Statistics Institute (NSI)
* Preliminary

Capital and asset utilization

There is strong evidence that the fixed capital of small private firms is mainly financed from personal and family sources. Personal savings, family property or inheritance and assistance from acquaintances (or, presumably, non-institutionalized, informal start-up credit) are the forms of support used the most to start businesses. A survey conducted by IME in 1996 proved that 82.4% of the private companies interviewed were financed mainly by personal, family or friends' savings. The credit structure deserves special attention: 62% of firms had not resorted to credit at all, while 41.5% had been financed "by acquaintances." Inter-firm credit probably falls into the latter group. Naturally, the unofficial start-up of a business leads to its subsequent unofficial practice. A strange fact is that 20% of those

Table 2: Comparable index of labor productivity in public and private sector

Year	1993	1994	1995	1996	1997
Productivity index	1.39	1.16	1.35	1.23	1.29

Source: NSI and IME calculations

interviewed in early 1996 declared they did not have any bank account at all.

Data from the Bulgarian National Bank (BNB) provide similar information:

Table 4 suggests two major conclusions:

First, until 1997 the private sector's share in bank credit was substantially lower than its contribution to GVA. This could either mean that private companies were achieving higher capital efficiency, or they had access to non-institutionalized credit. The situation in 1997 and 1998 changed, and the figures prove almost equal private sector shares in credit and GVA. The reason, however, is not that commercial banks have significantly increased the credit extended to private companies, but rather that most public-sector enterprises have been denied access to new loans. Central bank preliminary data prove that in 1998, public-sector companies received 36.3% of the short term and 3.6% of the long-term credit extended that year.

Second, the share of investment in fixed assets in private companies is lower than the value added they produce. This could mean that private entrepreneurs utilize assets better than public sector managers, while, on the other hand, private firms engage in labor-intensive rather than capital-intensive activities. Given that labor productivity in private firms has been consistently higher than that in state-owned ones, it turns out that private entrepreneurs generate higher incomes with the same amount of fixed assets.

Table 3: Performance of SMEs in the private and public sector (NSI sample data)

Employees	Enterpeises- number	%	Sales	Profit	Loss	Employess number	average	Net profit	ASE	ASEE
Private										
1-5	1,307	31	116,474,724	7,642,480	3,247,214	3,108	2.4	4,395,266	89,116	37,476
6-10	736	18	104,013,497	4,243,069	3,569,213	5,848	7.9	673,856	141,323	17,786
11-15	550	13	76,143,403	3,907,723	3,668,634	7,105	12.9	239,089	138,443	10,717
16-20	456	11	70,056,124	9,671,105	11,556,237	8,153	17.9	-1,885,132	153,632	8,593
21-50	1,103	27	209,796,928	12,527,869	9,203,011	36,238	32.9	3,324,858	190,206	5,789
Total	**4,152**	**100**	**576,484,676**	**37,992,246**	**31,244,309**	**60,452**	**14.6**	**6,747,937**	**138,845**	**9,536**
Public										
1-5	290	18	30,291,646	453,505	2,572,054	872	3.0	-2,118,549	104,454	34,738
6-10	239	15	7,118,575	528,273	540,339	1,896	7.9	-12,066	29,785	3,755
11-15	225	14	133,367,752	715,258	511,125	2,899	12.9	204,133	592,746	46,005
16-20	199	12	14,752,717	811,957	2,057,655	3,598	18.1	-1,245,698	74,134	4,100
21-50	682	42	59,114,793	3,110,524	6,836,843	22,680	33.3	-3,726,319	86,679	2,606
Total	**1,636**	**100**	**244,645,483**	**5,619,517**	**12,518,016**	**31,945**	**19.5**	**-6,898,499**	**149,539**	**7,658**

ASE: Average sales per enterprise
ASEE: Average sales per employee per enterprise

Source: NSI sample

Table 4: Private Sector - credit extended,investment and share of GVA (in % of total)

Year	1993	1994	1995	1996	1997	1998*
Share of credit extended	12.40	13.90	25.90	21.21	57.49	63.3
Share of enterprise investments (expenditures for purchasing fixed assets)	22.76	39.04	44.45	38.53	54.40	N/A.
Share of GVA	35.40	39.40	48.00	52.50	58.80	63.7

* Preliminary
Source: BNB, NSI and IME calculations

Size and structure of small business in Bulgaria

Statisticians still cannot specify the total number of companies registered and truly active in Bulgaria. The latest edition of the statistical yearbook states that according to the BULSTAT (Statistical registry which includes all economic subjects) register, the number of "active economic agents" as of December 31, 1997, was 447,714, 428,672 of them private. Data in table 5, however, includes only registered companies – i.e., any activities, such as agricultural production, that are not registered with the court are not taken into account. According to the classification provided by the SME Draft Law, companies with less than 10 employees are "microfirms," those with 10-50 are small enterprises and those with 50-100 are medium-sized enterprises. Using the categories described above, the table below provides data on the sector distribution of SMEs in Bulgaria.

The distribution of private companies by sectors leads to several conclusions.

First, most companies are engaged in trade (60.4%), industry (12.25%) and the provision of services (8.86%). This is not surprising, if we recall the legacy of credit and fixed assets in the private sector. Since privatization was delayed, access to credit was restricted, and few incentives for investment were provided, private entrepreneurs specialized in sectors with low capital consumption.

Second, micro, small and medium-sized enterprises differ significantly in terms of activity. Since microfirms account for 94% of the total number of active companies, their distribution by sector parallels aggregate sector distribution. At the same time, small companies are almost equally involved in trade and industry, and agriculture and forestry comes next with 20%. The high share of agricultural firms might be explained by the fact that small agricultural producers do not usually register companies according to the Commercial Code, and therefore are left unaccounted for, while at the same time farms with more than 10 employees are forced to register. The share of small businesses in the trade and service sectors is half that of microfirms, which means that retail traders and service providers rarely employ more than 10 people. The share of industrial firms is two and a half times higher, which means that serious industrial activities require at least 10 workers. Medium-sized companies are involved mainly in industry and agriculture, while trade comes third with a share of only 17%.

Table 6: Private business by size and activity

Sector	Industry	Agriculture &Forestry	Construction	Trade	Transport	Services	Finance	Other	Total
Microfirms									
number	19,388	4,479	6,591	111,025	12,532	16,211	870	6,241	177,337
%	10.93	2.53	3.72	62.61	7.07	9.14	0.49	3.52	100.00
employees	36,764	11,994	13,133	155,886	16,724	24,526	1,703	9,945	270,675
%	13.58	4.43	4.85	57.59	6.18	9.06	0.63	3.67	100.00
small									
number	23,63	1,710	836	2,588	297	414	170	369	8,747
%	27.01	19.55	9.56	29.59	3.40	4.73	1.94	4.22	100.00
employees	50,114	38,345	16,859	48,124	5,826	8,166	3,828	7,450	17,8712
%	28.04	21.46	9.43	26.93	3.26	4.57	2.14	4.17	100.00
medium									
number	555	314	97	223	32	60	16	39	1,336
%	41.54	23.50	7.26	16.69	2.40	4.49	1.20	2.92	100.00
employees	39,194	21,185	6,909	15,213	2,458	3,950	1,092	2,649	92,650
%	42.30	22.87	7.46	16.42	2.65	4.26	1.18	2.86	100.00
Total									
number	23,110	6,620	7,617	113,956	12,899	16,721	1,082	6,676	188,681
%	12.25	3.51	4.04	60.40	6.84	8.86	0.57	3.54	100.00
employees	379,087	90,449	55,594	244,150	34,394	45,007	11,948	25,114	885,743
%	42.80	10.21	6.28	27.56	3.88	5.08	1.35	2.84	100.00

Source: NSI and IME calculations

Third, there is an interesting distribution in terms of the number of companies and number of workers employed. The table shows, in general, that the employment share of industrial, agricultural and construction companies is higher than their share of the number of companies involved in the respective activities. The case in the trade, transport and service sectors is just the opposite. This suggests that, on average, companies in industry, agriculture and construction tend to employ more people.

SMEs and employment potential: Who creates jobs?

In theory, SMEs are expected to reduce the unemployment resulting from structural reform. In order to find evidence to confirm this expectation, we analyze employment dynamics over the past three years.

The table below demonstrates that significant employment growth really comes from small and medium-sized enterprises. In fact, it should be even higher, given the fact that it is easier for them to have more unregistered labor contracts than larger companies. Although 1996 was an exceptional year in all respects, it is obvious that small and medium-sized companies have the greatest potential for employment absorption. The drastic reduction in the number of self-employed in 1996 was due to the year's economic hardship, as a result of which many of the self-

Table 5: Size and structure of the private sector, 1995-1997

Employees	1995		1996		1997	
	Firms	Empl's	Firms	Empl's	Firms	Empl's
Self-employed	162,039	151,538	151,033	127,161	122,305	133,637
1-9	39,182	102,927	45,982	119,680	55,032	137,038
10-19	3,760	50,194	4,642	62,155	5,109	68,824
20-49	2,780	84,331	3,184	96,363	3,638	109,888
50-99	985	67,046	1,122	76,471	1,336	92,650
100-249	522	76,890	563	83,586	899	137,462
250 or more	137	64,606	174	88,225	362	206,244
Total	**209,405**	**597,532**	**206,700**	**65,3641**	**188,681**	**885,743**

Source: NSI and IME calculations

employed did not submit annual balance sheets. The next year, however, was closer to normal and growth was again witnessed.

Larger enterprises, on the contrary, declined in employment. This tendency is growing, which can be explained by the already-existing hidden unemployment in large companies. Since most of the large private companies are privatized state ones, a big shift in employment to large private firms was observed. However, the overall balance was a loss of 9,100 jobs in large businesses in 1996 and nearly 121,000 jobs in 1997. The tendency is clear from the graph below:

Table 7: Employment by size of enterprise (private and public)

Company range	1995	1996	Change	1997	Change
Self-employed	**151,548**	**127,165**	**-24,383**	**133,637**	**6,472**
1-9	113,014	127,694	14,680	146,064	18,370
Total micro	**264,562**	**254,859**	**-9,703**	**279,701**	**24,842**
10-19	74,053	84,492	10,439	90,654	6,162
20-49	192,523	202,317	9,794	208,723	6,406
Total small	**266,576**	**286,809**	**20,233**	**299,377**	**12,568**
Total medium	**260,724**	**268,127**	**7,403**	**270,704**	**2,577**
100-249	437,850	439,774	1,924	418,678	-21,096
250+	1,130,972	1,119,948	-11,024	1,020,189	-99,759
Total large	**1,568,822**	**1,559,722**	**-9,100**	**1,438,867**	**-120,855**
Total employees	**2,360,684**	**2,369,517**	**8,833**	**2,288,649**	**-80,868**

Source: NSI and IME calculations

Table 8: SMEs and unemployment in the "bottom ten" municipalities:

	NE	%LF	LF	NC	Jobs	CTLF	%LFSME
Borino	1,007	46.36	2,172	34	159	15.65	7.32
Kajnardja	1,021	43.84	2,329	18	199	7.73	8.54
Kaolinovo	2,729	41.97	6,502	25	232	3.84	3.57
Antonovo	1,449	41.63	3,481	22	176	6.32	5.06
Nedelino	1,960	41.07	4,772	37	226	7.75	4.74
Rujinci	865	39.35	2,198	3	33	1.36	1.50
Dimovo	1,197	37.76	3,170	14	192	4.42	6.06
Borovan	974	37.62	2,589	19	226	7.34	8.73
Omurtag	4,949	37.06	13,354	65	407	4.87	3.05
Rakitovo	2,764	36.25	7,624	21	50	2.75	0.66
Total	**18,915**	**39.25**	**48,191**	**258**	**1,900**	**6.20**	**4.92**

Source: NSI and IME calculations

Table 9: SMEs and unemployment in the "top ten" municipalities:

	NE	%LF	LF	NC	Jobs	CTLF	%LFSME
Tryavna	344	4.32	7,963	127	610	15.95	7.66
Bobovdol	266	4.57	5,818	34	201	5.84	3.45
Pirdop	227	5.17	4,394	63	384	14.34	8.74
Bourgas	5,666	5.50	103,001	1,855	8,338	18.01	8.10
Sevlievo	1,099	5.53	19,875	245	1,371	12.33	6.90
Suhindol	77	5.74	1,341	1	4	0.75	0.30
Anton	48	5.88	816	10	47	12.25	5.76
Plovdiv	9,821	5.92	165,929	3,784	16,625	22.80	10.02
Varna	10,333	6.97	148,246	3,153	14,851	21.27	10.02
Gabrovo	2,816	7.04	39,996	998	3,857	24.95	9.64
Total	**30,697**	**6.17**	**497,379**	**10,270**	**46,288**	**14.85**	**7.06**

Source: NSI and IME calculations

Legend:

NE - Number of employed

LF - Labor force

NC - Number of companies

CTLF - companies per 1000 of labor force

LFSME - share of labor force employed in SMEs

The big question is: where do the people from the big companies go? The options are:

- some to the small and medium sector;
- some retired;
- some to agribusiness; and
- some to the shadow economy.

The last segment probably consists of unregistered self-employed workers. The optimistic sign is that these people choose not to enter the unemployed "community." In this respect, even if they stay in the shadow portion of small business, it is preferable than having them stay in the "sunshine" of the unemployment rolls.

So, in discussing unemployment reduction we must take into account the fact that large enterprises (both state and private) will generally be a source of unemployment rather than employment. The state-owned companies will be so because they are expected be either liquidated or privatized. Once privatized, they are not expected to increase employment. Given the high hidden unemployment in the state sector, large enterprises' short-term development strategies will probably be focused on increasing efficiency and productivity at existing levels of employment. Thus, only micro, small and medium-sized companies are promising in terms of unemployment absorption potential. In long term, the only feasible means of unemployment reduction is through self-employment. In this respect it is necessary to assess why the people chosen the fourth option mentioned above prefer to stay in the shadows, and under what conditions they would choose to enter the formal sector.

Is there a significant correlation between SME development and unemployment on a regional level?

In general, small private businesses create new jobs. We can assume that regions with better-developed small business sectors suffer less unemployment. Some useful indicators could be the number-of-registered-companies-to-labor-force ratio and the percentage of labor force employed by small companies. These could be treated as "small business development indices." The table below provides data on small business (companies with up to 50 employees) in the top and bottom ten Bulgarian municipalities in terms of unemployment. The city of Sofia is intentionally not included.

After aggregating the ratios in top and bottom ten municipalities, it turns out that the regions with highest unemployment record "only" 6.2 small firms per 1,000 people in the labor force, while the top ten regions have 14.85 companies per 1,000 people in the labor force. Small businesses provide jobs for 4.92% of the labor force in the bottom ten municipalities, while those in the top ten municipalities provide 7.06%.

A general conclusion might be that regions with more small companies usually suffer less unemployment. This is especially true in big cities, such as Plovdiv, Varna or Gabrovo, where the number of jobs in small firms is significantly above average, and at the same time unemployment rates are among the lowest in the country. However, the data are not straightforward. Bobovdol enjoys the second-best employment rate, despite an extremely underdeveloped SME sector (because of the mining and energy plants there). Borino and Kajnardja, which suffer the highest unemployment rates, at the same time enjoy small business development indices significantly higher even than those in some of the "top ten" municipalities.

Thus, in order to answer the question of whether a correlation exists between the level of SME development (and especially of private SMEs) and employment, it is necessary to compare trends regarding unemployment rates and employment in SMEs by municipality. This data is available from the annual reports submitted to NSI (aggregated for each municipality), and from the National Employment Service. The unemployment rate in each municipality can be compared to the level of jobs in SMEs per 100 persons in the labor force in each municipality. If there is a correlation, the trends described above would have inverse slopes; that is, a higher unemployment rate would mean a low number of small business jobs. At first glance, the unemployment trend varies widely, and hence the correlation is probably weak. In order to trace whether any interdependency exists at all, the unemployment trend was transformed into a trend line through polynomial regression.

The result shown in the graph below proves the general hypothesis that the higher the level of private SME development (measured by the number of jobs in private SMEs per 100 able-bodied persons), the trend is for lower unemployment.

Regression proves a certain degree of correlation between small business employment and the unemployment rate. In general, this means that small private companies are, and could further be, an engine for growth and employment. The large variation from the general trend, however, should make us cautious in deriving any straightforward conclusions.

Summary and conclusions

On the basis of the analyses and calculations outlined above, the following conclusions can be drawn:

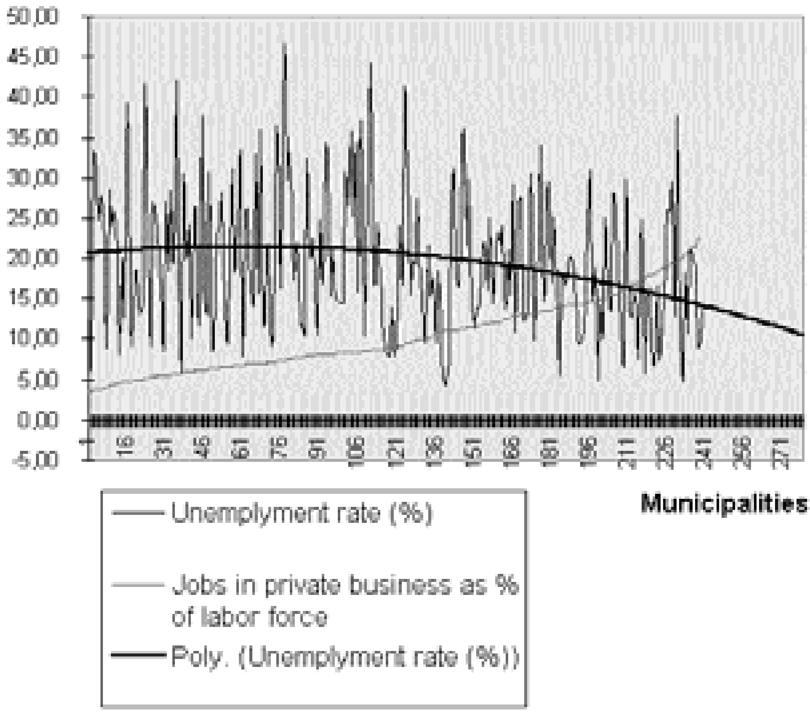
First, micro, small and medium-sized companies are the most dynamic agents in the Bulgarian economy.

Second, there is a clear distinction between private and public SMEs. The private segment of the SME population is the most promising – both in terms of employment and in terms of financial results. Thus, when talking about assistance for SMEs, it should be assistance for private SMEs, not for public SMEs.

Third, there is a correlation between the level of private SME development and the level of unemployment; the higher the level of private SME development, the lower the unemployment rate. Regions with a high level of small business development are generally the regions with low unemployment, and vice-versa – high unemployment usually goes hand-in-hand with under-developed small business.

However, despite this optimistic statement, the role of the existing private SMEs should not be overestimated. Already-existing and further expected (as a result of structural reform) unemployment cannot be

Graph: Correlation between SME development and unemployment



absorbed in the short term by the existing private SMEs. Even according to the most optimistic scenarios for their growth, they cannot absorb the whole unemployment stream. This brings us to the fourth conclusion: in the short term, only self-employment (including in the "shadow economy") can absorb a significant part of increasing unemployment.

This means, fifth, that in addressing unemployment reduction, the government is has an interest in the self-employment of the unemployed, even in the shadow economy. Hence, in choosing between the two objectives of diminishing the shadow segment of the economy and reducing unemployment, the latter should be a priority.

And the last, general, conclusion: any assistance to SMEs should not provide subsidies. Subsidies inevitably blur the diversity of the competitiveness levels of different enterprises and help the weakest part of the population to survive. As a result, subsidies encourage low efficiency and poor performance. The concept of assistance to private SMEs should be boiled down to enabling a more "friendly" economic environment for privately-owned SMEs.

Balkans in 2010: Croatia Background

by Latchezar Bogdanov, IME

Acknowledgments

This paper is based on statistical information from the Croatian Bureau of Statistics (CBS), the EBRD, and Standard & Poor's Sovereign Ratings Service, and data provided in response to a standardized questionnaire by Mr. Predrag Bejakovic from the Institute for Public Finance, Zagreb. Other opinions and conclusions provided are based on interviews with Ms. Marina Kesner-Skreb and Mr. Anto Bajo from the Institute for Public Finance, Mr. Sasa Madzarevic from the Ministry of Finance, and Ms Igeta Drinovac and Mr. Vedran Sosic from the research department of the National Bank of Croatia (HNB), as well as the personal observations of the author, who visited Croatia in May 1997 and April 21-23, 1999.

Country background.

On June 25, 1991, Croatia and Slovenia declared independence. After a six-month war with the Yugoslav army and Serb militias, a peace agreement between Croatia and Yugoslavia was signed on January 2, 1992. Shortly afterward Croatia gained international recognition as an independent state. However, up until the Dayton Agreement of 1995 Croatia was involved in the Bosnia conflict.

Table 1: Nominal GDP 1992-1998

Year	1992	1993	1994	1995	1996	1997	1998*
Nominal GDP (USD m)	10,241	10,871	14,592	18,811	19,738	19,321	21,600

* Estimate

GDP per capita increased from about US $2,200 in 1992 to some US $4,700 in 1998. Over the period 1995-1998 the Croatian economy recorded real GDP growth of 20%, or an average of 4.5% annually. The 1998 GDP level reached 76% of the pre-independence level in 1990. Inflation has been kept low – the CPI averaged 3.7% for the period of 1995-1998 while the PPI averaged a modest 0.8% for the same period. The foreign exchange reserves of the HNB increased from US $1,895 million to US $2,816 million in 1998. Gross government debt increased from 17.9% of GDP in 1995 to 25% of GDP in 1998. The unemployment rate increased from 14.5% to 18% over the same period. Budget deficits averaged 1.2% of GDP in 1995-1997, and for 1998 there was a modest surplus of 1% of GDP. A major share of GDP is held by the service sector, at 65%, industry comes next with 25%, and agriculture accounts for 10%.

The number of registered business entities increased from 74,000 in 1992 to 181,000 in June 1998, or an average annual growth rate of 13.3%. The major business activities are trade (45% of registered companies), finance (11%), industry (10%) and construction (6%). Two sectors have distinctly private ownership: trade, with 61.8%, and construction with 52.6%. Private involvement seems relatively low in the service (25.2%) and transport (4.62%) sectors. The high level of state ownership in services and transport might lead to low flexibility and lack of adjustment to adverse international or domestic economic developments.

Government Budget

Government expenditures accounted for 54.6% of GDP in 1998 and are scheduled to reach 57% in 1999. Their share grew constantly between 1995 and 1998, from 48.9% of GDP to 54.6% in 1998. Major revenue sources for 1998 were: VAT, 50% of total tax revenues; excises, 14.3%; personal income tax, 12.2%; taxes on international trade, 10.6%; etc. The high share of VAT might be explained by the negative trade balance, since imports are taxed and exports are not. Defensecontinues to be a major expenditure, with 10.9% of central budget spending or some 2.6% of GDP. Capital expenditures accounted for 13% of total expenditures, with 10% dedicated to the procurement of fixed capital assets. This item could be used as a first buffer to ameliorate fiscal gaps. Subsidies account for some 2% (although the trend is an upward one) of budget expenditures, or 0.5% of GDP, and are mainly directed toward agriculture and shipyards. Two facts related to local budgets are important: first, local authorities cannot borrow abroad, and second, local authorities of cities larger than 40,000 have the right to determine a so-called "surcharge" above the "federal" personal income tax, within a range of 5-18 percentage points. The latter provides for certain regional fiscal competition, which can be used by local governments to attract investment through tax instruments. At the same time, the ban on external borrowing guarantees long-term central control over the size of public debt. The pension fund is separated from the central budget, but still relies on transfers from the budget. Its level for 1998 was about DM 260 million. The government is allowed borrow up to 5% of GDP from the Central Bank, but the total amount borrowed should be repaid by the end of the year. The maximum amount for pro-inflationary refinancing is about 36% of the foreign exchange reserves of the HNB.

Financial Sector

Sixty percent of total banking system assets are held by state-owned banks, according to the Institute for Public Finance, and in 1997 the four largest banks held 57% of the assets. According to the EBRD, however, private banks hold 64% of the assets. The number of commercial banks increased during the credit expansion in 1997, when domestic credit jumped by 44%. High interest spreads between lending and saving rates attracted new investors, according to analysts from the HNB. Capital requirements comply with the Basle standards, with an 8% capital adequacy ratio and a minimum equity requirement of approximately US $7.8 million for banks with foreign exchange operations and approximately US $2.6 million for domestic licensed banks. Experience and educational requirements are imposed upon bank management. The number of banks is slowly decreasing. In 1998 only relatively small banks were harmed by the withdrawal of deposits, while at the same time deposits in larger banks increased by comparable volume (about DM 800 million). According to S&P the sector is still fragile and overpopulated, though asset quality was improved through the ongoing rehabilitation of major state-owned banks. Croatia also enjoys a relatively high rate of domestic savings, which could foster a further increase in investment.

Debt Management

Total external debt increased from 24% of GDP in 1995 to 39% of GDP in 1998. Private external debt for 1998 was about 13% of GDP, or one-third of total foreign debt. Domestic public debt decreased from 16.7% of GDP in 1995 to 10% in 1998. Interest payments scheduled for 1999 account for some 1.4% of GDP. The biggest share of domestic debt is comprised of obligations to repay foreign exchange deposits (which were frozen in 1993-1996). The amount is US $900 million (41% of total outstanding domestic debt), is due in 2005 and has an annual interest rate of 5%. About 71% of the debt is due before 2010. T-bills account for US $120 million, or 5.5% of total domestic debt. External debt service accounted for 14.9% of exports in 1995, reached 20% in 1998 and is expected to be 25% in 1999.

Foreign trade and major partners

Foreign trade as share of GDP ranged from 60.8% (in 1998) to 68.7% (in 1997) for the 1995-1998 period. The U.S. dollar volumes ranged from US $12 billion to US $13 billion.

Between 1995 and 1997 the trade deficit increased from US $3.2 billion to US $5 billion, or 17% and 26% of GDP, respectively. In 1998, the trade deficit fell to US $3.9 billion, or 18% of GDP. Tourism covered 50% of the trade deficit in 1998 according to the country presentation at the 1999 EBRD Annual Meeting in London (the Institute for Public Finance estimates tourism revenues for 1998 at US $2.7 billion). Major export destinations are the EU, with 45% of total exports; CEFTA countries, with 16.4%; and other European developing economies, with 23.6% (data for 1997).

Trade with Balkan countries totaled US $2.14 billion in 1998, or 16.6% of all foreign trade. Croatia is a net exporter to Balkan countries, with exports of US $1,172 billion (25.8% of total exports) and imports of US $968 million (11.6% of total imports). Major partners in the region were Slovenia (exports of US $432 million and imports of US $722 million), and Bosnia & Herzegovina (exports of US $654 million and imports of US $156 million).

Table2: Companies and employment by sectors

Registered companies (June 1998)	Industry	Agriculture &Forestry	Construction	Trade	Transport	Services	Finances	Other	Total
number	18,160	3,649	10,698	81,388	8,365	5,513	19,438	33,786	181,007
out of them, private (%)	31.2	21.60	52.6	61.8	13.80	25.20	33.8	2.20	27.30
share of total (%)	10.03	2.02	5.91	44.96	4.62	3.05	10.74	18.67	100
number of employees	320,000	35,000	67,000	147,000	88,000	43,000	69,000	226,000	995,000
share of total (%)	32.16	3.52	6.73	14.77	8.84	4.32	6.93	22.71	100
average number of employees per company	17.62	9.59	6.26	1.81	10.52	7.80	3.55	6.69	5.50

Table 3: Savings and Investment

Year	1995	1996	1997	1998
Gross domestic savings as % of GDP	12.0	17.6	11.5	17.4
Gross domestic investment as % of GDP	18.8	22.1	23.9	24.9

Source: S&P Sovereign Ratings Service

Table 4: Major Debt Indicators

Indicator	1995	1996	1997	1998
Gross external debt (USD, millions)	4,538	4,808	6,662	8,197
Gross domestic debt (USD, millions*)	3,137	3,045	2,371	2,154
External debt service as % of exports	14.9	12.9	16.3	20.0
Share of general government gross debt denominated in local currency	93.2	56.2	55.6	40.0

* estimated at annual average exchange rate
Source: S&P Sovereign Ratings Service; Ministry of Finance

Institutions

The state institutions of independent Croatia are relatively new. A quick overview of major institutional developments in the country follows:

Existing state monopolies - At present, water and electricity supply, gas transmission, roads and telecommunications are subject to government monopoly. Croatian Telecoms is scheduled for privatization in 1999. The state monopoly in energy supply and transmission will remain. Concessions are to be applied to roads.

Capital markets - The Zagreb stock exchange, which was founded in 1918, was revived in 1991. It is registered as non-profit joint-stock company. Its members are banks and brokerage houses. Two smaller, unofficial (OTC) markets operate in Varazdin and Osijek.

Deposit guarantee system - Corporate accounts are not insured. Private deposits are 100% insured up to the level of HRK 100,000 (DM 26,000) per person (cumulative).

Registers - The property register is centralized and based on property, but not available in electronic form.

Bankruptcy - Bankruptcy procedures are rarely used, and their average term is 12 months. The Finance Ministry usually blocks accounts. Contract enforcement is poor.

Foreign exchange - Foreigners are not allowed to buy HRK-denominated debt.

Credit ratings - Local currency: BBB+/Stable/A-2; foreign currency: BBB-/Stable/A-3.

Fiscal system - Treasury system was introduced in 1999.

Foreign trade - WTO membership expected by end-1999

Political

The Croatian constitution provides for a bicameral parliament, a president elected by popular vote and a three-tier judiciary system. Presidential elections are held once every 5 years, members of parliament (both lower and upper house) have 4-year terms. The prime minister is nominated by the president and later approved by the parliament. Franjo Tudjmann has been president since 1990, and was reelected in 1997 to another 5-year term. The country has had three governments in the last nine years. President Tudjmann is losing confidence – in January 1998 he was the second-most respected person in the country, while in January 1999 he ranked 35th. Still, his term does not end until 2002. His major assets seem to be war and nationalism. He identifies independent Croatia with himself, claiming every political opponent to be an enemy of independence. At the same time, moderates enjoy higher approval ratings than Mr. Tudjmann. The next general elections are scheduled for the spring of 2001. Serb, Hungarian and Roma ethnic parties exist. Political protection is considered important in procurement tenders, privatization and access to subsidies.

Table 5: Foreign trade with Balkan countries in millions of USD in 1998

Countries	Trade flows (USD m)	
	Imports	Exports
Albania	0	0
Bulgaria	0	5
Bosnia & Herzegovina	156	654
Greece	0	0
Macedonia	56	64
Slovenia	722	432
Romania	15	7
Turkey	0	0
Yugoslavia	19	17

Conclusions

With the fastest-growing economy and the second-highest per-capita GDP in the region, Croatia will survive the war in Yugoslavia with negligible to moderate losses. Croatia is physically detachable from its Balkan neighbors. Zagreb is only 170 kilometers away from the Trieste port in Italy. Both railway and road infrastructure allow for convenient transportation to EU member countries. Croatia cannot be isolated from the West by any regional conflict coming from the south or east. The only two countries that could affect Croatian economic development in any meaningful way are Slovenia and Bosnia-Herzegovina.

Cooperation with international institutions, however, seems fragile. After a three-year IMF extended agreement worth US $490 million was signed in March 1997, the lack of progress in implementing the Dayton and Erdut peace accords caused a delay in IMF Board approval for the first review of the program. The same reasons kept the World Bank and the EBRD out of the country after mid-1997. EU financial assistance is limited to humanitarian aid, and the PHARE program was canceled in 1995. Furthermore, Croatia decided to stop making purchases under the agreement in the autumn of 1998. Overall, dependence on official foreign financing is low, which makes decision-making relatively indifferent to IFI support. Trade flows with Slovenia and Bosnia-Herzegovina are significant, amounting to 9% and 6.3% of overall foreign trade, respectively. Other countries have a negligible share of Croatian trade. Croatia is export-dependent on Bosnia-Herzegovina, which accounts for 17% of Croatian exports. Croatia will maintain a high level of trade deficit. Its financing depends on tourism (about 50% for 1998), foreign direct investment and foreign private debt financing. Tourists from the former Yugoslavia account for 17% of total tourist-nights, however, only 2% come from Bosnia-Herzegovina and the rest from Slovenia. Tourists from other emerging markets account for 27% of tourist-nights. The dependence on emerging market tourists is relatively high, at 44%. The direct impact of the war in Yugoslavia, in terms of tourists from war-torn countries, is negligible. The tourism industry, however, is sensitive to political instability, which could undermine foreign exchange inflows in the future. Foreign direct investment has been a negligible source of current account financing. Its level by September 1998 was US $2 billion, US $420 per capita, or 24% of total outstanding external debt at the time. The equity market is still underdeveloped, with only a few stocks (such as Zagrebacka Banka and Pliva) traded on the floor. The level of foreign equity investment is negligible for the moment. At the same time, Croatia managed to finance a huge current account deficit by borrowing on international financial markets. After favorable credit ratings of BBB-/Stable/A-3 on foreign currency debt were granted in January 1997, the government switched to foreign financing, and the gross external debt (public and private) increased by 39% in 1997 and by 23% in 1998. In March 1999, the country managed a EUR 300 million seven-year bond issue with annual interest coupon of 7.375%. The bonds provided relatively cheap financing, with a 375-basis point spread over German government bonds. The local-currency component of government debt decreased, from 93.2% in 1995 to 40% in 1998. These facts mean that the Croatian government is increasingly borrowing abroad, thus increasing foreign exchange inflows, but at the same time increasing default risk. Apart from its north-east territories, Croatia is ethnically uniform. Since the current ruling party and President Tudjmann root their political legacy in the national independence and strength of the Republic, in the event of loss of confidence, ethnic problems might be "invented" for electoral purposes.