Through Economy to Democracy and Security?

An Integrated Approach to Stability in South East Europe

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PREFACE

At a moment when the international community is dealing – struggling, actually – with new security challenges, some of which are internal disputes between members of two of the most powerful (and successful) military and economic organisations in history, NATO and the EU, it is worth remembering that some things do evolve in a positive direction.

The Dubrovnik workshop on the issue of economic security in South East Europe provides testimony that persistent engagement is paying off. Croatia, especially, is on its way to being welcomed in the European Union. Certainly, many analysts in the workshop reflected wistfully on comparisons of economic performance from pre-war levels. Such an analysis is a two-edged sword. On the one hand, it shows in an objective manner that there is far more public good reaped from integrative policies which foster and multiply trade opportunities. Indeed, the comparison with pre-war levels offers the chance to calculate just where Croatia might be had there been no war.

At least some of the elite of Croatian society are realising that it is far better for everyone to have disagreements and trade than to sabotage decades of good commercial relations for the sake of ethnic purity. As many are now discovering, the drive towards ethnic purity is usually riddled with craters and shell holes, some of which inflicted by the armed forces of concerned members of the international community. Most of all, there is the looming understanding that the isolation brought by ethnic purity, if one is consistent with such policies, will not put bread and butter on the table. To some, it might look like an appealing discourse, but exclusion of the different element of one's society can only bring condemnation from without, and one of the most useful tools of the international community remain trade sanctions.

On the other hand, the comparison with pre-war levels of trade is not a reminiscence of times when inter-ethnic relations were harmonious. They weren't always, but then again, inter-ethnic relations in all countries suffer from friction. And as we have argued in a preceding workshop, the burden of history in the Balkans, as heavy as it may be, proved insufficient to warlords in the region. A lot of concerted effort needed to be applied to bring about the cataclysm of the early 90s. This has brought a state of mind that may lead comparisons with pre-war trade levels and those of today to be used as another factor of resentment against the perceived aggressor. This is why it would perhaps be better if trade indicators concentrated more on net progress since the Dayton Accords were signed. This way, populations, academics and analysts everywhere concentrate on what will be rather than what could have been.

An interesting feature revealed during the workshop is that pre-war trade relation patterns are being re-established. While the doors of the EU and NATO have remained closed to Balkan countries (and for cause), they have had to trade somehow to offset the comparative disadvantages between them. Of course, some part of that trade is illicit and certainly a factor of insecurity to the region and to Europe. But it shows that hatred may not be that deep-rooted after all, or rather that rationality is gaining the upper hand over emotions.

Economic and commercial progress remains fragile. Our world is subject to tectonic shocks as it realigns for a new order. As a result, the markets will remain volatile and this may adversely affect regions transiting to a market economy, much like the crisis of 1997 has affected Russia, for example. This means that opportunities must not be missed, least of all the opportunity to demonstrate satisfaction and praise for the rebuilding efforts of the countries affected by the Yugoslav wars. The Dubrovnik workshop was just such an occasion to celebrate and take stock of progress made, and also the moment to notice the inconsistency associated with wanting to split from the Yugoslav federation to join the European Union.

The uneasy admission that former enemies will relatively soon be invited to be members participates to the notion that the scars of the war are healing, albeit slowly. There remain substantial challenges, some of which are caused by the relative isolation of the region from other economic poles. This first part of the publication deals with just such challenges. Surveys on socio-economic performance in the Balkans for the last ten years offer little to cheer about. Yet the situation is no more dramatic than in some of our own "developed" countries, where unemployment, for example, is heavily regionalized. In effect, the regional average, which stands at some 25.5%, is only marginally worse than the 20% unemployment rate in some regions of Canada to take one example (seasonal unemployment in the Maritime provinces, or regions depending on non-diversified industry). The message is that everything must be put in perspective.

The most potent indicator of increased well-being is the problem of brain-drain. Again, while this is a serious problem taken in the traditional context of the nation-State, no country is immune to this problem. This is one of the staples of globalisation, and, if anything, increasing brain-drain may simply mean that better opportunities are found elsewhere and that more individuals have the means to travel. We cannot judge the impact of the flight of talents from national shores anywhere. This phenomenon is too new. There needs to be greater research done on this subject, otherwise we cannot tell a curse from a blessing.

One way that is deemed effective in controlling brain-drain is foreign direct investment (FDI) into the region. As guest companies open branches in host countries, they create opportunities for local employment. Such was the philosophy –and result– of Microsoft's presence in the region. The success of the endeavour prevents in some way the flight of the more educated and technically capable. Yet a large part of our discussions focussed on the perceived evils of FDI. The repatriation of profits without reinvestment participates to a situation where means to

address or cure social ills remain missing. In that respect, Milford Bateman's paper makes for compelling reading.

Yet, if the Baltic example is anything to go by, the answer to peace and development lies in more FDI. Perhaps the problems of their predecessors will inform policies in the Balkans. For those investors looking for a bonanza similar to the one that the end of Communism has offered, now is the chance. Yet this chance is made attractive and viable if and only if there is material security in the region.

We have not been able to decide whether a functioning economy is the harbinger of effective democracy. Perhaps it is better this way. The "enlightened" West has its own problems with democracy in the wake of the Iraq crisis, and the mutual funds scandal ringing ever more loudly in the United States and Canada make the West's claims of official corruption seem hollow. This of course, does not excuse corruption, and Western administrative and political purity is only half-saved by democratic transparency. Clearly, every country can sustain better governance.

But the fact remains that whatever the initial indifference to the Balkan crisis may have meant, continued engagement from without is slowly extracting the region from endemic tension and fear. It may be that, within our lifetime, we will look at Bosnia, Croatia, Serbia, Slovenia and the former Yugoslav Republic of Macedonia[1] as no more the back yard of Europe, but as complete, efficient and reliable partners.

Much work remains. But the tide is turning. The process of development in the region, as difficult as it may have been for the donors and receiv-

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[1] Turkey recognises Macedonia under its constitutional name. The use of the term Macedonia does not imply that the Austrian Republic recognises the Former Yugoslav Republic of Macedonia under that name. The term was left as is by the editors to respect authors' wishes.

ers, may yet provide a model for other cases. Mr. Solana's draft EU security strategy puts a lot of emphasis on prevention and engagement as a means to avoid or overcome State collapse. There is no doubt that the economic involvement of great powers, and the prospect of political rewards such as EU membership are excellent motivators for reform. Nor is there any doubt that the other engine of reform, the general will of populations too long left out of mainstream economic activity, will soon make its voice heard, as it demands a fair chance to advance in the community of developed economies.

The editors are indebted to Capt. Ernst M. Felberbauer for his tireless efforts, and to all the staff at the Austrian National Defence Academy for the celerity with which they produced this publication. They are also grateful for the contribution of panellists and presenters at the Dubrovnik workshop, who made the discussions and topics so lively. We could not be silent on the role of the Austrian Ministry of Defence, which funds large parts of these workshops as well as the Partnership for Peace Consortium of Defence Academies and Security Studies Institutes, which bears the major share of all costs. We hope that the conclusions emerging from this publication in particular will show that this was money well spent, as the region manifestly finds its way to stability and peace.

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PART 1:

INTRODUCTION: SURVEY OF ECONOMIC AND SOCIAL CHALLENGES IN SOUTH EAST EUROPE

Hermine Vidovic

Labour Markets and Employment Development in South East Europe

Introduction

In contrast to the Central European transition countries, the economies of South East Europe (SEE) have been facing complex and interrelated political and economic problems. The dissolution of Yugoslavia combined with market losses, war in Bosnia and Herzegovina and Croatia, sanctions finally culminating in the Kosovo conflict were the main causes of political and economic instability in the whole region. Taking into account these factors, output recovery has been much slower in SEE than in the Central European countries. Measured in purchasing power standards, Croatia is the best performer in the region, with its GDP at about 38% of the EU average. Next comes Bulgaria (32%), whereas the respective values for Serbia and Montenegro and Albania range between 15-17%. Looking at the economic performance in the 1990-2002 period, Croatia and Romania reached almost 94% of their pre-transitional level in 2002, followed by Bulgaria and Macedonia (about 88% each). Serbia and Montenegro, the worst-affected, reached only about half of what it was in 1990. The cumulative output decline there was one of the largest among all the Central and East European countries.[2]

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[2] In contrast, Poland had surpassed its pre-transition level by 56% and Slovenia by 35% in 2002.

Despite the resumption of economic growth in most of the countries there was no essential improvement on the labour markets in the South East European countries over the past years. In 2002, only Bulgaria and Croatia showed a slight employment increase. In Bulgaria the turn-around was mainly due to a recovery of some manufacturing branches contributing to net job creation as well as active labour market policy measures and the launching of public works programmes (ECE 2003). New jobs in Croatia were mainly provided in the services and construction sectors, the latter due to motorway construction.

Demographic trends

Population data of the former Yugoslavia have to be taken with caution due to the war in the region and the following waves of refugees, especially for the successor states. During the past decade – apart from the extreme case of Bosnia and Herzegovina – population decreased significantly also in Bulgaria, Romania and to a lesser extent in Croatia, fell slightly in Serbia and Montenegro and remained almost unchanged in Macedonia (See table 1 in Annex).

Albania is the only country reporting a remarkable increase in population over the 1991-2001 period. Between 1989 and 1996 more than half a million people left Bulgaria, which was up to 1993 mainly due to the emigration of Muslims to Turkey. Later on, the poor economic situation caused well-educated (young) people to emigrate either to the USA and Canada or to Western Europe. In Bulgaria these developments have led to a considerable depopulation of large areas of the country, mainly the underdeveloped, border and mountain regions (ETF 2000a). The steady population decline in Romania from 1991 onwards was caused both by the negative natural increase and net outward-migration. Similar to Bulgaria, a remarkable size of educated youth has been leaving the country every year. The brain drain problem is a common feature of all SEE countries. Estimates for Bosnia and Herzegovina in the 1996-1998 period put the number of highly qualified who left the country at 42000, three quarters of which were below 40 years of age. During the first

years of the 1990s about 17000 young qualified people left Macedonia (ETF 2000b). A strong outflow of qualified labour was reported also for Serbia and Montenegro. Triggering a steep increase of legal and illegal emigration mainly to Greece and Italy[3] about 40% of the university professors and researchers have left Albania over the 1990-1999 period. Apart from a sizeable external migration, Albania faced an internal mass migration from rural to urban areas (UNDP 2000, p. 46).

In most countries the share of the working age population (15-64 years) accounts for roughly two thirds of the population. With the exception of Albania all countries report an increasing share of people older than 65, the proportion of which is highest in Bulgaria. Ageing of the population is becoming also a problem in rural areas of Romania where the elderly are the majority of the population. Data on Serbia and Montenegro are not available. In accordance with the rising shares of the productive and post productive age groups, the share of young people up to the age of 14 years has been on the decline. The proportion of the pre-productive age group is highest in Albania (32%) and in Macedonia (25%) and lowest in Bulgaria (16%).

Employment

All countries in South East Europe, except Serbia and Montenegro, have been facing dramatic employment cuts over the last decade, by more than one quarter on average (See Figure 1 in Annex). Apart from Bosnia/Herzegovina, Macedonia and Bulgaria were affected most, suffering job losses by almost one third over the 1989-2002 period; in Romania employment fell by about 30% and in Albania by 26%. In Serbia and Montenegro the number of jobs was by about one fifth lower than in

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[3] The majority of emigrants are males in the age between 20 and 30 years. Emigration is mainly driven by economic reasons. Most of the Albanian emigrants are temporary or seasonally employed. About half of the emigration is illegal nowadays, at the beginning of the 1990s this ratio was almost 90% (UNDP 2000, Telo 1999).

1989, and in Croatia by 16%. However, based on health insurance data the employment decline in Croatia was among the highest in region, down by 28.5%.[4] Roughly speaking about 3.3 million jobs got lost in the 1990-2002 period and a big share of the workforce has exited from the labour market altogether, with a growing number of discouraged workers.

Declining employment is clearly reflected in the steady drop of activity and employment rates over the 1996-2002 period (See figure 2 in Annex). Available LFS data indicate a fall in all SEE countries for both men and women (except Macedonia, where the female employment rate increased). Croatia and Romania are by far hardest hit, with the employment rate down by 9 and 8 percentage points. In all countries economic activity rates (labour force as a percentage of the working age population 15-64 years) were lower than the EU average.

The employment population ratio (employed as a percentage of total population) remained stagnant, but low in most of the countries (See figure 2 in Annex). In Macedonia only 27.5% of the population are employed, followed by Albania, Bulgaria and Croatia (30-35%). Romania reports the highest (but also declining) ratio, at 44.6%[5], slightly below the EU average of 45.4%.

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4 LFS results, published since 1996 have to be taken with caution as well, as up to the second half of 1999, parts of the Croatian territory (Krajina and Eastern Slavonia) were not included in the sample frame. This might explain the different employment developments between 1999 and 2000, with the Statistical Office data reporting a 3% employment decline and the LFS data (for the first half of the year each) an increase of 2%.

5 All these ratios are biased as they do not include employment in the shadow economy.

2.1 Employment patterns

Since the beginning of transition SEE countries have been undergoing a rapid de-industrialisation process, while employment in services and agriculture remained high. The latter differs quite substantially from developments observed in the central European transition countries, where everywhere except Poland a rapid urbanisation process is under way (See figure 3 in Annex).

Apart from Albania employing some 70% of the total workforce in agriculture, Romania is the most outstanding example where agricultural employment amounted to 35% of the total in 2002 based on LFS data. Agriculture still accounts for about one quarter of total employment in Bulgaria and about 23% in Macedonia. Also in Croatia, agriculture still plays an important role absorbing about 15% of total employment in 2002. Like Slovenia, registration data reveal a much lower proportion of those employed in agriculture than the labour force survey does. Data on the sectoral composition of employment in Serbia and Montenegro are not available; but based on the information obtained from the labour force surveys, the proportion of agricultural employment may account for an estimated 22% of the total. In general one may conclude that the inflow of laid off labour from the industrial and construction sectors to agriculture was eased through the emergence of numerous small farms after the privatisation of large state owned agricultural enterprises; thus agriculture acts as a buffer or shock absorber against unemployment (UNECE 2000, p. 105).

A common feature of all SEE countries is the sharp contraction of industrial employment (including construction). Apart from Bosnia and Herzegovina the rate of decline is highest in Bulgaria and Romania, where more than half of industrial jobs got lost over the transition period, in Macedonia close to 50% and in Croatia more than 40%. In SEE the proportion of industrial employment is smaller than in the most advanced

transition countries, accounting for less than 30% of total employment.[6] Only in Macedonia does the share of industrial employment exceed that mark with a proportion comparable to Hungary (about one third of the total).

The services sector is underdeveloped by European standards but also in comparison with Central European transition countries. Apart from the extreme value of Albania, where the services sector absorbs only about one fifth of total employment, that sector is most developed in Croatia, absorbing more than half of total employed.[7] Compared to other countries of the region there was a dynamic development in the Croatian services sector (especially in tourism, but also in transport) already in the seventies and eighties percentage points. Services sector employment differs substantially across countries and sectors. Altogether we observe an upward employment trend in 1) wholesale and retail trade in all countries, except Macedonia, 2) real estate, and other business services including legal services, accounting, engineering in all countries except Romania (not explicitly shown for Serbia and Montenegro) and in 3) public administration and defence (except Croatia). In contrast, employment fell in a) transport and communication, b) health, social work and c) education. Developments in other segments of the services sector were rather diverse.

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6 In Slovenia and the Czech Republic, industry and construction account for almost 40% of total employment.

7 The services sector employment accounts for about 58% in Hungary (the most ‘advanced’ country).

Unemployment

Following the sharp contraction of employment, the number of jobless (and accordingly the unemployment rate) grew strongly in all SEE countries, except Serbia and Montenegro[8] (See figure 3 in Annex). Apart from the extreme case of Macedonia (37%) and Bosnia, where the unemployment rate ranks between 37 and 39%, in the first half of 2003, Serbia and Montenegro reports one third of the labour force being registered as unemployed, Croatia and Bulgaria record a decline in registered unemployment rates to 19% and 14% respectively.[9] Romania is the only exception, posting a rate of about 7%, which suggests that most of the (industrial) restructuring remains to be done.

In all successor states of the former Yugoslavia and to some extent in Romania the registered unemployment rate tends to be higher than the rate obtained from labour force surveys (LFS). The largest discrepancies occurred in Croatia and in Serbia and Montenegro where the registered unemployment rates were by 7 and 12 percentage points higher than the LFS rate, in Romania the difference was about 3 % in 2002. Incentives

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8 Though reporting high levels of registered unemployment both in relative and absolute terms, over the last decade the number of jobless increased less dramatically in Serbia and Montenegro than in other countries of the region. During the period of UN sanctions against Yugoslavia layoffs were prohibited and paid leave very common. Disguised unemployment has been growing steadily during the past decade and was estimated at some 30-40 % of the employed (Arandarenko 2000). Taking into account that the privatisation process is only at the beginning, unemployment is expected to further increase in the years to come.

9 Figures for registered unemployment especially in the successor states of the former Yugoslavia may overstate the actual number of unemployed. Results obtained from the LFS conducted in these countries indicate much lower jobless rates. These discrepancies might be explained by the fact that a large number of registered unemployed is in *de facto* self-employed in agriculture or works in the informal economy and/or registered unemployed are often not actively seeking a job to they register in order to be insured (see also UNECE 2003, p. 75).

for registration either for those who are working in the informal sector or who are simply unwilling to work are the possibility to be covered by health insurance or to receive some other social benefits. In 2002 in Croatia, a total of 136000 or 39% of the average registered unemployed in this period did not fulfil the international criteria of unemployment either because they did not seek a job (38%), did not accept a job offered (15%) or they worked unofficially (41%).

Although there are substantial inter-country differences, several common features of unemployment can be identified: 1) long-term unemployment is extremely high, 2) youth unemployment (job seekers without working experience) has been increasing rapidly, for example in Serbia and Montenegro about two thirds of the unemployed are first time job seekers. 3) the lowest skill and educational groups are over-proportionately affected and 4) unemployment levels among ethnic minorities and other socially disadvantaged groups are many times higher than the average rate.

The share of unemployed who have been out of work for more than one year can be seen as a guideline indicator of the extent of structural unemployment. Data available for the countries under review show that the problem of long-term unemployment is even more severe than in the other transition countries. Highest values are reported for Albania (over 90%), Macedonia (85%) and Serbia and Montenegro (75%); in Bulgaria two thirds of total unemployment is long-term, in Croatia and Romania slightly more than half (See figure 4 in Annex). In the latter the incidence of long-term unemployment (among people who had worked before becoming unemployed) is highest for those who had a job in the state owned sector: about half of them have been unemployed for two years or more. People less affected are those who had worked in the private sector and self-employed workers (Bisogno 2000).

In most countries chances of becoming employed after entering the pool of job seekers are limited. In Bulgaria, the probability that the unemployed will find a job within the first twelve months of being unemployed is around 6.2%. The incidence of long-term unemployment there

is highest in rural areas, for women re-entering the labour market, the low-educated and low-skilled and young people who have graduated from secondary and tertiary education (ETF 2000a). In Croatia about one third of the unemployed that have worked before are facing unemployment spells of two years or more. In Romania long-term unemployment is a feature of urban areas.

Unemployment hits young people disproportionately. In most countries of the region the LFS unemployment rate among people younger than 25 years is twice as high as the total unemployment rate, in Romania it is even three times higher. The high rates of 58% and about 50% in Macedonia and Serbia and Montenegro indicate a quite critical situation of young people on the respective labour markets (See figure 5 in Annex). Young people do lack professional experience, options are either to emigrate or enter the shadow economy (poor working terms). Youth unemployment is mainly long-term in Albania and Romania, in Albania young job seekers (below 31 years) account for 59% of total long-term unemployed. In Romania, the problem of long-term unemployment among young people is mainly concentrated in urban areas; the lower incidence in rural areas might be due to the possibility of seasonal work, but also due to the migration of young people to the bigger cities. The latter phenomenon can be observed in most countries of the region – Albania, Bulgaria, Montenegro and Romania. Other vulnerable groups among young people are the young Roma in Romania and Bulgaria, young returnees, refugees, demobilised soldiers, and disabled soldiers in Bosnia and Herzegovina and in Serbia and Montenegro (see also ETF 2000).

The main reason for the high unemployment incidence of young people in most countries are widespread skill mismatches (the qualification obtained does not respond to the requirements on the labour market) and school drop-out rates. The latter is particularly obvious in Albania, where about 40% of the young people complete their studies after compulsory education (ETF2000b)

The youth unemployment rate varies also significantly across EU member states, it is particularly high in Italy and Greece, where 26-27% of young people in the labour force are unemployed, while the respective value for Austria is 7% (European Commission 2003).[10]

Similar as in other transition countries and in the EU there are large regional disparities in unemployment in South East Europe. In general, unemployment tends to be lowest in big cities with a developed services sector and in regions with diversified industrial economy. The low territorial mobility of the labour force is aggravated by the lack of housing and/ or high rents, high transport costs and/or the cut of public transport. As far as data are available, in most countries under review, unemployment is lowest in the capital cities.

The unemployment incidence is very high among ethnic minorities. In Bulgaria the jobless rate among the Roma population reaches about 80%, which is five times higher than the national average; most affected are young people below 30 years of age, about two thirds have never worked (ETF 2000).[11] The unemployment rate of Turks and Pomaks (Bulgarian Muslims) is lower than that of the Roma, but is concentrated in some regions where tobacco and mining companies were closed down in the wake of restructuring. A common feature of ethnic minorities is their low educational, which is even more pronounced among the Roma than among the Turks and Pomaks.

Informal economy

When speaking about the labour market in South East Europe it is unavoidable to refer to the informal economy which plays an important

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[10] In 2002 the youth unemployment rate in the EU and in the membership-hopeful countries was 15% and 32% respectively.

[11] The Roma population in Bulgaria numbers about 540000 persons, Bulgarian Turks and Bulgarian Muslims about 700000 people.

role in the whole region. Generally one may argue that the size of the informal economy in SEE is considerably higher than in the CEE countries. However, the estimated magnitude of this sector can vary strongly depending on the method used for calculation. In most countries the informal economy is concentrated in agriculture, trade and construction. A recent study concludes that in Macedonia the informal activities are on the increase in health care, ministries and government bodies and public enterprises (Jankulovska 2002).

According to Christie and Holzner (2003) Albania and Kosovo had the highest proportion of informal activity in 2001, while Croatia was the country with the lowest share of the grey economy (See figure 4 in Annex).

Conclusions

Over the past decade, about 3.3 million jobs were lost in the SEE countries. A large share of the workforce has exited the labour market altogether, with a growing number of discouraged workers and declining activity rates all over the region. The huge job losses in industry and construction have been absorbed only to a very small extent by the services sector; the latter is still underdeveloped by Western but also Central European standards – Croatia being the only exception. In most countries unemployment increased rapidly and remained at persistently high levels and 'the intensity is quite unusual by European standards' (Daianu, 2002). The huge proportion of long-term unemployed workers may lead to the erosion of skills, and it might be expected that many of them will exit the labour market altogether, pointing to a further decline in activity rates. Taking into account that transformation is still at the beginning, the labour market situation will further deteriorate.

Future job creation will first of all depend on sustainable economic growth. In contrast to Western European economies, where a GDP growth of about 2% is sufficient to enable new job creation, the respective value in the transition economies stands at about 4-5%. Another

important factor to increase employment is the development of small and medium-sized private enterprises and the ability of SEE countries to succeed in attracting foreign investment. Furthermore, the upgrading of skills will be one of the major tasks in order to overcome the problem of the skill mismatch. An indispensable precondition, however, for a substantial economic improvement in the region in general and on the labour market in particular is to achieve and maintain political stability.

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PART 2:

Intra Regional and European Trade as Engine of Security and Democracy

Boris Vujčić and Vedran Šošić[12]

South East Europe and the Trade Potential of Croatia

Introduction

The question of the trade regime for Central and Eastern European countries (CEEC) has during the last decade been the subject of an intense discussion amongst the policymakers and academia from both within the region and from the EU. The main issues around which the discussion has concentrated were those of enhancing the catching-up process by the means of trade liberalization, and protection of the "sensitive" industries within the EU.

Regarding the design of the trade regime for the South East European (SEE) countries[13], the issue of the speed of their accession towards the EU, and/or regional approach has added a new component to the discussion. The current discussion has not been very insightful with respect to the "hard facts" on the present level of integration within the region and

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[12] We would like to thank Ms. Maja Bukovšak on her assistance.

[13] SEE countries are here defined as Croatia, Bosnia and Herzegovina, Serbia and Montenegro, Macedonia and Albania, i.e. "trade isolated" countries that were neither EU candidate countries nor CEFTA members.

its relationship with the EU. An obvious fact is that all countries have in one way or the other been excluded from international trade integration during the nineties. Also, it is obvious that the region is an economic dwarf, which makes any serious competitive threat to the EU highly unlikely.

In this paper we first present some stylized facts on the Croatian trade, and the SEE trade. Second, we analyze the level of trade integration within the region, using simple tools such as trade openness ratio and trade concentration indices. We try to explain why the trade development in Croatia did not observe the expected transitional behavior. Then we observe selected trade issues arising from the specific institutional features of these countries. Finally, we discuss the "correct" design of the trade regime for Croatia and SEE.

1. Trade and Transition: The Forces at Work

A typical transition country can be described as a small and open economy often with a newly (re)gained independence. Croatia, indeed, fits quite well into this definition. At the onset of transition, three distinct forces were shaping the trade pattern of a typical transition country. First was a collapse of the COMECON. Another contribution to a new economic geography was the dissolution of multinational states like the USSR, Czech Republic and Yugoslavia. Third was an increase in trade openness ratio (TOR) as a consequence of policies of stabilization, liberalization and privatization.

Although the former Yugoslavia was not a member of the COMECON, its collapse, which accompanied the fall of the Iron Curtain, led to a diversion of excess trade with that block. Havrylyshyn and Pritchett (1991) suggest on the basis of gravity equations, that during the period 1980-1982 Yugoslav trade with CEE exceeded the “norm” by 13 percentage points of the total trade. At the same time, trade with Northern Europe fell short of “natural” trade by 18 percentage points. This was fairly small in comparison with their estimates of trade reorientation

needed in other CEE countries. For example, it was estimated that Czechoslovakia needed trade reorientation accounting for more than 70 per cent of its total trade. Based again on the gravity approach, Wang and Winters (1994) draw a somewhat different conclusion for the year 1985. Although intra-COMECON trade broadly matched the potential, trade with market economies fell by and large below the potential. Hungary appeared to be the most open of the CEE countries with actual trade with market economies reaching 30% of the potential. Unfortunately, Wang and Winters did not estimate the potential trade for Yugoslavia, but one can assume, based on other studies, that Yugoslavia (Croatia) suffered from less trade bias than other the CEE.

Baldwin's (1994) results for the last pre-transition year 1989 confirmed that there was too much intra-CEEC trade. The extent of trade diversion varied from 160% of excess trade with the East for Romania to 40% for Poland. Potential CEE exports to the EU were 4.8 times higher than the reality, while the potential EU exports to CEE were 2.1 times higher than the reality. Although Croatia was at that time still a part of Yugoslavia, which prevented comparison of potential with actual values, Baldwin has also estimated a pattern of potential Croatian exports. According to these estimates, the EC-12 should in the long run become the destination for around 60% of Croatian exports. If exports to the European free trade area are also added, this increases the share to 76%.

In addition, Baldwin presents a projection of trade pattern in the scenario of partial income catch-up. Although the effects of the partial income catch-up would make the trade amongst the CEEC's remain important, trade with the Western Europe will become dominant with the trade share ranging for different countries between 50% and 70%.

Even though different studies come to different quantitative conclusions with respect to the intra-CEEC trade, they all agree that prior to the collapse of the COMECON there existed a large potential for an increase in trade with the Western countries. The main reason behind the different estimates, apart from the differences in the estimation methods, samples

and periods for which the simulation exercises were run, lies in the great uncertainty about the exact values of the relevant variables. This is especially true for the GDP of the CEE and the value of trade flows that existed amongst them, estimates of which varied a great deal.

Although trade reorientation that was caused by the COMECON collapse led to a slump in demand, it was not necessarily bad since it helped the convergence towards "natural" patterns. Indeed, most of the CEEC's recovered fairly quickly as their exports to the EU grew at double-digit rates.

The dissolution of the supranational states left the inheritance of large home country biases in trade structure amongst the successor states. Even if the impact of the war that followed the Croatian separation from Yugoslavia is neglected, the emergence of the borders, dividing previously united economic area necessarily leads to a decrease in the level of trade between the newly independent countries. In other words, a division of a country decreases the home bias that existed in trade, although it usually takes a long time before the effect fully takes place. One can observe wide spectrum of opinions with respect to reasons that lead to the fall in trade. While Djankov and Freund (2000) consider home-bias to be mostly a result of tariffs and endogenous historical developments which are specific for each country (e.g. the development of the transport network and other infrastructure, production and consumption chains, and business networks), other researchers add a number of other reasons. Rose (2000) points to the role that common currency has in promoting trade amongst countries (some of the most obvious reasons are disappearance of the costs of exchange as well as exchange rate uncertainty). One also has to take into account the costs of acquiring information, which increases when one is doing business over the border (see, for example, Obstfeld and Rogoff, 2000).

A classical case of secession is the Austro-Hungarian Empire break-up of 1919 (de Ménil and Maurel). According to their estimates, five years after the break-up trade decreased to 60% of the pre-WW I level, which

was still four times more than what would have been expected according to the gravity model.

Contemporary estimates of home country bias in trade for high-income economies vary across countries as well as across different studies. McCallum (1995), a pioneer on this topic, estimated the bias for Canada using the 1988 data for provinces. He shows that Canadian provinces, after accounting for size and income, used to trade 22 times more amongst themselves than with US federal states.[14] Later studies present somewhat lower estimates. Helliwell (1998) found that during the period 1993-96 Canadian provinces traded 12 times more between themselves than with US federal states. Wei (1996) estimated home trade biases for a number of countries. The average value of bias for an OECD country during the period 1982-94, after controlling for a number of possibly important factors (adjacency, remoteness, language), was about 2.3, which is much smaller than the previous estimates. However, this still means that national borders play an important role in directing trade flows. The estimated home country bias showed a great deal of variation through the sample - USA exhibited the smallest bias of only 1.4, while Portugal came in first with internal trade exceeding external trade by a factor of 5.7.

One cannot look at the home country bias without taking into account the level of openness, which represents the other side of the coin. Since larger countries have a natural tendency to trade less with abroad, in comparison to smaller countries, it is possible to overcome shortcomings of the simple trade openness ratio (TOR) by looking at the home country bias in trade.

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[14] Editor's note: 1988 is the date when the original Free Trade Agreement was signed with the United States. Prior to that, Canada enjoyed protectionist policies which may account for McCallum's results.

Secession, quite naturally, increases the level of openness of the country because it turns previously domestic trade into foreign trade. However, due to a decrease in home country bias, it is quite possible that the post-secession foreign trade separation is smaller than total trade that a country previously conducted, both domestic and foreign.

Before the transition started, except for trade flows that existed amongst them, transition countries were relatively closed economies. This was a consequence of restrictions that central planning imposed, and of the planner's aspirations to insulate the country from influences of the world economy. One of the manifestations of that phenomenon was rather high home country bias, estimated for the successor states.

Former Yugoslavia was, by international standards, not an exception to this rule, although some of the studies mentioned suggest that the quantity of trade distortions in Croatia was lower in comparison to other transition countries. The GDP share of merchandise exports and imports 1987, five years prior to the break-up, was less than 40% (World Development Report, 1989). Croatia accounted for a quarter of Yugoslav GDP (Sirotković, 1996). The data from the 1987 input-output tables reveal that Croatian trade with former Republics was more than two times larger than overall foreign trade. Although detailed estimates of the home country bias in trade for former Yugoslavia are not available, one can guess that trade amongst the former Yugoslav Republics exceeded trade with other countries by a high multiple even after accounting for factors such as income and distance. Abundant foreign trade regulations that existed together with control over foreign exchange were the main impediments to wider foreign trade.

Fidrmuc and Fidrmuc (2000) present a partial piece of evidence on the size of home country bias in former Yugoslavia. According to their study, the level of trade between Slovenia and Croatia in 1990, prior to the break-up, exceeded the normal level 24 times. This figure is rather high in comparison to the above-mentioned estimates of home country biases that are present in high-income countries, but low in comparison

to other transition countries. For example, according to the same study, trade flows amongst the three groups of newly independent countries: the Czech Republic and Slovakia, the Baltic States and the group comprised of Belarus, Russia and Ukraine exceeded the norm by 41-43 times. Even several years after Communism collapsed, the levels of trade still surpassed the effect of PTAs that replaced unitary states. The level of trade between Croatia and Slovenia exceeded the "norm" two times, between the Czech and the Slovak Republics it was seven times, 13 times between the Baltic states and 30 times between Belarus, Russia and Ukraine.

Havrylyshyn (1998) showed that countries that have made the most progress in structural reforms have also gone farthest in diversifying their exports to new destinations - at least regarding the EU. This points to the fact that there is a correlation between domestic policies and the convergence of actual and potential trade structure. The second regularity observed by Havrylyshyn is the relationship between the progress of reforms and the level of openness. This is in concordance with the predictions based on gravity equations and assumed impediments to trade that were present before the reforms took place.

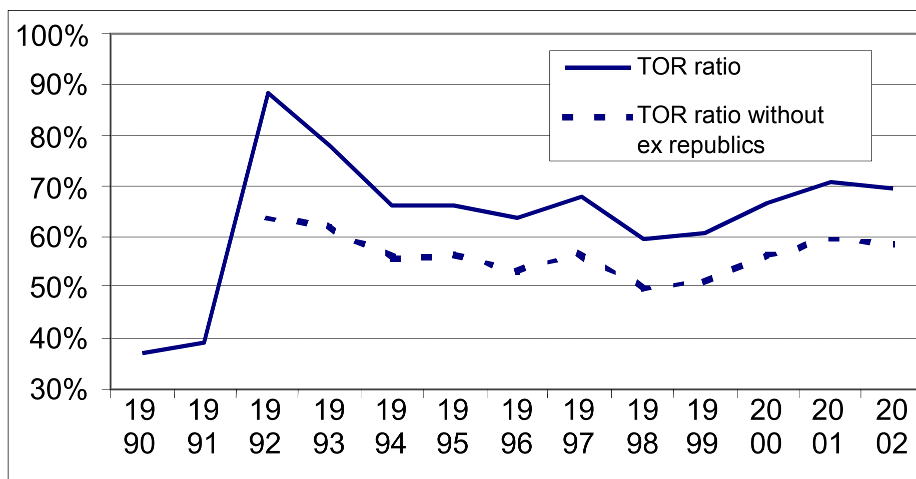
In addition to the three issues mentioned above, which affect trade in more or less unambiguous manner, GDP growth also plays an important role in driving the quantities of international trade and the levels of openness. Those countries that grow faster end up trading more both in volumes and as a share of GDP. Others, less fortunate, may turn out to have lower trade shares and volumes.

2. Croatia: A Somewhat Different Story

At the time of the declaration of independence, with the TOR being as high as 88%, Croatia was an open economy, much more open than former Yugoslavia ever was. Considering the above-mentioned determinants of trade that were expected to increase Croatia's trade integration with the EU and other developed economies, as well as to further de-

crease a modest (e.g. in comparison with 1987) share of trade with former Yugoslav Republics, one would have anticipated further increase in the level of openness. Yet, contrary to the expectations, quite the opposite happened. In 1993, exactly a year after Croatia became independent, TOR sharply decreased to 78%. The fall continued in 1994, when TOR declined further to 66%. Thereafter TOR remained at the stable level, with the exception of 1998 and 1999, during which imports were reduced due to economic recession.

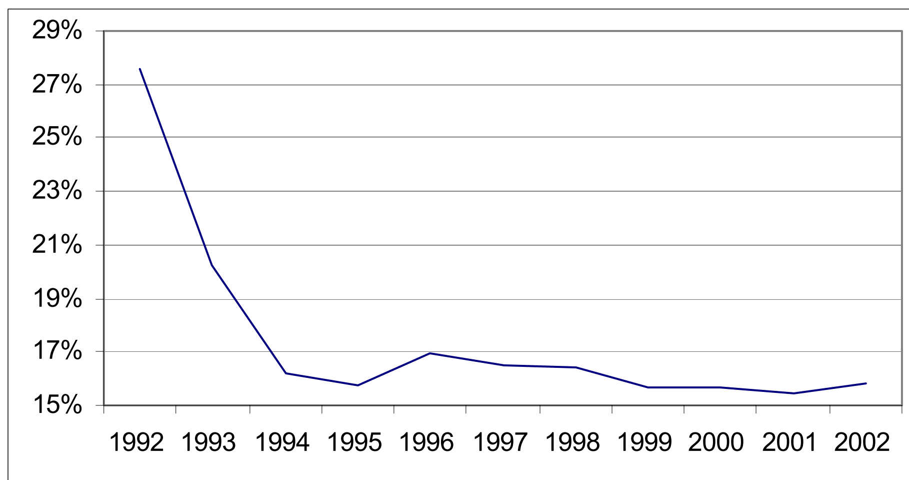
Figure 1: Trade Openness Ratio (TOR) – Croatia



Source: Central Bureau of Statistics, Monthly Statistical Report, various issues

It has to be noted that the sharp fall in the TOR was not a result of a decrease in trade with former Republics of Yugoslavia. If one looks at the TOR without taking them into account, a similar trend of decline and stagnation can be observed, although a little less pronounced.

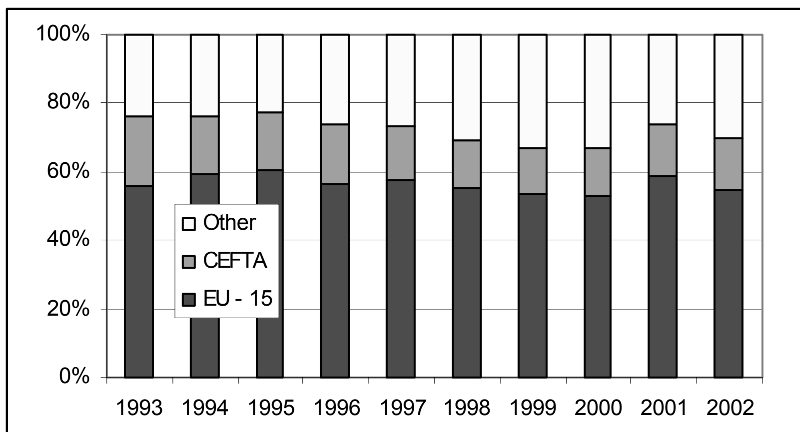
Figure 2: The Share of Former Republics in Croatia's Foreign Trade



Source: Central Bureau of Statistics, Monthly Statistical Report, various issues

How can this unusual decline in TOR be explained? Especially having in mind that Croatia, according to the most commonly used indicators (e.g. EBRD), belongs to the group of advanced transition economies, i.e. those countries that are, according to the findings in Havrylyshyn (1998), supposed to make the most progress in opening-up and diversifying their trade? Not only did the TOR not increase, but the regional structure of Croatian trade didn't change either as expected. After the declaration of the independence, the share of trade with the EU was 57%. Ten years later, it was some 2% less. It can be noticed that trade share of countries constituting CEFTA at the same time fell from 23% to 15%. Most of this fall was compensated for by an increase in trade with other former Yugoslav Republics Bosnia and Herzegovina and Macedonia after the end of the war in 1995.

Figure 3: Geographical pattern of Croatian trade



Source: Central Bureau of Statistics, Monthly Statistical Report, various issues

So, what are the likely reasons behind the observed fall in openness and stagnant trade structure? In 1993 and 1994, the main reason for the rapid decline in the TOR was break-up of trade links with former Yugoslav republics, as can be seen from the Figure 1 which demonstrates that the decline in TOR was much slower excluding the former Yugoslav Republics. However, even excluding them, TOR recorded a falling trend. The main explanation, along the reasons mentioned in (Vujčić, Presečan, 1999) was the exclusion of Croatia from trade associations in the region. Croatia did not have an association agreement with the EU, was not a member of the CEFTA, and did not even have bilateral trade agreements with its main trading partners except for the bilateral free trade agreements with Macedonia and Slovenia, which have been in force since October 1997, and January 1998 respectively. Bosnia and Herzegovina was the first country with which a free trade agreement was signed, but was broken in 1998[15], and then renewed on an asymmetrical basis in

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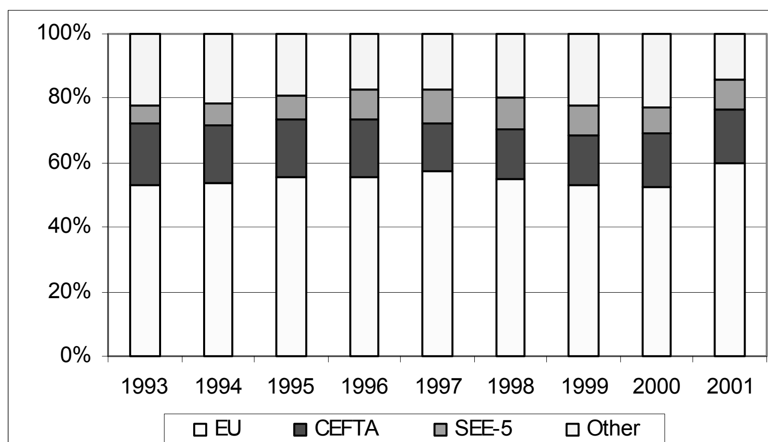
[15] Because of the IMF insistence on higher tariff revenues for Bosnia and Herzegovina.

January 2001. Until mid-2001 Croatia was not even a member of the WTO. These were all huge impediments to trade development and increase in the TOR.

3. How does Croatia fit into the region?

After looking at the dynamics of the Croatian trade during the 1990's, we address the question of the present level of Croatian integration with South-East Europe (SEE) and tackle the issue of its future development. The intra-regional trade share of the SEE countries in 1993 stood at 5.6%. This share increased once the war was over in 1995. In 1997 it reached the level of 10.3% and then fell slightly afterwards. The increase was mostly at the expense of CEFTA countries, whose share decreased, as well as the share of trade with other countries, while the trade share of the EU countries remained practically unchanged. Croatia, accounting for over half of total trade of the region and well above the third of intra-regional trade, was the principal force giving the integrative impulse amongst the countries in the region.

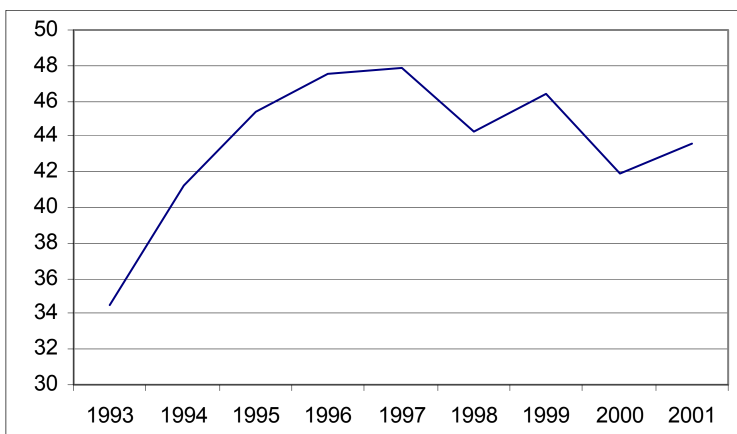
Figure 4: The regional Trade Pattern of SEE-5 Countries



Source: IMF Direction of Trade Statistics, 2000

Taking into account the fact that, for example, share of trading conducted within the grouping of the Benelux countries, a highly integrated, and economically much larger region, was 13% (Flörkemeier, 2001), a share of 10% for a much smaller and less integrated SEE group seems to be quite high. Adjusting the intraregional trade shares by a measure of the region's importance in the world trade gives a simple trade concentration ratios (or trade intensity ratios). This indicator shows to what degree the trade between the group of countries is concentrated amongst them.

Figure 5: Trade Concentration Indicators for the SEE-5 Countries



Source: IMF Direction of Trade Statistics, 2000 and author's calculations

There was a clear increasing trend in the trade concentration indicator for the SEE-5 countries reaching a value of near 50 at the end of the post war period. This tells us that countries from the region used to trade amongst them 50 times more with any other country anywhere in the world. This indicator has fallen slightly in the following years due to the slightly decreased share of trade among SEE countries, but still remained quite high. In order to compare the SEE countries with some of the well-established regional trading blocks, in Table 1 we present the same indicator for a number of regional trading blocks.

Table 1: Trade Concentration Ratios for Different Regions

	1993	1994	1995	1996	1997	1998	1999	2000	2001
SEE	34.5	41.3	45.4	47.5	47.9	44.3	46.4	41.9	43.6
APEC		1.6							
ASEAN		3.6							
EU (after 1995)		1.6							
EU (before 1995)		2.1							
Mercosur		12.8							
Andean Community		12.6							
NAFTA		2.2							

Source: Frankel (1997)

It can be noticed that trade concentration ratios reveal much higher levels of integration amongst the SEE countries in comparison to the existing trading blocks. Although the data on intra-regional trade show that EU countries trade a lot between themselves, the level of actual trade concentration is much smaller in comparison to other trading blocks because of their size and importance in the world economy. Also, one has to be careful when comparing the absolute levels of trade concentration index for countries that differ in the level of development because more developed economies tend to export a wide variety of products and to better diversify their exports geographically (Flörkemeier, 2001). What is more surprising is a very high trade concentration level in the SEE countries even in comparison to smaller blocks such as Mercosur or the

Andean Community. According to the trade concentration indices, the SEE group seems to be very highly integrated.

Trade concentration index indicate the level to which a country is integrated into the world economy, which means that different country sizes and different levels of openness do not influence the result. This index, however, does not take into account the effects of income and transportation costs. Moreover, it can compare across different levels of integration, but it cannot tell anything about the levels of trade creation and diversion that are created with the formation of trading blocks or the performance of the trading structure. Although compatible with a wide range of trade theories, the gravity approach is unable to predict the composition of the goods that are supposed to be imported or exported by a country. One has to look at the underlying theory of trade in order to obtain an answer to that question.

Based on a detailed gravity analysis, Christie (2001) concludes that although there is some fragmentation within the region, overall it seems that intra-regional trade flows are high compared to overall level of their trade. Albania is isolated from the region and trade flows between Croatia and Serbia and Montenegro are low, but most other flows are "unnaturally high". Since trade flows are on average above the expected, which is in line with conclusion based on presented trade concentration indices, it seems that most of the trade potential for SEE countries lays with the CEFTA and EU member countries.

Another possible way to look for trade potential between those countries is to observe patterns of comparative advantages. If the comparative advantages of these countries differ, it may provide a fertile ground for trade. However, if there is a similarity of their comparative advantages, it may be more beneficial for them to engage in trade with countries endowed with different comparative advantages. As Astrov (2001) notes, manufacturing exports from the region mostly include labor intensive products that require a low or medium/blue collar level of skills. Broad areas of the region's comparative advantage include textile and textile products, leather and leather products, wood and wood products, basic

metals and fabricated metal products. All countries have comparative disadvantages in chemicals and chemical products, machinery and equipment, electrical and optical equipment and transport equipment. Therefore, CEE economies compete amongst themselves with their products and to the extent their comparative advantages are concerned, it may be more beneficial to seek closer integration with advanced economies, such as EU member countries.

4. Trade and institutional issues

As was demonstrated in the first chapter, institutional reform has profound impact on trade. EBRD (2002) transition indicators show that there is a lot of variation in the level of institutional development between countries. Therefore, as a consequence of institutional deficiencies, trading with partners from the region is often complicated. Dimitrov and Stanchev (2001) point out a few important obstacles to further regional trade integration based on survey results. First of all, contract enforcement and receiving payments rank high amongst the difficulties faced by the firms engaged in regional trade. Legal procedures in SEE countries are bad and it usually takes unacceptably long period of time before the cases close. Moreover, one third of all transactions are made in cash, which may be connected with illegal funds and certainly makes facilitating the transaction more expensive. Furthermore, barter is involved in 12% of total transaction, which causes difficulties to exporters and may be connected with tax evasion. Further on, even when the financial system transfers facilitates the transactions, banks located outside of the region are frequently used. This complicates matters even further and makes trade more expensive.

Given all the difficulties faced by the companies, it seems that doing business in SEE countries provide only a temporary refuge for selling uncompetitive products. Therefore, a successful exporting strategy cannot be based on penetration of these markets as it may trap exporters into unsustainable market niches.

Conclusion

A question that we attempted to answer in this paper was where does Croatia belong? An answer to that question is important because the design of the “right” trade system can accelerate the convergence process. Often, in an attempt to identify the “functional” regions trade-wise, trade system designers are tempted to rely on the actual trade flows. However, if one seeks the right trade regime to facilitate trade and growth, this approach is misleading due to hysteresis in historical links and complete disregard of trade potentials.

An obvious conclusion from our analysis is that the largest trade potential for Croatia lies with the EU and CEFTA countries. Further on, in terms of specialization, Croatia still does not differ much from other countries in the region, which means that their economies do not complement each other, but rather compete, making them a sub-optimal choice of trading partners. Finally, increasing trade focus on the region may additionally burden exporters with insecurity, contract enforcement problems and hold back the institutional advancement. In terms of trade system design it would, therefore, not be desirable to exclude any of those countries from the pan-European trading arrangements as they pursue further trade liberalization amongst themselves. The correct sequencing of trade liberalization will eliminate current trade biases and contribute most towards realizing potential trade growth.

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The Role of Competitiveness for Stability in South East Europe

Introduction

The Stabilization and Association Process (SAP) was initiated by the EU for countries not covered by European agreements, i.e. Albania, Bosnia and Herzegovina, Croatia, Macedonia and Serbia and Montenegro. The process is realized through Stabilization and Association Agreements (SAA) that the EU already concluded with Croatia and Macedonia, which have important implications for international trade and investment. The SAAs focus on respect for democratic principles and strengthening links of the countries of the region with the single market. They foresee the establishment of a free trade area with the EU and set out rights and obligations in areas such as competition and state aid rules, intellectual property and rights of establishment, which will allow the economies of the region to begin to integrate with the EU. Therefore, the SAP should be regarded as a tool for integration of the countries of South-East Europe into the emerging pan-European free trade area, resulting in removals of trade barriers between all countries that are gaining associate membership status. It should be regarded as a process of transformation of small, closed national economies to countries integrated in a wide area of free movement of goods, services and investment.

This process especially includes regional cooperation. While the SAA provides for individual approaches to the EU, it is also related to regional cooperation defined as a series of bilateral agreements between the SEE countries that have signed the SAA. For example, a “Memorandum of Understanding on Trade Liberalization and Facilitation” was signed on June 27, 2001 between Albania, Bosnia-Herzegovina, Bulgaria, Croatia, Macedonia, Romania and Serbia and Montenegro. Following the Memorandum, free trade between the signatory countries has been realized by completing a network of free trade agreements by 2003. These agreements provide for free trade in at least 90 % of the parties' mutual trade, within a transition period not longer than 6 years.

However, while free trade within South-East Europe could remove significant constraints to intraregional trade, the main focus shall remain on the overall process of integrating these countries in the European Union. The EU remains the main trading partner of all the SEE countries and there is a large potential to increase trade and cooperation between the two, which would also bring to overall development of these countries. Therefore, it is important that all the SEE countries move forward in trade liberalization also within the WTO framework, providing for the opportunities for large scale investment, long-term cooperation and mergers and acquisitions at the regional level.

The purpose of this paper is to help identify the role of increasing competitiveness of the SEE countries within the mentioned framework, in order to make them eligible for the full EU membership as soon as possible. The paper relies on the findings of the Global Competitiveness Report 2003/2004 as the main tool for assessing the standing of competitiveness in SEE countries.

The Process – What Can We Expect?

The importance of regional cooperation in South-East Europe should not be neglected, while stabilization and security is of the utmost importance to boost economic growth. However, the SEE region is rather heterogenous; in terms of GDP per capita and in terms of trade flows Christie (2000) found that while overall trade between the SEE countries is not exceeding normal (non-preferential) trade, South-East Europe cannot be considered a trading region. Gligorov (2000) argues that South-East Europe is not even likely to become a trading region due to many different relations of the countries within SEE with the other countries and regions.

This becomes more evident when referring to the progress of integration with the EU. The EU signed agreements with Bulgaria and Romania in 1993, and the two countries are expected to meet accession criteria by 2007. Croatia signed the Stabilization and Association Agreement (SAA) in October 2001, with the perspective of establishing a free trade area after a transitional period of 6 years. The Interim Agreement, covering trade and trade-related measures, entered into force on March 1, 2002. Croatia submitted its application for EU membership on February 21, 2003 and may prove to be capable of catching up with Bulgaria in its preparations, and

even of going ahead of Romania. However, the three will most likely join the EU at the same time, probably in 2008.

The EU signed the SAA also with FYR Macedonia in April 2001, however with a different transitional period than in the Croatian case. Macedonia shall fully open its market to the EU imports in 2011, 4 years later than Croatia. The other SEE countries are significantly lagging behind. Albania began negotiations on the SAA in February 2003. Under the best scenario, Serbia and Montenegro could sign an SAA with the EU at the end of 2004. Work is also underway on a feasibility study to open negotiations on a Stabilisation and Association Agreement with Bosnia and Herzegovina. In addition, Bosnia and Herzegovina, as well as Serbia and Montenegro have not even become members of the WTO, which is usually the first step towards European integration while incorporating many reforms of the foreign trade system and related laws and institutions.

This diverse integration situation leads to the conclusion that, although the SEE countries have mutually signed bilateral free trade agreements, there is no room to integrate them in a kind of customs union that would provide for identical foreign trade regime towards the rest of the world. The bilateral and multilateral agreements with third parties already created significant differences in the structure and level of custom duties and non-tariff barriers in the countries. By virtue of these agreement, for instance, Bulgaria and Romania have already fully liberalized trade in industrial products with the EU, Croatia and Macedonia are reducing tariffs yearly according to a precise schedule, while other countries of the region have not even started the process. The WTO has also incorporated a trade liberalization schedule specific to each case.

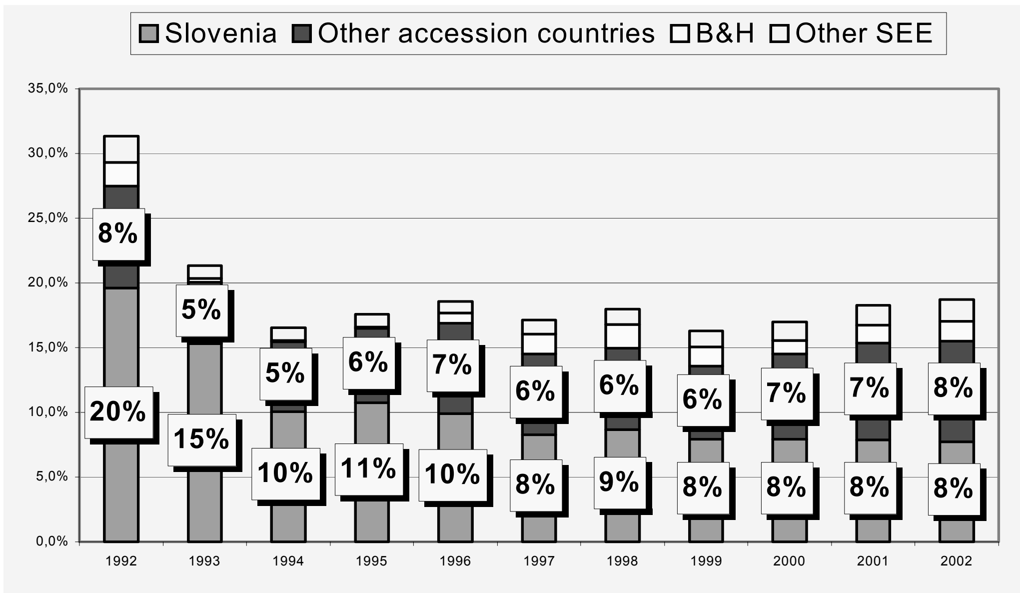
It would be misleading to think that the advanced countries of the region shall wait for the other countries to catch up. While the aforementioned processes are irreversible, this would imply that Bulgaria, Croatia and Romania shall wait many years, until the least developed SEE country becomes ready to join the EU. Even provided a significant acceleration of the integration process for those lagging behind, the advanced countries may fail to benefit from further integration with the EU if they have to wait. Therefore, this paper stands for the fast-track approach meaning that each of the SEE countries shall join the full EU membership when it is ready, pulling the others to follow the path. An optimistic view, based on the author’s

educated guess is that Bulgaria and Croatia may be ready for the EU membership in 2008, Macedonia and Romania in 2010, while Bosnia and Herzegovina, Serbia and Montenegro and Albania may become eligible by 2012.

Reasons for a fast-track approach

Why is it important for the SEE countries to urge the EU to use an individual approach to full membership of the SEE countries? The main reason is that the higher the integration level, the stronger the impetus for creating trade and development, which may be noted from the experience of the countries of Central Europe. As evident from figure 1, the average share of total exports of goods and services in GDP of the most successful Central European Countries (Czech Republic, Estonia, Hungary, Slovakia and Slovenia) has increased from 45% in 1994 to as high as 70% in 2000, while the share of Croatian exports in GDP has not surpassed the initial level. Therefore, we can argue that the absence of deeper integration with the EU resulted in a loss of market shares in the most important export markets. Croatian share in imports from the EU fell from 0,34% in 1993 to a mere 0,19% in 2000, while the share of Central European Countries (CECs) almost doubled.

Figure 1: Total exports of goods and services as percentage of GDP, selected countries, 1994-2000



Source: Galinec et al. (2002)

Having in mind that the CECs shall become full EU members in 2004, it is of the utmost importance to create opportunities for the increase of SEE trade with the EU, by going on with the integration process. Further integration with the EU shall bring new investment needed for restructuring and transfer of technology, by creating strong ties with the leading EU firms and other developed countries.

However, it is not easy to estimate the trade effects European integrations while the analysis should encompass the overall framework of the process includes the following developments:

Within the SAP, trade liberalization is underway, including elimination of tariffs between the EU and SEE countries, and between the SEE countries themselves;

The European Union shall accept new members among CEE, which shall further stimulate trade and investment flows between them, partly at the expense of SEE countries entering at a lower integration level[16];

All the countries are liberalizing towards third countries. The EU is lowering its Most Favoured Nation (MFN) tariffs, and negotiates free trade agreements (FTAs) with a number of other countries, including Mediterranean countries. The Central European countries will lower tariffs towards third countries by adopting EU foreign trade regimes, while the SEE countries liberalize non-preferential imports according to WTO schedules.

The EU itself continues its own integration by creating the monetary union and undertaking a number of common policies which shall stimulate its intraregional trade and cooperation.

Some of these processes shall stimulate trade from the point of view of individual SEE countries, while others may be detrimental. Figure 2 presents a scheme of the described processes and effects, with a tentative hypothesis of their effect on Croatian trade.

Therefore, it may be wrong to analyze the effects of SAA or regional liberalization using a ceteris paribus assumption (i.e. disregarding other simultaneous integration processes). It appears that a multi-country model should be employed to capture most of the mentioned processes. Therefore, it is important to note that the accuracy of predictions of future SEE countries trade flows is very limited.

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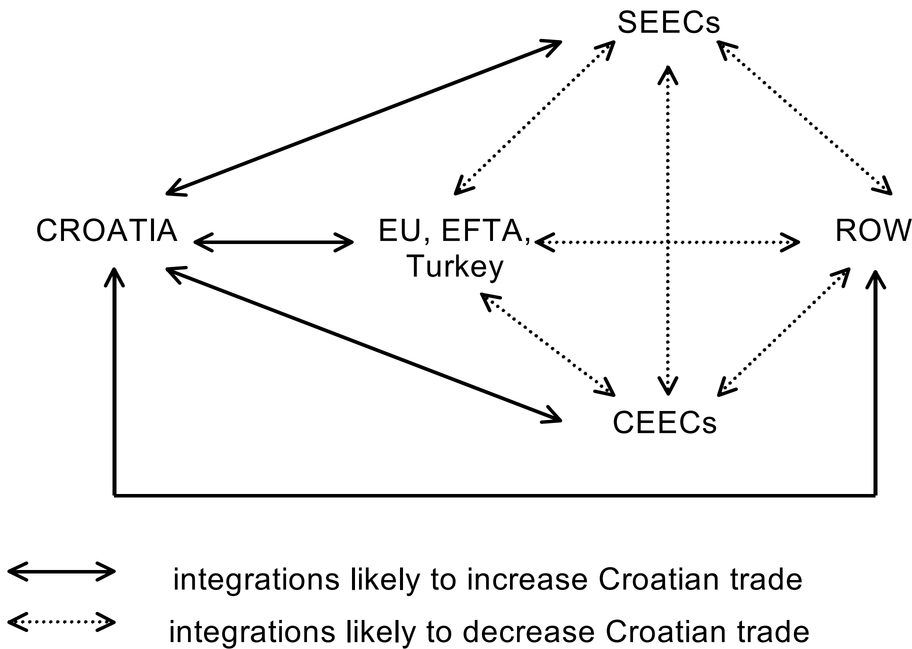
[16] While full EU membership implies economic and (typically later) monetary union, association status is somewhat deeper than a simple free-trade area.

Figure 2: Mid-term integration processes



In recent literature we found a number of gravity-type analyses focused on the effects of the Europe Agreements (See: Kaminski (2000), Fidrmuc and Fidrmuc, (2000), and Christie (2000)). Generally, these analyses have shown that the advanced CEE countries have quickly approached a "normal" level of trade suggested by models, due to the dismantlement of trade barriers and passed this level through foreign investment that created trade, implying that the EU association status may have increased trade between the associated countries and the EU in the range between 30% and 90% while the full EU membership brings a further increase of trade by some 30-40%.

However, the gravity models used in the aforementioned studies were not able to deal with the complexity of trade relations in South-East Europe, with the significant propensity to trade between the countries of former Yugoslavia, and the very low trade between these countries and Albania, Bulgaria and Romania. To assess potential trade, it may be needed to add additional variables, such as common border, language similarity or com-

patibility of the production structure, due to historical belonging to the same state[17].

As indicated in figure 3, Croatian trade with the countries of former Yugoslavia in the last decade was significantly below the 1987 figures, when these countries were part of the same federation, with relatively high tariffs versus the rest of the world. Trade with particular countries of former Yugoslavia developed differently throughout the last decade. Trade with Serbia and Montenegro recently emerged from very low figures, only to reach 5% of the pre-war level[18]. Trade with Macedonia seems to have stabilized at 20% of the pre-war level, helped by a free-trade agreement signed in 1996, and moreover by easing transit traffic through Serbia and Montenegro.[19] After falling during the war, trade with Bosnia and Herzegovina started a rise again from 1995, helped by a free trade accord, and an increase of consumption in Bosnia. Low tariffs mean a lot in trade between the two countries, which is evident from the downturn suffered in 1999 and 2000, when the FTA was suspended, and the positive reaction in 2001, when it was reintroduced. The FTA has most likely stopped the downturn trend of trade between Croatia and Slovenia.

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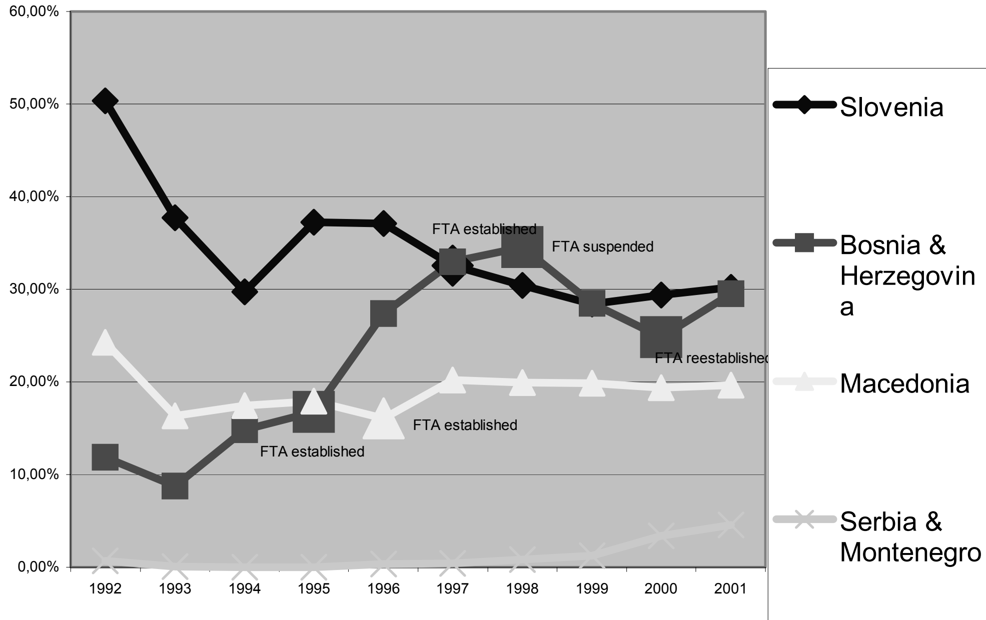
[17] In addition, there is a significant influence of war conflicts on the production and trade in the countries under review. For instance, production capacities of B&H were largely destroyed in war, resulting in enormous trade deficit. Apart from that, there are strong consumer preferences in parts of B&H towards goods from Croatia and S&M. Also, these two countries are the only partners for B&H with functional preferential trading regimes, which may strongly divert B&H from trading with the rest of the world.

[18] This is no surprise knowing that former authorities of S&M were involved in war in Croatia, and were introduced trade sanctions.

[19] Croatia and Macedonia do not have a common border.

Figure 3: Croatian trade with the countries of former Yugoslavia (% of 1987 trade)



Source: Central Bureau of Statistics, 1987 data, based on input-output tables

Generally, in spite of trade liberalization, Croatian trade with Slovenia, Macedonia and Bosnia and Herzegovina virtually stagnated throughout the last 3 years, at a level significantly lower than the pre-war level, however somewhat above the "normal" level, due to cultural and language similarities[20].

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[20] Fidrmuc and Fidrmuc, (2000) found that neighboring countries tend to trade some 50% above the "normal" level, while the countries with common history and similar languages (Austria and Germany, Belgium and the Netherlands, Sweden and Norway) trade 2-3 times more than normal. The authors expect

Hence, it is important to maintain and stimulate trade relations between the countries of former Yugoslavia which may be hindered by different timetable of joining EU. This can be illustrated by describing the consequences of Slovenian gaining full EU membership in 2004 on Croatian imports. As is evident from figure 4, from the total Croatian imports, some 8% originate in Slovenia and an additional 8% in other new EU members, meaning that imports from these countries are rather important for the Croatian economy. When these countries join EU in 2004, they shall adopt the EU foreign trade regime also towards Croatia. While Croatia is a member to the Central European Free Trade Agreement (CEFTA) and has maintained free trade with these countries, there would be a significant deterioration of trade relation by reintroducing tariffs for imports from these countries as towards the existing EU members. However, this has been largely counteracted. By signing the SAA within a very short transition period (that would eliminate more than 90% of tariff protection towards the EU by 2004), Croatia provided for a minimal disruption of trade relation versus new member countries while no significant trade barriers would be lifted.

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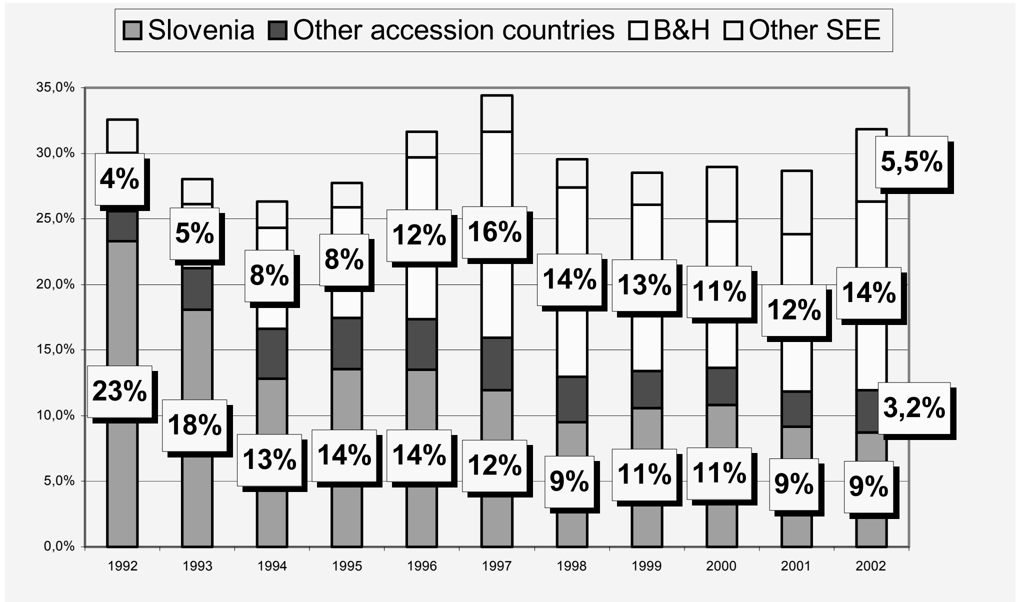
that trade between the CEE countries shall remain significantly above the normal level.

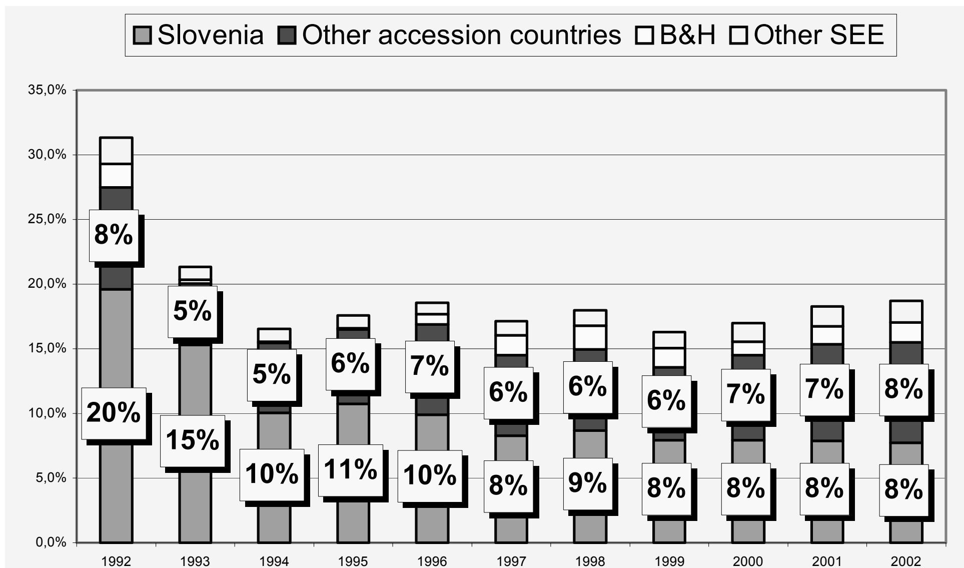
Figure 4: Composition of Croatian imports 1992-2002



Source: Central Bureau of Statistics

This problem shall also arise when Croatia becomes a new EU member before some of the other SEE countries because trade with them may be disrupted. While previous figures indicate that Croatian imports from these countries is rather small, exports are significant, making for some 20% of Croatian total in 2002 (Figure 5).

Figure 5 Composition of Croatian exports 1992-2000



Source: Central Bureau of Statistics

Nevertheless, there is a way how intra-regional trade between the SEE countries will not be discriminated against by first-wave EU applicants who adopt the EU foreign trade regimes; should the other SEE countries conclude their SAAs with the EU with an accelerated liberalization schedule, no significant new barriers should be introduced when other countries go further in the process of European integration. Although the EU may provide certain transitional measures that would maintain preferential trade if these countries failed to conclude such agreements, this would not be the best solution and the EU rejected that approach proposed by Slovenia in the current accession process.

While the aforementioned problems may be solved, it is important to maintain the vision of integrating all the SEE countries as full EU members and their overwhelming role in stimulating economic development, while EU membership shall create a business climate that would enable the economy to take advantage of a whole range of trade and investment opportunities. With this ultimate goal envisaged, all SEE may concentrate on reforms needed to provide economic growth and a thorough transformation into a market economy.

The Role of Competitiveness for the Integration of the SEE countries into the EU

Within the Stabilization and Association Process, the importance of regional cooperation should be given priority, while security is a prerequisite for economic growth. Apart from that, it is important that all the SEE countries move forward in trade liberalization in order to create opportunities for large scale investment, long-term cooperation and mergers and acquisitions at the regional level.

Cooperation between the SEE countries in various fields is very much needed, including elimination of all barriers to regional trade in goods and services, providing for diagonal accumulation of origin, maintaining access to public procurement and regulating state aid and competition policy, which all should stimulate regional cooperation in order to avoid the “hub and spoke” structure versus the EU, moving fast from being a trouble-making area towards a business oriented fast-growing region. Possible ways of partnership in the SAP may also include activities leading to the intensi-

fication of negotiations on SAAs and full EU membership, including promotion of regional security, combating illegal activities, building compatible infrastructure and removing non-tariff trade barriers. However it is essential to create partnerships to enhance the competitiveness of the SEE, at the regional level as well as in individual countries.

The role of competitiveness for the success both in achieving high economic growth and as a prerequisite in the process of European integration is undisputed. There are many studies pointing out the importance of competitiveness for economic development. In a narrow sense, SEE countries have solid competitive advantages, having a well educated workforce and (apart from Croatia) rather low labor costs. Although current EU membership criteria mark low GDP per capita as a negative factor, low labor costs may be a solid starting point for the creation of a competitive production base if these countries are integrated in the EU economic sphere. The SEE countries are by no means basket cases. The countries of former Yugoslavia were in the 80s more advanced in trade relations with the West, having a market-oriented production structure and a sound technological base, better than most of the countries that will become full EU members in 2004. Therefore, these are solid grounds to opt for fast economic growth, provided necessary reforms are made to tackle the problems of high unemployment, due to war, low investment and being left out of the integration processes throughout «the lost decade» of the 90s.

According to the available analyses there is still a long way to go, while the countries of South-East Europe are relatively low ranked in the most popular competitiveness benchmark tables. Although the concept of competitiveness has been a rather controversial topic in the literature, with its tradition of publishing for more than 20 years and a large number of countries included, the Global Competitiveness Report, by the World Economic Forum, a Geneva-based independent international organisation, remains the most comprehensive source for the comparative analysis of positive and negative features of many economies throughout the world, providing a valuable analytical tool for upgrading the framework for economic and social development. The report is commonly used as a benchmarking tool for governments in identifying main impediments to economic growth and also by the business sector when dealing with strategic and investment decisions.

The Global Competitiveness Report 2003-2004 examined the competitive positions of 102 countries, including Bulgaria, Croatia, Macedonia, Romania and Serbia. The main tool for analysing national competitiveness is the Growth Competitiveness Index, consisting of three indicators: level of technology, quality of public institutions and the macroeconomic environment.

Table 1: Rank values of the competitiveness of the SEE countries

<table>
<tr><td colspan="9">Growth Competitiveness Index:</td></tr>
<tr><td colspan="9">Bulgaria 64
Croatia 53
Macedonia 81
Romania 75
Serbia 77</td></tr>
<tr><td colspan="3">Macroeconomic environment:</td><td colspan="3">Public institutions:</td><td colspan="3">Technology:</td></tr>
<tr><td colspan="3">Bulgaria 73
Croatia 55
Macedonia 80
Romania 81
Serbia 87</td><td colspan="3">Bulgaria 62
Croatia 67
Macedonia 93
Romania 86
Serbia 77</td><td colspan="3">Bulgaria 63
Croatia 41
Macedonia 70
Romania 55
Serbia 66</td></tr>
<tr><td></td><td>Stability</td><td>Credit Rating</td><td>Govt. waste</td><td>Contracts and law</td><td>Corruption</td><td>Innovation</td><td>ICT</td><td>Technology transfer</td></tr>
<tr><td>Bulgaria</td><td>76</td><td>57</td><td>86</td><td>92</td><td>35</td><td>43</td><td>49</td><td>67</td></tr>
<tr><td>Croatia</td><td>51</td><td>49</td><td>59</td><td>81</td><td>54</td><td>48</td><td>39</td><td>43</td></tr>
<tr><td>Macedonia</td><td>67</td><td>83</td><td>79</td><td>96</td><td>86</td><td>63</td><td>63</td><td>59</td></tr>
<tr><td>Romania</td><td>81</td><td>66</td><td>96</td><td>83</td><td>90</td><td>56</td><td>54</td><td>38</td></tr>
<tr><td>Serbia</td><td>86</td><td>93</td><td>56</td><td>77</td><td>74</td><td>62</td><td>55</td><td>60</td></tr>
</table>

Source: Global Competitiveness Report 2003/2004

The SEE countries are rather low in the global competitiveness list. Out of 102 countries included in this issue of the report, best placed among the SEE countries is Croatia in 53rd place, followed by Bulgaria ranked 64th

while Macedonia has only reached 81st position, and Romania and Serbia placed in between, in 75th and 77th positions respectively.

Generally, these countries do not lag much behind according to the technology index, while the macroeconomic environment and public institutions are more significant obstacles to growth of these countries. This analysis may serve as a basic framework for focusing reforms, backed with the help of EU funds as well as World Bank projects.

There is also scope for regional co-operation in sharing best practices and assisting countries that have more significant problems in certain fields. For instance, countries of the region can learn from the Croatian experience with economic stability, while Serbia may share its experience with low waste of government spending. Bulgaria is a showcase for combating corruption, while Romania seems to have solid technology transfer. Furthermore, cooperative frameworks or regional task forces may be stood up to help individual countries with specific problems.

Conclusion

There is a strong need to follow the fast-track approach of individual accession for SEE countries which have progressed farther in their integration. In that process, it is important that the later entrants do not lag behind significantly, not to disrupt the regional trade and cooperation opportunities. However, full EU membership for all the SEE countries shall be the ultimate goal to exploit the benefits of rounding up the process of European integration. Having that in mind, it is of the utmost importance that the SEE countries work hard and cooperate in eliminating the most significant obstacles of competitiveness both at national and regional levels.

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PART 3:

A CRITICAL DISCOURSE ABOUT FOREIGN DIRECT INVESTMENT INPUT IN SOUTH EAST EUROPE

Zvonimir Savić and Ante Žigman

The Role of Foreign Direct Investments[21]

Introduction

Foreign direct investment (FDI) is a resident entity in one economy investing in an enterprise entity in another economy and thus obtaining a lasting interest in an enterprise resident in another economy. Under the definition of the International Monetary Fund in the fifth edition of the Balance of Payments Manual, foreign direct investment is at hand when a direct investor (non-resident) owns 10% or more of ordinary shares or voting power in the resident (economic entity) of another country. The level of 10% is set arbitrarily because it is presumed that an investor with a higher ownership share has also a more significant influence in reaching decisions connected with managing a company. FDI is distinguished from other types of investments in that it is based on the fact that there is a permanent interest of the investor in the enterprise as well as interest in the management of the company. The IMF permits the possibility of an individual country deciding subjectively whether or not a particular investment belongs to the group of foreign direct investments. For example, if an investor owns more than 10% of an economic entity in a country but does not have an effective influence in the management of this entity, such an investment cannot be deemed FDI. Investors (non-residents) may be private or legal entities, groups of individuals or legal entities, governments or government agencies or any other similar foreign organisation that has a share in the domicile economic entity

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[21] The views expressed in this paper are those of the authors and do not necessarily reflect the views of the Raiffeisenbank Austria.

pursuant to the above definition. One more characteristic of FDI is that the foreign investor reaches the decision on the investment on the highest, strategic level. In contrast, there are also portfolio investments, where the investor has no long term interest in the company that is taking part in reaching decisions. In its definition of portfolio investments the IMF includes shares, bonds, money market instruments and financial derivatives such as options as their basic instruments. Portfolio investments, in contrast to FDI, assume that an investment is conducted in an effort to maximise the value of the investor portfolio and achieve the expected yield against the least possible risk.

Foreign direct investments can be divided into two groups: greenfield investments and brownfield investments. Greenfield investments are all FDI through which new production assets are created, brownfield investments include all FDI through which existing plants and companies are acquired by taking control. The latter also includes foreign direct investments resulting from privatisation.

FDI – investor and receiver motives

If market economy principles are to be applied on the FDI market, then there needs to be interest for FDI from both an investor and a recipient. One of the investor's motives for making such an investment may be the way to optimise the portfolio of a multinational company[22]. However, here certain problems arise, mostly from the aspect of differentiating shares bought for management purposes (FDI) and shares related to portfolio investments, i.e. shares purchased for investment purposes. The second motive can be to eliminate the imperfections of the market via foreign investments, i.e. by linking the purchased company to the mother company. Through FDI the effect of the economy of scale of the mother company is enhanced. Another motive of the investor can be the expected higher yield from the subsidiary created by FDI compared to the mother company because the purchased company (branch/subsidiary), due to a certain market in close proximity and perhaps lower costs, may be in a more favourable position in the market. In addition, domestic producers hold the advantage of knowing the market, consumer preferences and local ways of doing business. A further

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22 A company with subsidiaries in different countries.

investor motive to buy a company in another country and open branches can be for the purpose of easier exports (export-oriented investments). In such a way the investor penetrates a foreign market which gives him access to resources, technology and/or cheaper labour force.

One of significant motives when deciding on a FDI is certainly the location as well as characteristics of the receiver country (so-called investment environment). Under this term we understand the infrastructure development level, economic power of the market and its consumer capacity (measured by GDP and GDP per capita), country risk, i.e. the government inability to repay its debts, etc., and of course, political stability.

All these elements make countries different and thus influence their ability to attract FDI. Therefore, governments implement different economic measures to stimulate FDI. Some of those measures are fiscal in nature such as income tax reductions, income tax payment deferrals, and exemption from import duties and double taxation avoidance. It should be said here that tax relief is a frequent incentive in transition countries, which leads to the danger of further competitive tax reductions. Financial incentives are another way of attracting FDI and include subsidising loan repayment, providing guarantees for non-commercial risks, and approving government aid. Accumulation of different FDI incentives and benefits can also lead to negative consequences in countries competing for FDI because investors may even doubt the country giving such wholehearted support to FDI and thus give up the investment.

On the other hand, FDI receivers also have their motives and they are all based on the advantages brought to a country by FDI. For example, advantages arise from taxes paid by the FDI receiver-company into the country's budget. One of the advantages, especially, in case of greenfield investments, lies in creating new jobs and consequently transferring knowledge, technology and management skills to domestic employees (the so-called spillover). There may be positive effects of the increased integration into multinational companies. Advantages brought about by FDI can arise in the form of a positive effect on other companies in that particular branch of business (increasing competition), which results in rising productivity. There is also one more important receiver motive that should be stressed: foreign direct investments are not counted into a country's external debt so they have and additional reason for wanting many such investments.

In listing all the advantages for receiver countries one should bare in mind the potential social costs of FDI. In the case of labour force rationalisation, disruptions in the labour market could arise. There can be problems in the balance of payments if companies import more than they export as well as if there is no sufficient spill-over, that is insufficient transfer of advanced technologies. One more negative effect of FDI is the emergence of monopolies in the receiver country. There is also the negative influence of excessive emphasis on FDI because support for one company at the expense of others causes a decline in effectiveness and competitiveness. Regional competition in attracting FDI, which leads to excessive concessions and incentives to foreign investors, can result in concentration in only one industrial activity.

In short, empirical research shows that domestic companies do not always benefit from FDI because the true nature of the relationship with the company which was invested into the domestic economy greatly differs from country to country and among different industrial branches. However, Croatia does not posess sufficient human resources, reputation and financial strength to be able to develop an efficient economy capable of standing up to competitors from developed countries within a short period of time. Attracting FDI should speed up this process because other East European countries from the immediate neighbourhood have gone far in the process of European integration and receive foreign investments.

FDI calculation methodology in transition countries

Many Eastern European countries try to comply with the IMF's definitions when processing FDI data. Therefore, they include reinvested earnings, loans from the mother company and cash purchase of securities etc. into their calculations. The basic methodological problem is how to cover all investment types. Although all Central and Eastern Europe countries try to comply with the IMF's definitions and methodological guidelines in reality there are numerous difficulties because national methodologies are often not clearly defined and are prone to changes. Still, the trend is improving both in accuracy and coverage. Central banks of aforementioned countries are the main institutions for collecting FDI data, although data is sometimes collected also by statistical offices or other agencies. According to international standards, data should be converted from the local currency into dollars at the exchange rate at the end of the period. One can notice that in case

of the dollar gaining strength, as over past periods, FDIs are devaluated. This methodology is used by most central banks: the Czech, the Hungarian, the Polish, the Slovak, the Slovenian and central banks of the Baltic countries. Central banks from Bulgaria, Romania and former Soviet countries sum up their dollar inflows thus increasing their FDI levels compared to other countries. Such and similar methodological problems cause limited accuracy in comparing FDIs and regional cumulative data can be understood only as estimates. These facts should be kept in mind when making further FDI analyses.

The table of the levels of international investments in Croatia is compiled in line with the methodology recommended by the IMF as explained in more detail at the beginning of this article. Statements of commercial banks, companies, the central national bank (CNB) and the Zagreb Stock Exchange are used as data sources. Data on foreign direct and portfolio investments are taken over from the CNB's statistical research. Foreign investments in the Republic of Croatia are shown in American dollars and, depending on the source, converted from original currencies into dollars at the current or average monthly mid-point exchange rate of the CNB taken for transaction or at the CNB's mid-point exchange rate as at the report date.

Attracting and retaining FDI

One of the most important challenges of transition economies, in the medium-term, will be to maintain a stable FDI inflow both to cover the external deficit and to raise competitiveness. A reduction in the growth of the global economy could negatively influence the expansion of multinational companies and consequently FDI. During recent years there has been a notable increase in the FDI inflow into CEB countries[23] attracted mostly by lower production costs, proximity of the European Union and improvement in the business environment. In the beginning FDI inflow was connected to mass privatization, especially within the banking and telecommunication sectors.

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[23] According to EBRD, CEB (Central eastern Europe and the Baltic States) are: Croatia, the Czech Republic, Estonia, Hungary, Lithuania, Latvia, Poland, Slovakia and Slovenia.

Some of the most significant privatization accomplishments in the past three years have been the privatisation of Slovakia's Blobtel (USD 180 million) and Slovenian Telekomunikacije (USD 939 million), Lithuanian Lietuvos Telekomas (USD 161 million), Polish Telekomunikacja Polska (USD 4.3 billion) and Croatian Hrvatske Telekomunikacije (USD 859 million for a 35% stake in 1999 and another EUR 500 million for additional 16% stake in 2001). In the banking sector we can list numerous privatization examples: Bulbank in Bulgaria (USD 316 million), Slovenska Sporitelna (USD 373 million) in Slovakia, Lithuanian Taupomasis (USD 37.5 million), PBZ in Croatia (USD 300 million in 2000, not including the sale of the remaining state-owned share at the end of last year in the amount of USD 140 million). However, the privatization process is nearing its end in the more advanced transition countries. As a result, attracting the so-called greenfield investments and supporting merger and acquisition processes in the private sector has become more and more important. Up to date, the largest Greenfield investment in the region was realised in January of 2002 when the French PSA Peugeot Citroën announced its EUR 700 million investment in construction of a car plant in the Slovak town of Trillionava. The production of 300,000 cars and employment of 3,500 workers is expected to commence in 2006.

The example of Hungary best illustrates the challenge arising from keeping FDI once the privatization neared its end. Ever since 1995 – 1996 Hungary collected around USD 6.7 billion foreign direct investments only to see their decline ever since, often going down to below USD 1.5 billion a year. However, Hungary represents a specific case of a country which managed to attract investment into exporting sectors resulting in a substantial rise in its exports.

The European Bank for Reconstruction and Development (EBRD) has been systematically monitoring transition countries and consequently their investment environment, i.e. the characteristics of FDI receiver countries According to their records, Hungary, the Czech Republic and Slovakia have gone the furthest in privatisation of large companies, with over 50% in private hands. The last big privatization was arranged in Slovakia (sale of a large gas transport company for USD 2.8 billion). In the privatization of smaller companies, in addition to already mentioned states, Slovenia and Croatia have also gone far. The characteristics shared by all these states is that none owns a small company any longer.

The South East European countries[24], with the exception of Bulgaria and Romania, are far behind Central European and Baltic countries with regards to FDI primarily due to high political instability and slow reform. Therefore, the privatization process, especially of large companies, is at significantly lower level compared to Central Europe and Baltic countries.

FDI in Croatia

A significant increase of FDI inflows in Croatia began in 1996, when war operations on Croatian territory were concluded and shares of the pharmaceutical company "Pliva" and the major Croatian bank "Zagrebačka Banka" were quoted on London Stock Exchange. Croatia obtained a sovereign rating in early 1997 and further inflow of FDI was generated.

Ever since 1999 foreign direct investments (FDI) had regularly exceeded one billion dollars, but last year this trend was not continued. According to the data by the Croatian National Bank, in 2002 foreign direct investment in Croatia registered USD 980.5 million. A record high was recorded in 2001 at USD 1.53 billion and last year did not reach even two thirds of that amount. Although the end of last year saw the sale of the remaining state-held stake in one of Croatia's leading banks, FDI failed to reach their record levels due to a delay in the privatisation of the state insurer Croatia Osiguranje and the state oil and gas concern INA. Analysis broken down by economic activity showed that last year (2002) was dominated by the item "other money business", which accounted for 63.75% of total foreign direct investments. Almost two thirds of last year's FDI came from Austria and Italy. Cumulatively, in the period from 1993 to 2002 foreign direct investment totalled USD 7.47 billion, out of which telecommunications account for roughly one fourth (26.25%).

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[24] According to the EBRD's definition SEE (Southeastern Europe) countries are: Albania, Bulgaria, Bosnia and Herzegovina, Yugoslavia and Rumania.

Foreign direct investments in Croatia
In million USD

	Equity investments		Reinvested earnings	Debt securities		Other capital		Total
	Claims	Liabilities		Claims	Liabilities	Claims	Liabilities	
1993	0,00	120,26	n/a	n/a	n/a	n/a	n/a	120,26
1994	0,00	116,96	n/a	n/a	n/a	n/a	n/a	116,96
1995	0,00	114,21	n/a	n/a	n/a	n/a	n/a	114,21
1996	0,00	510,77	n/a	n/a	n/a	n/a	n/a	510,77
1997	0,00	359,48	40,35	0,00	2,65	-7,95	140,99	535,52
1998	0,00	635,57	68,26	0,00	0,00	-14,65	243,24	932,42
1999	0,00	1.283,68	47,08	0,00	0,36	-0,61	137,07	1.467,58
2000	0,00	711,38	93,91	0,00	0,01	0,01	283,40	1.088,70
2001	0,00	814,97	153,00	0,00	-1,63	0,13	593,22	1.559,69
2002	0,00	502,84	169,86	0,00	0,00	-0,30	308,11	980,51
2003 Q1, Q2	0,00	2,76	684,30	0,00	0,00	0,10	303,49	990,65
Total	**0,00**	**5.172,87**	**1.256,77**	**0,00**	**1,39**	**-23,27**	**2.009,51**	**8.417,27**

Source: Croatian National Bank

FDI in Croatia reached in the first half of this year USD 990.65 million, thus exCentral and Eastern Europeding the last year's USD 980.1 million. FDI data in the second half of the year should be influenced by the sale of the 25% share in INA (state oil and gas company). Broken down by different activities, analysis has showed that the first half of this year was dominated by categories “other retail trade in non-specialised stores” and “other monetary intermediation” which together accounted for over 51% of FDI over the period in question. FDI in the abovementioned economic activities were largely seen in the second quarter of the year. The lion's share of FDI in the first half of the year came from Austria (30.23%) and USA (27.54%), especially over the second quarter.

Telecommunications is the activity that from 1993 to the middle of 2003 attracted the most investments (sale stakes in high technology), with a share of 25.5% in the overall result.

FDI inflows

	FDI, inflow, mn USD						average
		1998	1999	2000	2001	2002e	
CEE	Croatia*	932	1.468	1.089	1.560	981	1.206
	Slovakia	684	354	2.052	1.654	5.080	1.965
	Poland	6.365	7.270	9.341	5.713	3.900	6.518
	Hungary	2.036	1.977	1.646	2.440	1.300	1.880
	Slovenia	248	107	136	503	700	339
	Czech Rep.	3.718	6.313	4.987	4.924	8.226	5.634
SEE	Bulgaria	537	806	1.002	692	458	699
	Romania	2.031	1.041	1.025	1.157	1.300	1.311
	Serbia and M.	n.a.	112	25	165	450	188
	Macedonia	n.a.	30	176	443	75	181
	Albania	n.a.	41	143	207	135	132
	Bosnia and H.	n.a.	177	146	125	284	183

e-estimate; *-complete data; source: worldmarketsanalysis, central banks, WIIW, EBRD

FDI per capita

	FDI, per capita, USD						average
		1998	1999	2000	2001	2002e	
CEE	Croatia*	210	331	245	351	221	272
	Slovakia	126	65	378	305	941	363
	Poland	165	188	242	148	101	169
	Hungary	203	197	164	243	127	187
	Slovenia	128	55	70	259	361	175
	Czech Rep.	363	616	487	480	803	550
SEE	Bulgaria	71	107	133	92	61	93
	Romania	91	47	46	52	58	59
	Serbia and M.	n.a.	11	2	15	42	18
	Macedonia	n.a.	15	87	218	37	89
	Albania	n.a.	12	42	61	40	39
	Bosnia and H.	n.a.	45	37	32	73	47

e-estimate; *-complete data; source: worldmarketsanalysis, central banks, WIIW, EBRD

Albania

Foreign investments in Albania in 2003 will not meet the USD 300 million target, Albanian Agency for Foreign Investment Encouragement (AFIE) reported early in October 2003. Despite the non-achievable profit, the agency expects nearly double year-on-year increase in foreign investments during the year. The foreign investments in the country are expected to reach USD 1.0 billion in the period between 2003 and 2006. According to AFIE data, which started a campaign promoting economic opportunities in Albania in an effort to boost foreign direct investments, foreign investments in Albania totalled USD 180 million in 2001, and around USD 135 million in 2002. AFIE together with the Agency for Imports Encouragement and the Agency for Small and Medium-Sized Enterprises were created as part of an international programme for boosting foreign investments in South Eastern Europe and particularly in the Balkans. The agencies aim to create a favourable climate for development of active private domestic and foreign companies in Albania.

Macedonia

Foreign investments flow into Macedonia increased to more than USD 400 million in 2001 from USD 178 million, mainly due to the privatisation of local telecom monopoly MakTel in 2001. The country was out of the global negative trend of international foreign investment flows in 2001. Macedonia rated 66th, among 140 countries included in the World Investment Report 2002 (of United Nations Conference on Trade and Development) in terms of foreign investments as an active part of the country's GDP for the period 1998-2000. Foreign investments accounted for an average 0.9% of Macedonia's GDP over the period.

Macedonian experts see foreign direct investments in 2003 as even smaller than in 2001, when the country was shaken by a seven-month armed conflict. The Government does not expect any significant foreign investment for the remaining months of 2003 and the year is seen as having the lowest FDI rate in years. The cabinet has drafted a programme for promotion of investments, setting priority on the introduction of tax holidays for FDI, fighting corruption, easing the legislative framework for foreign investments and setting up a state agency for investment promotion. The programme sees the lack of political stability in the region, the small market of two million consumers with low purchasing power, the lack of decen-

tralisation of authorities, outdated industrial capacities and sluggish judiciary system as the main obstacles to FDI. In addition the programme points out the permanent ethnic tension in the country, the increasing competition from neighbouring economies and the heavy reliance of local economy on state subsidies as weak points of the Macedonian market. On the other hand, the cabinet sees the stable macroeconomic indicators, low labour cost, the closeness to the Adriatic and Mediterranean seas and good road infrastructure as the country's key advantages.

Bulgaria and Romania

Bulgaria and Romania account for slightly less than 10% of the foreign direct investment (FDI) in the Central and Eastern European region in the period between 1997 and 2001. Although the global investment flow decreased from USD 1.4 trillion in 2000 to USD 650 billion in 2002, the Central and Eastern European region has avoided being overwhelmed by the trend. The total flow of foreign direct investment to Central and Eastern Europe and the Baltic states grew by 51% in the period from 1997 to 2001, from USD 19 billion to USD 28.7 billion. The positive data concerning the FDI flow is not confined only to the countries joining the EU in 2004, as Southeastern states remain an attractive FDI destination. Bulgaria and Romania accounted for over USD 1.0 billion of foreign direct investment in the first half of 2003, a 36% annual increase. The chief drawback remains the disproportionate distribution of investment in the region, with the Czech Republic, Poland, Hungary and Slovakia accounting for 60% of the total FDI flow in the region, while Romania and Bulgaria jointly garner 10%.

Foreign direct investment flows to Bulgaria reached USD 526.9 million in the first half of the year, up 50.3% on the same period in 2002, according to data released by the country's Foreign Investment Agency. This does not include proCentral and Eastern Europeds from privatisation. The capital flows from abroad financed 53.6% of the current-account deficit for the year to date, which marks a major decrease on the same period last year when investment flows almost covered the entire deficit. The cause is ultimately the deterioration in the current account balance over the same period. Investments made in the first half of the year exCentral and Eastern Europeded investments for the entire 2002 and the agency is hoping that Bulgaria will exCentral and Eastern Europed the USD 1 billion mark for the year's end. The increase in investment is a direct consequence of the in-

creasing confidence in Bulgaria, brought about by the western-orientated administration and the macroeconomic stability engendered by the IMF support for the sovereign for the past five years, in the wake of the 1997 financial crisis.

Romania looks as if it will now have difficulty meeting the foreign direct investment target it has set itself for 2003 after disappointing figures for the first two quarters. FDI inflows between January and June amounted to USD 449 million, down by USD 156 million over the same period in 2002. This was in spite of good first quarter figures, which showed a doubling of FDI inflow year-on-year to reach USD 316 million and which led the head of the foreign investment agency, ARIS, to come up with the optimistic forecast of USD 2billion for the whole year. Quarter 2, however, saw a dramatic decline in the amount of FDI coming in, with only USD 29 million registered in June, for example. ARIS head Marian Sanuta still appears confident that Romania can reach its official target of USD 1.7 billion in FDI for 2003, but has admitted that this will require an acceleration of the privatisation process. However, the target is dependent on the flagship privatisation of Petrom bringing in around USD 1 billion, and this now looks in danger of being postponed until 2004.

Romania remains a reasonably attractive investment destination and has seen an increase in FDI levels over the past two years as labour costs have risen in the 2004 European Union (EU) candidate countries in central Europe while, at the same time, Romania has moved closer to EU legislative norms. However, with the slowdown in Western Europe now likely to last longer than originally expected, prospective investors may be drawing in their horns. The country's healthy first quarter figures were also likely to have been artificially buoyed by the effect of the completion of land restitution procedures. Given the relatively low absolute levels of FDI, moreover, major deals can easily swing the figures one way or another. The target FDI revenues for 2003's budget are unlikely to be met, especially if, as seems likely, the Petrom sale is delayed. However, with Romania's consolidated first two quarters budget deficit at only 0.8% of GDP, even without the Petrom revenue, the 2003 deficit is likely to come in within the International Monetary Fund's target for Romania.

Serbia and Montenegro

Political risk was affecting foreign direct investment since the start of 2003 and that it would have to work hard to meet a USD 600 million target agreed with the International Monetary Fund. Since the assassination of Prime Minister on March 12, Serbia's ruling reformers have engaged in a series of bitter political squabbles, affecting reforms and investment. Western diplomats have expressed alarm that the two sides, which both want closer links with the European Union and Western-style market economies, are devoting so much energy to damaging each other rather than implementing reforms. According to an IMF estimate, foreign direct investment and privatisation receipts in 2003 should reach some USD 600 million, mainly coming from privatisations. So far in 2003 there had been some capital outflow - Serbia spent earlier this year EUR 120 million as a part payment to buy back a 29% stake in its Telekom Srbija monopoly from Telekom Italia. Before the Prime Minister's assassination, Serbia had hoped for USD 400 million in greenfield investment and USD 1.0 billion in privatisation receipts.

Conclusion

Theoretically, FDI inflow should generate a general rise in investments, especially in cases where domestic companies have limited access to sources of capital. However, the influence of FDI depends on the recipient country, local economic policies, type of FDI as well as the strength and development level of domestic companies, in other words, starting position of the receiver country. In some cases FDI has a positive effect on GDP by stimulating other domestic and foreign investments (so-called crowding in). This is mostly the case when FDI creates new production assets or a new economy sector (greenfield investments). It should be stressed here that FDI in European transition countries is mostly a consequence of the government portfolio privatization and to a lesser extent greenfield investments. At the beginning FDI rarely entered production or exporting sectors because they arose from large-scale telecommunication and financial sector privatization.

Expected FDI effects can be monitored through several indicators: the influence on GDP, economic growth, employment, investment, improved efficiency and competitiveness, exports etc. It is extremely important which

economic sector FDI is directed to. Therefore, positive and negative effects of FDI on a particular sector, and economy in general, should be kept in mind. By expecting a positive effect on economic activity individual countries stimulate FDI inflow through fiscal, financial and other measures which can and must be managed for the benefit of a country's further development.

A remarkable economic transition is underway in South East Europe and it is being facilitated by international investment. By world historical standards, FDI has come to South East Europe at a remarkable rapid pace, starting from literally zero in some countries only 6-7 years ago. As a percentage of GDP, FDI inflows into South East Europe are running at the same rate as the Central and Eastern European region achieved in the 1990s. South East Europe is the new investment opportunity, uniquely providing high returns with diminishing risks.

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Imposing Ideology as "Best Practise": The Problematic Role of the International Financial Institutions in the Reconstruction and Development of South East Europe

Introduction

The reconstruction and development of post-communist South East Europe since 1988 has taken place within the framework of the neo-liberal policy model that was effectively imposed upon the region by the Bretton Woods institutions - the World Bank and IMF. As elsewhere in central and eastern Europe (see Sachs, 1990), the confident prediction made by both institutions was that their preferred policy framework would ensure both a rapid and a sustainable post-communist, and then after 1995 and 1999 a post-conflict, reconstruction and development trajectory. What has transpired instead is something quite different: unstoppable de-industrialisation, dramatically rising poverty, unemployment levels now officially among the highest in the world, high levels of inequality, declining life expectancy, rising employee insecurity and deteriorating working conditions for many, an unprecedented rise in the level of corruption and criminality, drastically declining levels of solidarity and tolerance within already distressed communities, increasingly unsustainable trade and foreign debt levels, and collapsing public health, recreation and welfare services. In spite of such overtly negative results, the World Bank and IMF (hereafter, the International Financial Institutions, IFIs), as well as associated regional develop-

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[25] This paper represents a personal viewpoint and is not meant to represent the views of IMO or those of any other organisation with which the author is, or has been, employed by or associated with. My thanks to the several anonymous economic development and financial sector practitioners working in the region who kindly offered substantive comments, some additional examples to use, and a number of corrections to an earlier draft. All remaining errors are naturally mine alone. An earlier version of this paper was presented at the Conference *"From Transition to Development: Globalisation and Political Economy of Development in Transition"*, Sarajevo, Bosnia and Herzegovina, October 9-11, 2003. My thanks to several participants for their comments.

ment institutions, such as the EBRD, do not appear to have become at all discouraged with the standard neo-liberal policy model. On the contrary, it retains the unequivocal support of the IFIs in South East Europe, as indeed it does just about everywhere else in the world, most recently with respect to the reconstruction of Iraq.[26]

There are both macro-economic and micro-economic aspects to the neo-liberal policy model. Complementing the neo-liberal "shock therapy" macro-economic policies in each of the countries of South East Europe was a standard package of neo-liberal micro-economic policies and programmes. These principally aimed to promote enterprise and community development from the "bottom-up". As the old state-owned sector was expected to contract, a new "bottom-up" dynamic of small enterprise development was expected to be called forth that could provide the requisite replacement jobs, income and security. Somewhat later, in order to provide the most conducive atmosphere within which local economic development process could take place, it was felt necessary to rebuild forms of community solidarity, trust-based interaction and horizontal and vertical social networking arrangements. Robert Putnam's (1993) concept of social capital was then seized upon, particularly within the World Bank,[27] to serve as the conceptual framework within which this goal could be both theoretically articulated and practically applied. With these two overarching local issues in mind – enterprise development and social capital accumulation – a number of core local policy interventions were established and provided with substantial financial support by the international community: new sources of commercial small-scale finance, new forms of commercialised business development support, and specific projects and project linkages aiming to establish and reinforce social capital building processes.

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[26] In mid-September 2003 the US government-led Coalition Authority announced a dramatic programme of privatisation and other neo-liberal structural reforms for the country, designed in co-operation with both the World Bank and IMF, thus deliberately pre-empting any future democratically elected Iraqi administration from setting its own framework for the economic management and future of the country ("Say No to Privatisation", *The Guardian*, London, September 23, 2003).

[27] See, for example, the World Bank's website focusing on social capital - www.worldbank.org/poverty/scapital.

In this paper I argue that the current economic predicament in South East Europe very much has its roots not only in the neo-liberal macro-economic policies favoured by the IFIs, but also in the package of neo-liberal micro-economic policies that were simultaneously introduced. The various local strands of the neo-liberal model have received very significant donor financial and technical support since the reconstruction and development process began in 1990, then effectively again in 1995 after the Dayton Peace Agreement and in 1999 after the NATO bombardment of Serbia. However, they have signally failed to establish the gist of the widely anticipated sustainable "bottom-up" local economic and social development trajectory, and may actually have substantially exacerbated the situation in many crucial respects. I examine the three core local economic and community development programmes established and supported by the IFIs, and find that there are serious problems with regard to both their supposed goals and positive impact. I conclude that the still very significant support for these problematic local strands of the neo-liberal policy model can be best accounted for by the political/ideological mission of the IFIs, which is to "lock in" neo-liberal principles, policies and institutions in the region no matter what the results.

Background

It was apparent by the 1980s that the communist economies of central and Eastern Europe were in serious difficulty and major reform was both necessary and inevitable. However, whilst recognising the gravity of their own situation, many in central and Eastern Europe were also in no doubt that the radical free market model of capitalism would likely offer very little material improvement for the vast majority of the population. As a result, there was a strong base of support in central and eastern Europe for a transition towards an economic model based upon an East Asian/Scandinavian-type "Third Way" between the two polar extremes of communism and capitalism, involving a sizeable public sector, a substantial co-operative sector, an extensive social welfare system, and the judicious deployment of various indicative planning and industrial policy instruments to help ensure macro-economic balance and micro-economic dynamism. For example, the bulk of the "Solidarity" movement's activists in Poland spent most of the 1980s arguing for a genuinely worker self-managed economy along modified Yugoslav worker self-management lines (Hardy and Rainnie, 1996). The

Hungarians had already been extensively experimenting, not unsuccessfully, with de-centralised planning mechanisms, co-operatives and worker self-management, first through the New Economic Mechanism (NEM) introduced in 1968 and then through further marketising and democratising reforms implemented in the mid-1980s (Dallago, 2003). From 1987 onwards the Soviet Union introduced legislation to support the "bottom up" development of worker co-operatives, the numbers of which exploded across the country within just a few years (Jones and Moskoff, 1991). Meanwhile, senior officials in the Soviet government hotly debated a variety of different plans to bring to an end central planning and convert all state property into worker self-managed enterprises operating within a regulated market economy, with the Mondragon regional co-operative system in northern Spain serving as one of their main points of reference.[28]

Although these various well-meaning reforms were unlikely to have facilitated an overnight transformation of the communist economies, they were nevertheless very clearly heading in the direction of steadily improving economic performance, an increase in general living standards and – significantly - the further introduction of democratic concepts and practises into both the economic and political sphere. This steady, if fitful, improvement was criticised at the time by the neo-liberal policy establishment in the western economies, as well as by those driven by Cold War considerations to decry whatever policy measures emanated from governments in communist central and eastern Europe (of course, in view of the transition depression that actually took place in the region – see below - we should just note in passing that such "steady progress" would perhaps have represented a major triumph for the region). Notwithstanding, the key western governments, overwhelmingly driven by the foreign policy imperatives of the US government (see Gowan, 1995), combined in 1990 to demand the full text-

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[28] At the end of the 1980s a large number of high level visits were undertaken by many of Gorbachev's most senior advisors to the famous Mondragon Co-operative Complex in northern Spain (reported in *The Guardian*, December 1, 1989). Many independent opinion polls undertaken in the Soviet Union at the time pointed out that the emerging and well-publicised ideas to promote worker–ownership and control as the core of a drastically reformed economic system were attracting considerable public support (reported in *The Guardian*, March 6, 1990).

book free market capitalist economy outcome for central and eastern Europe and nothing less.

The macro-economic policy model introduced to facilitate the historic transformation process from centrally planned communism to radical free market capitalism was a derivation of the neo-liberal policy model that was introduced in the early 1980s in both the UK under the Thatcher government and in the USA under the Reagan administration. There were many dissenting opinions in central and Eastern Europe at the time, but these views were quickly marginalised as being representative of former communist officials unwilling to see sense. There were also strong calls for caution coming from various policy communities in the western economies, but these also received short shrift. For example, a number of economists working in developing countries were warning that the forthcoming transition to a more market-based economy in the region would be courting disaster if, as per the textbook neo-liberal model, it did not involve a major role fore the state as mediator between competing interests and to work toward longer run development goals. The East Asian "Tiger" economies' experience, and also that of China since 1980, are obvious positive demonstrations of the catalysing and balancing role that is required of the state during a period of major post-system change and/or post-conflict reconstruction and development (for example, Madsen et al, 1994, Perkins, 1994; Taylor, 1994). At the same time, the collapse of many developing countries in the aftermath of the de-legitimation and collapse of state institutions - for example, Lebanon in the 1980s (Goglio, 1998) – offered a sobering lesson on the possible catastrophic downside of what Standing (2002) has termed "state desertion".

The key to the establishment of the neo-liberal model as "the only game in town" in central and Eastern Europe was the self-interest and power of the US Treasury, the World Bank and IMF (Gowan, 1995; Stiglitz, 2002, 2003). By deploying a mixture of political pressure, aid conditionality and financial support to develop local neo-liberal policy elites able to "push from the inside", the Washington "troika" were almost everywhere able to brush aside all local policies and ideas and successfully ram through their own policy preferences for stabilisation, liberalisation, privatisation and minimisation of the state. Other key institutions, such as the European Commission, readily went along with the required changes since such neo-

liberal parameters are also fundamental to the EU project itself (Amin and Tomaney, 1995), as well to more specific projects such as Enlargement.

The neo-liberal policy model has by now racked up more than a decade of experience in central and Eastern Europe. What have been the results? The IFIs themselves almost universally portray the end results so far as broadly optimistic. Typically the transition process is described as having established at least “the basic fundamentals for future growth”, though often recognising that there has been “some pain along the way” (for example, see Stern, 1997; Business Central Europe, 1999). However, a closer look at the categories routinely deployed to convey transition “success” reveals the use of very many self-selected neo-liberal imperatives to be the crucial markers – such as the extent of privatisation achieved, number of private entrepreneurs established, or degree of labour market flexibility – rather than actual economic variables, such as the level of investment, the level of poverty, real wage levels, the level of domestic R&D, the rate of unemployment, and so on.[29] So, some care must be taken when interpreting the IFIs own estimations of transition success because there are very obvious reasons why they might, and in practise clearly do, seek to focus upon the positive and downplay the negative side. More important, therefore, is the fact that a growing number of independent observers now concede that the standard neo-liberal policy model imposed upon the region by the IFIs has actually produced very poor results indeed (Elster et al, 1998; Milanovic, 1998; Standing, 2002; Stiglitz, 1999, 2002), if not an outright calamity (Andor and Summers, 1998). The UNDP has been especially critical of the neo-liberal transition policies, particularly because of their very scant regard for key human development indicators (UNDP, 1999, 2003a).

It is useful (partly because it also usefully illustrates a theme taken up later in this paper) to consider in a little more detail the example of Poland, the transition economy which for a long time was considered the “star performer”. It is now clear that this optimistic view was more a case of wishful thinking than hard (or at least sustainable) reality. Neo-liberal microeconomic policies played an important role here. Analysts such as Johnson and Loveman (1995) wrongly ascribed Poland’s initial economic success to

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[29] A persistent offender in this regard is the EBRD - see *EBRD Transition Reports* (various) London: EBRD.

the massive rise in micro-entrepreneurship – some two million new entrepreneurs in the two years after 1990. The picture painted was of a dynamic and vigorous entrepreneurial sector creating jobs, wealth and exports, and productively inter-linking with other parts of the economy. Poland's traditionally very strong informal sector operating under communism had seemingly been transformed into the main motor of post-communist growth and development, very much in accordance with the "Latin Americanisation" view associated with the work of De Soto (1989).

In fact this rosy view was very far from reality. In practise, a very large percentage of the nearly two million new small enterprises registered since 1990 were actually self-employed individuals mostly involved in simple shuttle trading activities. Much of the shuttle trading took place across the Polish-German border, but also a significant part involved travel to Russia, Ukraine, Belarus and elsewhere in the east.[30] It quickly became clear that these types of informal shuttle trading enterprises actually had very little growth potential, largely avoided all forms of taxation, tariffs and other social responsibilities, and helped to embed and legitimise criminality and corruption within society. One of the most serious effects was that in practise the new shuttle trading community helped to facilitate the immediate flood of imports that contributed (along with a "shock therapy" induced "credit crunch") towards wiping out many local producers before they had had the time to acclimatise to the new market economy conditions via re-investment, re-tooling and restructuring. Many potentially viable small and large-scale industrial sector enterprises collapsed in the aftermath of the immediate flood of imports before they had had the time to "get their act in order", with unemployment rising very rapidly as a result. The activities of the growing population of shuttle traders signally contributed to the huge trade deficit. A major component of the burgeoning trade deficit arose when the agricultural sector collapsed under the weight of rapidly available and cheap EU items, one of the mainstays of shuttle-trader activity in the first

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[30] A number of years ago a world tourism survey rather surprisingly reported that Russia was the tenth most popular tourism destination in the world according to number of overnight stays. On closer examination it turned out that this form of "tourism" was overwhelmingly composed of Polish shuttle traders over-nighting before returning with their goods.

few years of the transition, turning a $557 mn surplus on agricultural products in 1989 into a $333 mn deficit with the EU by 1993. Farm incomes fell by 50% as a result and by 1995 60% of farms were technically bankrupt (see Andor and Summers, 1998, p 109). Overall, the new, largely informal population of shuttle traders represented a reflection not so much of the reinvigoration of the Polish economy, as claimed by such as Johnson and Loveman (ibid),[31] but both a "poverty-push" consequence of Poland's immediate "shock therapy"-induced recession and – crucially – a causative factor in the subsequent overall decline (see also Glinkina, 2003).[32]

Importantly, a good part of the necessary starting capital that allowed a great many shuttle traders to get started came from new forms of commercial micro-finance – so-called "new wave" micro-finance institutions. These new developing country-style local financial institutions disbursed very small sums of credit to anyone who could repay very high monthly interest rates over short repayment periods; in other words, financial support tailor-made for shuttle traders and the like, and for virtually no other type of business activity.[33] Even with such very small sums of cash the shuttle traders could begin operations abroad and generate substantial flows of imported

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[31] A claim very much accepted by Jeffrey Sachs in the introduction to the Johnson and Loveman book. Sachs was one of the main architects of the Polish "shock therapy" experiment begun in 1990, and directly and indirectly was responsible for the content of many of the other "shock therapy" programmes introduced in central and eastern Europe after 1990 (see Sachs, 1990).

[32] Such a scenario had emerged in an earlier episode of "shock therapy" restructuring – the UK economy in the early 1980s. Storey and Johnson (1987) denoted this trajectory the "Birmingham model" after the West Midlands city that suffered a major collapse of its economic base in the 1980s, and saw many redundant workers being forced into any form of petty business in order to survive. Such "poverty-push" entrepreneurship was an aspect of decline rather than success, they argued, and the ultimate recovery of this major industrial city had very little to do with these new small businesses.

[33] For example, of the more than 54,000 loans disbursed by *Findusz Mikro* between 1994 and March 1, 2003, amounting to over $100mn in total, 56% of the loans went to traders, 35% to services and 9% to production (data accessed on August 20, 2003 at { HYPERLINK http://www.finduszmikro.pl) }.

goods, particularly through the use of supplier credit.[34] Could other small enterprise structures have not arisen also in Poland at this time, possibly to compensate? This would have been difficult since government policy at that time in Poland was to not provide specific support for dynamic growth-oriented small enterprises – say, technology-intensive, export-oriented or innovative – but simply to establish the "appropriate" macro-economic framework within which such growth-oriented small enterprises should spontaneously emerge according to textbook neo-liberal automaticity principles. Crucially, this was the firm view of Leszek Balcerowicz, the main architect of the "shock therapy" programme in Poland, who argued that stabilisation, privatisation and liberalisation were all that was required in Poland to establish a sustainable small and medium enterprise development trajectory (see Balcerowicz, 1995, p 246). One result of this particular policy was that the very strong innovation, patent processing, invention and applied R&D base that existed in Poland prior to the transition (see Haudeville et al, 2002) was hardly touched as a source of new small enterprise dynamism and relevant technologies. For example, many of the technology-intensive SMEs that had started under late communism were forced to abandon their activities when the financial conditions drastically changed after 1990, many becoming shuttle traders as well.

The full implications of the neo-liberal "shock therapy" programme, and the massive expansion of the shuttle trading population, began to work their way through the economic system by the mid to late 1990s. The Polish economy finally began to register deteriorating performance on most categories. By mid-2002 the situation was beginning to look far worse, and even, according to the London-based Economist magazine (The Economist, July 27, 2002, p 38) beginning to register a threat to the entire plan for Polish EU Accession. The trade deficit was becoming unsustainable, the budget deficit also out of control, and the rate of unemployment had risen to nearly 20% (see The Economist, April 21, 2001, p 32). One major adverse impact was the drastic deterioration of the living conditions in most rural

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[34] Feakins (2002) reported that many Polish shuttle traders were able to take advantage of family and kinship ties in the EU countries, particularly in Germany, in order to access large quantities of supplier credit, "sale-or-return" goods and so on.

areas of Poland after 1990 where, according to Kowalski and Kaminski (1999), rural working and living conditions had by the late 1990s deteriorated to levels not seen since the mid-19th century. The Economist, an earlier (and still) very forceful supporter of strict neo-liberal orthodoxy, finally began to come clean on at least some of the adverse results of the neo-liberal experiment - against the background of a now quite unsustainable trade deficit and seemingly unstoppable industrial sector contraction, it was forced into the admission that it could now offer no clue whatsoever as to "what Poland will export to support its 40mn people" (ibid).

In truth, the dramatically poor performance of the neo-liberal model in central and eastern Europe, such as in Poland, is virtually no different to the results achieved in earlier and parallel neo-liberal experiments (see MacEwan, 1999; Chang, 2003). For sure the driving force behind the neo-liberal model itself – the USA – is entering a very difficult period after the unsustainable "boom" conditions of the 1990s (Stiglitz, 2003). In Argentina, perhaps the country in the late 1980s and early 1990s that most slavishly accepted the advice of the IFIs, the results have been quite disastrous.[35] For a time Argentina was only rivalled by OECD member New Zealand as the

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[35] An initial early 1990s boom was underpinned by the sale of virtually all of the countries main public utilities and other assets to foreign multinational companies, which quickly hiked up prices and began repatriating profits back to their home country on a huge scale. The downward effect on the incomes and demand of the poorer communities brought about by the now higher utility prices was marked. Terminated contracts for non-payment meant that whole new communities began to emerge 19th century-style without access to energy, water, waste collection and other amenities. The boom effectively came to an end when there was nothing left to sell off, though other crises elsewhere – in particular East Asia – helped to push the teetering economy over the edge. Argentina was forced to signal in 2001 that it was likely going to have to default on its debts of over $128 bn, creating the largest sovereign debt default in history. Poverty and unemployment subsequently rose dramatically, wages of the bottom sections of society collapsed even further, great swathes of domestic industry got into serious difficulty and/or closed down, and the entire country seemed about to explode. Even if a recovery can somehow be fashioned in the coming years to save part of what remains of the industrial structure, perhaps through a one-off devaluation boost, it will once more take many years before the situation is back to where it was at the start of the decade (McEwan, 2002).

country most willing to implement the core elements of the neo-liberal policy package. As in Argentina, Wade (2001) explains, New Zealand's experience with implementing neo-liberal orthodoxy was also a major economic and social setback. In most parts of Africa and south Asia, too, the results of neo-liberal policy packages (i.e., Structural Adjustment Programmes, SAPs) are widely seen as having been a disaster for the overwhelming majority of the populations in many countries (Weisbrot et al, 2000; SAPRIN, 2001). As a response to the growing criticisms of SAPs the IFIs launched the Poverty Reduction Strategy Papers (PRSP) process, which are essentially SAPs under a different name. But even with some marginal amendments to the IFIs approach towards developing countries in the PRSP process, such as beefed up consultation procedures and the like, Hardstaff (2003) sees no reason to believe that the situation will change substantively for the better. In fact, neo-liberal policies and programmes have been associated with economic stagnation or decline for the majority of countries since around 1980, and, for a few of the most dedicated adherents, economic chaos and social collapse (McEwan, 1999); yet such policies continue to be persevered with no matter what the consequences.

East Asia provides a further important indication of the supreme importance that the IFIs and key western governments appear to place upon adopting the ideologically correct neo-liberal policy model no matter what the results. In East Asia, however, there has been substantial pressure upon very successful economies to "change course" and move towards adopting the favoured neo-liberal approach. The East Asian "Tiger" economies are the obvious examples here. Coming under very intense political pressure in the late 1980s from the US government and the IFIs, along with their ideological affiliates, such as the OECD, several of the East Asian "Tiger" economies were reluctantly forced into abandoning many of their own "home-grown" state co-ordinated "growth with equity" policies that had served them so well over the previous thirty years. But the direct result of this enforced policy change, as Chang (2000) outlines, was the near economic collapse of several previously high performing countries. The proximate cause of the collapse was the demand (possibly driven, very simply, by pressure on the US government from Wall Street investment banks keen to pick up new business in the region – see Stiglitz, 2002, Chapter 8) that countries in the region liberalise their capital accounts. This led inter alia to vast uncontrollable "hot money" flows coming in. Much of this "hot

money” went on speculative financial and real estate projects. Later on, as conditions changed, an IMF-inspired attempt to retain these vast financial flows in the region led to interest rates being hiked up substantially. But apart from failing to curtail the outflow, high interest rates severely undermined the balance sheets of all companies in the region – good and bad – with the result that large numbers of companies went bankrupt, massive job losses took place and the regional economies went into a tailspin. It was only by swiftly and substantively changing course could these countries halt the rapid decline. And shortly thereafter they were able to resume their upward growth and equitable development trajectory (see Stiglitz, 2002; Chang, 2003). Most recently, China has come under mounting pressure to change its range of development policies to accord with the neo-liberal model favoured by Washington and the IFIs, in spite of being considered by many (for example, Perkins, 1994; UNDP, 2003a) to have been the most dramatic economic development and poverty reduction success story of the last thirty years.[36]

The former Yugoslavia

It is sometimes forgotten that an IMF-designed “shock therapy” policy model was first implemented in the former Yugoslavia in 1988, pre-dating the more well known “Balcerowicz Plan” introduced in Poland on January 1, 1990. The Yugoslav government under Prime Minister Ante Marković, a reformer with a clear understanding that the Yugoslav economy was in deep crisis and heading toward an inter-ethnic conflict unless major changes were made, effectively had no other option but to cave in to the IMF’s de-

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[36] In spite of China’s clear rejection of the standard neo-liberal policy package, this does not stop many neo-liberals from routinely claiming credit for its enormous economic development success. Analysis of globalisation - for example by the Paris-based OECD and the London-based *Economist* magazine - regularly considers China to be an exemplary case of an economy that achieved success simply because it “opened up to the world”. But nearly always the analysis fails to mention the highly interventionist industrial, trade and technology policies that China has extensively used to fashion its economic success – successful policies which, as Wade (2002) emphasises, are distinctly *not* being recommended by the IFIs to other developing and transition countries (see also Chang, 2003).

mands. However, as in the wider central and eastern Europe, there were numerous trends underway indicating the good sense of ensuring that the reform should build upon past worker self-management successes, while also dealing radically with past failures of the system – that is, the baby should not be thrown out with the bath-water. Branko Horvat (1982) was already making the case in the mid-1980s for modified – that is, genuine – worker self-managed structures to be allowed to emerge from the predictable collapse of Yugoslav communism, joined by many others as Yugoslavia itself began to collapse (see Ellerman, 1990; 1993; Estrin, 1991). Notwithstanding, the pioneering Yugoslav worker self-managed economy was quickly disassembled with almost nothing remaining of the unique form of industrial democracy that had at times proved to be very efficient indeed - in the 1950s and 1960s, Yugoslavia was one of the world's fastest growing economies, and for several years the fastest growing economy in the world.[37] The predictable result of the very rapid abandonment of worker self-management was further intensification of already severe economic problems, growing social chaos and, crucially, according to Woodward (1995), space for widespread political opportunism: the separation movements in Slovenia and Croatia ignored all domestic and international pleas for restraint and instead sought to court popularity by pinning the blame for the widespread poverty and suffering on to the Marković government. Against the resulting background of economic stagnation, hyper-nationalist propaganda and popular resentment at the unequal regional and social impact of "shock therapy", the country's collective leadership failed, tragically, to agree on a way to peacefully lay to rest the Federation.

Once the country broke up in 1991 an attempt was then made to implement similar neo-liberal policies in the newly independent Yugoslav successor states. This attempt was cut short when conflict broke out in 1992 in Bosnia. When the Yugoslav civil war finally came to an end with the Dayton Peace Agreement signed in Dayton (US) in December 1996, the IFIs moved very quickly to impose once more their favoured neo-liberal policy

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[37] However, the privatisation model adopted by the Slovenians after 1990 was, at the end of the day, responsible for a surprisingly high proportion of employee-owned businesses emerging out of the old socially-owned ones (Mencinger, 1996).

package of reforms alongside the reconstruction aid. Once more the argument was made by the IFIs that only if the neo-liberal fundamentals were quickly put into place would sustainable reconstruction and development be forthcoming (World Bank et al 1996; World Bank, 1997). This position also held fast yet again when the NATO bombardment of Serbia in 1999 precipitated a further round of economic destruction and chaos in the region (World Bank, 2000). Indeed, throughout the various twists and turns in South East Europe, no significant changes to the neo-liberal policy package were felt needed or were made to take into account, say, the vastly more difficult post-conflict situation in the region or in individual countries. Nor was there any attempt to address the implications of the serious problems having clearly emerged in the transition process in the wider central and eastern Europe using the same neo-liberal policy model. Pointedly, no account was taken of the high level of industrial, managerial, technology, educational and social development achieved in the former Yugoslavia prior to 1991,[38] and at least partially maintained since then under very trying circumstances.

The end results of the various neo-liberal programmes imposed upon South East Europe have been universally negative. Notwithstanding the superficial signs of progress – renovated houses, shops, roads and bridges – and the fact that for a very tiny urban elite there has been an historically unprecedented opportunity to amass enormous wealth and power, it remains the case that for the majority of the people in the region the outlook remains really rather grim. Apart from the inflation target, the situation has actually continued to decline since the end of the Yugoslav civil war in 1995 on virtually all major human development indicators – poverty, unemployment, inequality, social exclusion, corruption, community and job security, life expectancy, access to affordable health, recreation and education facilities, and so on (Young, 1999; Gomart, 2000; Horvat, 2000, 2002; Oxfam, 2000; Papić, 2000; Kekić, 2001; UNDP, 2002, 2003c). There was no serious attempt to preserve core industrial assets intimately related to the commercial viability of the enterprise sector as a whole, and to the ability to export and

[38] For example, the Yugoslav enterprise sector by the end of the 1970s had a slightly larger number of mainframe computers in use than in both the Italian and Austrian enterprise sectors combined (Radman, 2003).

supply local markets. Such a valuable societal asset – indeed, an asset that developing countries are desperately striving to attain[39] – was provided with almost no significant direct international support. Instead, privatisation of the enterprise sector (in fact, of everything) was expected to resolve all thorny problems related to both static and dynamic efficiency, and thus the long term sustainability of the economic base would be assured. Accordingly, it was also felt necessary to ensure that governments in the region could not establish their own pro-active financial and institutional structures, such as East Asian-style development banks and industrial policy and technology transfer institutions, which could interfere in the short term market-driven restructuring processes supposedly under way. Many such policy interventions were, and continue to be, routinely blocked by the IFIs all across the region (see below). Cruelly, the overall decline that has taken place in the region has transpired in spite of a major donor financial commitment to the region after 1995, outstripping the Marshall Plan in real per capita financial value (CFER, 2000).

Moreover, the most recent indications from some countries in the region are that the situation is actually likely to get worse over the next few years as the large donor aid flow finally begins to decline, one-off privatisation financial windfalls come to an end, and massive trade deficits and foreign debt levels come home to roost. Croatia, for example, now has to try to figure out how to tackle a near $20bn foreign debt, which by the end of 2003 was more than 70% of GDP, up from 30% of GDP in 1997. The first six months of 2003 alone saw a $2.5bn trade deficit in Croatia, up 50% in nominal terms from the previous year. Key factors in this deteriorating

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[39] According to the 2003 Annual Report of UNCTAD, such policies still unjustifiably remain off the agenda for most developing and transition economies today, effectively leaving these countries "with no chance of nurturing the home-grown firms which are crucial to economic success", according to Yilmaz Akyuz, an UNCTAD official associated with the report. What developing countries urgently need, Akyuz went on to say, was "...the policy space: the ability to nourish, support and develop domestic industries, and the capability to compete in international markets and to supply the home market" (See "Free-for-all on trade will harm everyone, says UN", *The Guardian*, October 3, 2003).

situation, according to the Governor of the Croatian National Bank,[40] were the rise in consumer goods imports set against stagnating industrial sector exports, and the nearly $1bn of profit taken out of the country by foreign banks and businesses in the first half of 2003 alone.[41] The chances of Serbia and Montenegro escaping the devastation visited upon it over the 1990s appears weak (UNDP, 2003c), and the recovery so far in this new political entity has been very fitful at best. Macedonia continues to flirt with economic disaster on a number of fronts, while the new NATO Protectorate of Kosovo would appear to have almost no chance to develop a sustainable economy under whatever final status permutation emerges. Social tensions and disaffection continue to rise all across the region on account of the enormous increase in poverty and deprivation which stands in stark contrast to the huge, conspicuous and often illegal enrichment of a small number of individuals.

The specific nature of some of the most debilitating trends and outcomes is well illustrated by the experience of Bosnia. Bosnia is a country with a strong tradition in engineering, construction and defence-related industries, a previously good number of important export-oriented industrial companies, solid University-level and other educational institutions specialising in industrial applications and basic R&D, and a well-developed – in some cases, world-class - applied R&D infrastructure, such as the EnergoInvest company's eight research bodies spread across the country. But the lack of supportive industrial development institutions and policies in the country has been palpable, and thus the resulting industrial collapse not entirely unanticipated (for example, see Bateman, 1995; Stojanov, 2000). When it finally became clear that the independent actions of private entrepreneurs, local investors, private banks and foreign investors - the essence of the neo-liberal economic recipe for growth - would be quite unable to vector into place a sustained recovery, some serious doubts started to appear in the donor community. When the forecasts indicated that worse was to come, some changes were finally precipitated. Recognising the impending threat to the

40 Reported in the Croatian Information Service, September 12, 2003.

41 The two factors are also related since the foreign banks have underpinned the consumer credit boom that has facilitated the rise in imports, particularly in the case of imported motor vehicles.

economy (and to their own peace-building efforts), by early 1999 the EU/Bosnia and Herzegovina Consultative Task Force, a body established by the Council of the European Union, urgently began to call for a "proper industrial policy strategy for Bosnia and Herzegovina".[42] This call followed on from the Peace Implementation Council's meeting in Madrid in January of that year, where "For the first time since the start of the reconstruction programme in Bosnia-Herzegovina, the international community explicitly asked for the adoption of a strategy for industrial development". Apparently, an industrial policy had "been emphasised by local experts for a long time" mainly because "the growth of new companies in Bosnia-Herzegovina has been minimal", but nothing whatsoever had been done.[43] Notwithstanding, almost no change to the then prevailing policy framework could be envisaged in the country because the IFIs simply refused to allow for such a change of course. According to the Head of the World Bank in Bosnia,[44] the country is now heading for an economic abyss if it does not receive major (i.e., $250-300mn) regular cash infusions into the near future.

The depth of the economic problems confronting South East Europe is now becoming accepted in many quarters. One result is that the EU is beginning to push much harder for a regional integration process and to prepare the region for further funding and technical support from Brussels, acutely aware that permanent instability on its southern borders would seriously undermine the Enlargement process and the progress of some existing EU members (e.g., Greece). Increased financial support from Brussels would indeed make things better, at least in the short term (to cover trade deficits, fiscal gaps, capital goods purchasing requirements, etc). However, the policy framework that animates the EU's drive for regional integration remains very firmly subordinated to the needs of the wider EU integration and world-wide economic globalisation processes, both of which strongly suggest nothing more at best than a very peripheral non-industrial future for most parts of South East Europe. This is why the growing calls for EU-style regional development policies and some more cash (for example, see Euro-

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42 EU Press release, February 16, 1999, Sarajevo.

43 Reported in *Reuters News Service*, January 26, 1999.

44 Reported in "A Nation unbuilt: Where did all the money go in Bosnia?" *International Herald Tribune*, February 18, 2003 page 4.

pean Stability Initiative, 2003) are so wide of the mark, even more so because the underlying policy model upon which much of this type of analysis is based - the Irish regional development experience – is itself increasingly being revealed as problematic.[45]

In the main section of this paper that now follows, I show that the deteriorating economic situation is not simply a factor of the neo-liberal macro-economic policy framework, but also very likely attributable to core neo-liberal micro-economic policies malfunctioning as well.

Key local neo-liberal interventions

Simultaneous to the imposition of neo-liberal macro-economic policies in the transition economies was the establishment of a whole raft of local neo-liberal policy interventions and programme initiatives. The core aim of these policies was to privatise and commercialise all local development interventions and programmes, and to vector all solutions to under-development and poverty solely through the prism of market forces. Development was to be recast as a profit-making business activity that could, and should, be undertaken by private commercial companies, including even multi-national corporations. Essentially three inter-connected local strands of neo-liberalism were prioritised by the IFIs in South East Europe. First, the so-called "new wave" micro-finance institution model was transferred over from the developing countries, such as Bangladesh and Bolivia, to begin a new life in South East Europe. These institutions were designed to provide financial support on strictly commercial terms to as many and any new small-scale businesses and individual entrepreneurs that might be in-

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[45] The Irish "Tiger" economy was/is a product of a quite specific constellation of factors – principally the large amounts of diaspora-led US foreign investment and the highest EU structural funds per capita quota in all of the EU – and such favourable circumstances would probably precipitate a boom of sorts almost anywhere. Therefore, Irish economic success cannot very easily be replicated elsewhere by policy design, though large sums of money would clearly help Keynesian-fashion. The recent relocation of many Irish-based US electronics plants to the Far East and the accelerating phasing out of EU structural funds financial support is having a quite deleterious impact upon the Irish economy (see "The Irish economy isn't purring, let alone growling", *International Herald Tribune*, February 25, 2003).

terested. Second, business development support for the raft of new businesses was to be provided by networks of commercially-oriented, independent Business Support Centres. Both of these local interventions would require an initial cash injection from the donors, but it was envisaged that they would ultimately survive as full or quasi-commercial entities by "earning their keep on the market". Third, though fully emerging only by the mid-1990s, the concept of social capital was increasingly deployed to articulate the international donor community's desire to (re)build a range of institutional linkages, solidarity, trust-based interaction and mutual support structures within the local community, ostensibly in order to underpin pro-poor development institutions and poverty reduction trends.

"New wave" micro-finance institutions

The neo-liberal project in the early 1980s gave rise to a distinctive new form of local financial support structure in the developing countries. This was the so-called "new wave" - sometimes also referred to as a "movement" or "revolution" - of micro-finance institutions (MFIs). These are independent, commercial, self-sustaining lending bodies supporting micro- and small enterprise development (see Otero and Rhyne, 1994; Robinson, 2001). "New wave" MFIs are designed to survive and expand in numbers via the profitable provision of small quantities of very short term credit at market-based interest rates to any client offering the best chance of repayment. Because they are apparently able to survive on their lending activities without the need for continuing outside financial support (i.e., subsidies) the "new wave" MFI model is immensely attractive to both the IFIs and governments, but particularly the former. Conceptually and practically, therefore, it has been offered significant support from the IFIs, bilateral agencies (especially USAID), international NGOs and, increasingly, a range of other bodies not conventionally associated with a concern for the situation confronting the world's poor, such as multinational corporations and major conservative media outlets.[46] Accordingly, the "new wave" MFI model at-

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[46] For example, the high-profile Micro-Credit Summit campaign has garnered a very exclusive list of individuals, senior politicians and multinational corporations, who have agreed to offer support for its aim of bringing commercial micro-credit to an additional 100 million families throughout the developing world by 2005. *The New York Times* and magazines such as *Business Week*

tracted substantial political support and donor agency funding in the context of the reconstruction of South East Europe (World Bank, 2000).

The crucial conjecture underpinning the widely supposed positive impact of the "new wave" MFI model is that because some individual clients can be seen to be better off than non-clients, this localised outcome can be aggregated up across the local and national economy to give an overall positive impact. The line of thinking here can be directly traced back to the standard neo-liberal contention that poverty and under-development are a result of simple market imperfections – here a generalised lack of small-scale finance (see, for example, DeSoto, 2000) - rather than related, say, to structural constraints within society associated with class, power, gender, ethnicity, and so on. It is thus posited that commercially-viable MFIs that can achieve both sustainability and greater outreach will ensure that the largest number of individuals can gain access to finance over time and can therefore engage in small-scale entrepreneurial activities; ergo the largest number of clients that will be able to raise their own individual/household income levels and escape from poverty.

Other than the burgeoning number of evaluations that compare the before and after situation of clients and non-clients, however, the "new wave" MFI model has been subject to hardly any critical evaluation of its fundamental conceptual and practical building blocks or its widely assumed wider positive aggregate impacts. Clearly, as Morduch (1998) notes, the supposed "win-win" scenario it conjures up – addressing poverty and under-development at little or no long term cost to donors and governments – is a very seductive idea indeed. Perhaps, then, it is not so surprising that the IFIs appear to be quite disinterested in commissioning wide-ranging evaluation exercises. Moreover, "new wave" MFI programmes now represent one of the main avenues through which local and international NGOs, consulting companies, Universities and other organisations are able to access contracts and funding, thus possibly reducing their willingness to engage in any

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have increasingly seen fit to editorialise and uncritically publicise the presumed benefits of commercial (i.e., "new wave") micro-finance provision as a way of helping the poor in poor countries.

critical examination of the model.[47] The situation leads Johnson (1998, p 21) to note that, "it is curious that the tools of impact assessment have not extended beyond users, or the organisations which serve them". Indeed, Robinson's (2001) three volume World Bank sponsored publication, widely held to be the reference book for the "new wave" MFI approach, contains no substantive discussion of aggregate impact, wider externalities or opportunity costs. Obvious practical alternatives, such as well-targeted public employment programmes that can very usefully address the serious plight of virtually the same client base of the "new wave" MFIs, typically refugees, women and demobilised soldiers (see UNDP, 2003c), remain marginalised.

In the context of South East Europe, however, it is possible to point to a number of conceptual and practical issues that appear to challenge the case for the "new wave" MFI approach (see Bateman, 2003a, 2003b). First, market-based (high) interest rates are used as the basis for loan decisions in order to best ensure the financial sustainability of the "new wave" MFI itself. However, a major de-industrialising effect arises as a result because the entrepreneurial/financial incentive structure within the local economy is incrementally adjusted in favour of short-term, high profit, low-technology, quick payback ventures – typically, shuttle traders, petty retailers, kiosks, street catering, and small-scale production operations that add value very quickly.[48] The new financial environment clearly acts to "crowd out" those projects requiring greater investment, using skilled labour, possibly export oriented, and where there is a need to adapt relatively sophisticated technologies (perhaps from declining state-owned firms) into the production process. At the same time, projects are also avoided if they involve long

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[47] One example is UK-based Oxfam GB, which now obtains a growing share of its programme funding from the UK government's Department for International Development (DFID) arm, which happens to fully support the principles of the "new wave" MFI model. Not surprisingly, perhaps, an increasing number of Oxfam's poverty alleviation programmes involve "new wave" MFI components.

[48] This is very typical elsewhere. Morduch (1998, p1) notes that petty traders make up the bulk of the clients of both Bolivia's *BancoSol* and Indonesia's *Badan Kredit Desa*, two of the most famous and financially self-sustaining "new wave" MFI programmes.

financial break even points, where there are only "adequate" profits and there may thus be some difficulty to service high interest rates, and also where there are costly and risky "learning curves" to endure. It is also important to note the existence of important feedback effects here, because high interest rates are also a partial function of the high local opportunity cost of capital, represented by the very high margins made on trading and importing activities. High shuttle trading and importing profits thus both encourage high(er) interest rates, because the commercial banks want their piece of the action,[49] and it is also the case that trading and importing operations are often the only possible entrepreneurial response to high interest rates, since most other types of businesses cannot service them. The "new wave" MFI thus further entrenches both the high interest rate aspect of commercial bank lending practises and the tendency to support only quick turnover businesses like traders and consumer goods importers.

The local financial environment thereby created - it can be termed a "disabling" environment - will act to significantly deter substantive small-scale projects from both becoming established and surviving. The many possible technology-intensive and related growth-oriented business ventures that could have emerged, say, from the region's substantial defence, construction, electronics and engineering sectors are likely to receive hardly any forms of support within such a local financial environment. Moreover, even if "new wave" MFIs eventually reach sufficient scale and outreach to deal with more substantive small-scale business projects, as proponents indeed claim will be the case (Robinson, 2002), irreparable damage will have been done to the local industrial structure in the meantime and negative "path dependency" effects generated - a clear case of "the cure perhaps being found, but in the meantime the patient has died". The history of many industrial countries and regions is marked out by artificially generated financial discontinuities, which presage an economic decline that may be exceedingly

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[49] In order to do this, commercial banks in South East Europe often inflate the official interest rate through the imposition of various "management charges", one off fees and other additional costs on top of the official interest rate and capital repayment costs. Some commercial bank managers also add a personal fee for themselves, but this is straight forward corruption of course.

difficult or costly to reverse at a later stage.[50] For the same reason we can also largely discount the related "primitive accumulation" argument derived from the fact that many small-scale traders and importers often use their accumulated capital to move into more substantive business areas of their own volition. The expansion of "new wave" MFIs in South East Europe is thus giving rise to a local financial environment quite unlike that which underpinned the dynamic small enterprise-driven successes of 1950s Italy and Japan, 1960s Taiwan or 1990s China (see Bateman, 1999; UNDP, 2003c), and more like that which helped to accelerate the de-industrialisation and structural distortions experienced in Poland since 1990 (see above).

The local finance sector-led reconstitution of an economic base along unsustainable, non-industrial lines has been particularly marked in Bosnia. Here one of the central interventions by the donor community was the establishment in 1997 by the World Bank of a network of "new wave" MFIs under the Local Initiatives Project (LIP), which was financed by a number of donors to the tune of over $40mn. The LIP was followed shortly thereaf-

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[50] A good example is the case of Scotland in the wake of the North Sea oil boom in the 1970s. With one or two well publicised exceptions (e.g., the Wood Group) most local engineering companies then servicing the Clyde shipyards and related heavy industrial sectors found the task of diversifying into the new market opened up by the oil boom almost impossible, thanks to the UK's traditionally anti-industry financial sector bias. Unlike in Norway, then enjoying a similar oil and gas boom, where the Norwegian government stepped in to offer very strong support for a local engineering oil and gas sub-sector to take root, the UK government thought market forces alone would (should) respond. They did not. By the early 1990s the situation had become obviously untenable and the government was forced to belatedly intervene much more directly to save at least part of the Scottish engineering sector. It established a number of special funding programmes to facilitate diversification into oil and gas work, provided tax and other financial benefits and significantly beefed up the powers of the initially very weak Offshore Supplies Office (OSO). But the damage by that time had been largely done, and the bulk of the most lucrative oil and gas-related industrial contracts ended up in the hands of US and Norwegian companies and, to a lesser extent, their French, Dutch and German counterparts (Bateman, 1994). Subsequently, many of the lessons learned were applied - this time quite successfully - to the task of developing the electronics sector in Scotland.

ter by the country's first "new wave" micro-enterprise bank – MEB Bank – with another $20mn of mixed donor funding. Note also that Bosnia's new liberalised private commercial banking sector was then (and still is) extremely risk-averse and resistant to dealing with the local enterprise sector, preferring instead to "invest" locally mobilised financial resources in German and UK bank accounts (Čaušević, 2002). These very much related institutional changes – the "new wave" MFIs and the privatisation and liberalisation of the banking sector are essentially the two sides of the same neoliberal coin - combined to undermine the industrial structure of the region in a quite dramatic manner. Entirely predictably the main clients of the emerging local financial system were virtually the same as in non-industrial developing countries - shuttle traders, kiosks, street retailers, caterers, and very small-scale producers adding value very quickly. The combination of high interest rates and short term repayment requirements (and sometimes also the need for significant collateral) very effectively "crowded out" virtually all more sophisticated and technology-intensive ventures, those with a higher risk profile, and those with a more distant financial break-even point. The "disabling" local financial system established under the patronage of the IFIs has thus clearly accelerated local industrial decline, rather than acted to deter it and/or underpin a sustainable local industrial structure based on some degree of local production in reasonably technology-intensive ventures. Notwithstanding the welcome, though very often largely temporary,[51] boost to employment and wealth-generation registered in those micro-businesses that were supported by Bosnia's "new wave" MFIs, the longer run result of the "disabling" financial environment thereby created

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[51] It is very widely recognised that a high percentage of the micro-businesses supported by "new wave" MFIs actually collapse very quickly. Indeed, many are actually only established with a very short life in mind, as when a refugee establishes an enterprise for a short duration to provide an income of sorts prior to returning home. For example, consider the ongoing impact assessment of the LIP programme in Bosnia (see Dunn and Tvrtkovic, 2003). Nearly 5% of the more than 3,300 micro-enterprises selected for the sample actually closed down in the 3 month time period between sample selection and survey interview. The researchers involved then, understandably, warn that in the two year period of the study "an even larger percentage of respondents may be expected to close their enterprises" (p 47).

has proved to be quite catastrophic for the Bosnian economy. The UNDP bleakly concurs, reporting that the Bosnian people have effectively been "…condemned to reliance on a grey, trade-based, unsustainable economy rather than a production-based one" (UNDP, 2002, p 38).

Subsequent events in Bosnia offer further evidence that the ideology of the "new wave" MFI is of most importance to the IFIs, not the results. When the accelerating de-industrialisation trajectory began to raise serious concerns in the local Bosnian policy establishment, some of Bosnia's best economists working in the Privatisation Agency in 1997-8 began to develop ideas for a complementary institution to work alongside the donor-driven structure of "new wave" MFIs. Recognising that the country's hard earned and not insignificant industrial legacy was effectively being abandoned thanks to the new "disabling" local financial structure, they began to lobby the IFIs and other donor institutions to support a new pro-active local financial institution. This was to be an SME Development Fund that would recycle back into the small enterprise sector the cash raised from the privatisation of Bosnia's large state enterprises. The new institution would offer financial support at affordable terms and maturities in order to "crowd in" the most risky, yet also likely to be the most dynamic and sustainable, relatively technology-intensive ventures. Both new starts and existing small and medium-sized growth-oriented enterprises would constitute the main client base. Part of the influence for this new institution was the European Recovery Programme (ERP) that very successfully operated in western Europe after 1945 (see Pöschl, 2003). The ERP disbursed very low cost loans for equipment and machinery purchase to very many local businesses in order that they could participate fully – if not exclusively – in the reconstruction effort, as opposed to businesses coming in from the more developed countries and taking most of the contracts. However, the response from the IFIs to this local idea for an SME Development Fund was unequivocal: the new wave" MFI model simply had to become the benchmark for all local financial institutions in Bosnia, and so this alternative local approach was pointedly and repeatedly blocked.

A second negative externality is closely related to the de-industrialization argument. This is the causative link between the type of clients necessarily (if only initially) preferred by the "new wave" MFIs and the rise of import dependency in south-east Europe. As noted, "new wave" MFIs were obliged to support large numbers of shuttle traders and other small-scale

importing operations, these being virtually the only quick/high profit business activities capable of repaying the high interest rates on loans offered over very short time periods. The additional and immediate flood of imported products thereby generated, however, added considerably to the already existing pressure on potentially viable local enterprises engaged in the process of re-learning, re-investing, re-tooling and restructuring in order to produce and compete on local markets. The widespread collapse of many of these potentially commercially viable local enterprises predictably transpired, including some already in the process of accessing donor financial and TA support. Such destruction simply cannot have been a surprise to the IFIs. In fact, it was very well known beforehand to the IFIs that deliberately and quickly established import channels would likely destroy even the most viable local industrial units before they had had time to "get their act in order" (see SAPRIN, 2001;[52] UNCTAD, 2002). The situation has now reached comic proportions in some parts of South East Europe. For example, in Bosnia and Kosovo the donor funded "new wave" MFI banks have become very profitable indeed - in fact, the most profitable in all of Central and Eastern Europe.[53] However, this bank-level profitability has been secured largely by helping a new class of shuttle traders, financial and land speculators and expensive consumption goods importers to emerge, a new business class that by its very nature is unlikely to facilitate technology transfer, be growth-oriented and will not develop constructive supply chain linkages to the other parts of the local economy (in fact, so far the only links established are to the criminal underworld and corrupt politicians). It would be hard to conceive of a local policy model operating in the region better able to establish an "African-style" colonial economic structure, characterized by a tiny, but very rich and powerful, speculating/trading/importing

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[52] The SAPRIN project was a major four-year study of the effects of donor policy in developing countries. It was designed and undertaken by the Washington DC-based NGO SAPRIN in collaboration with the World Bank. However, when it became clear to the World Bank that most of the people and NGOs consulted in the SAPRIN exercise wanted to criticise its own neo-liberal policies, it belatedly dis-associated itself from the SAPRIN programme and pointedly refused to publicise and disseminate the research results any further (see SAPRIN, 2001, p 3).

[53] Reported in *The Economist* magazine, September 14, 2002.

class ranged uneasily against an impoverished and largely unemployed or under-employed population. Indeed, in many parts of South East Europe the ongoing de-industrializing trajectory and mass reversion to pre-industrial petty entrepreneurial and subsistence agriculture survival strategies is often referred to as the "Africanisation" (Africanizacija) of the region.

Finally, one negative externality arises that is related to the enormous lobbying power the main proponents of the "new wave" MFIs have accumulated in south-east Europe. The "new wave" MFI lobby and supporting IFIs have increasingly sought to de-legitimise the role of state agency in local economic and community development. The "new wave" MFI model is clearly being lined up as the replacement for local state agency. The "new wave" MFI approach could very easily exist side-by-side with other more pro-active state structures offering long term financial support, such as East Asian-style local development banks, not least because their client base is likely to be very much different. But such a multi-faceted approach has simply not been tolerated. Thus, quite unlike in many other European countries under reconstruction after 1945, where pro-active state SME development banks, local financial funds and state capitalised financial co-operatives provided absolutely critical support for local economic development (see Bateman, 1999; Bateman et al, 2002; McIntyre, 2003), this option – of course suitably modified to take into account local conditions - has been consistently and firmly denied to governments in South East Europe.

The example of Bosnia noted above, where a pro-active local financial institution was blocked by the IFIs, has been repeated right across the region. A similar scenario occurred in Macedonia in 1995/6, for example, when local SME advocates joined with key Ministers in the then government to support an idea to establish a pro-active Development Bank that could offer "soft" conditions to key small enterprise projects in the country. The plan was headed off by the IFIs on the grounds of it not being sufficiently "market driven". Even though aoweeHown institution of sorts eventually did emerge with some IFI support - the Macedonian Bank for Development Promotion (MBDP) – this new bank was successfully stripped of any development banking functions, and it now acts as nothing more than a conduit for donor supplied commercial credit lines to commercial banks for on-lending. Also, in keeping with very strict IMF instructions to those involved in the Ministry of Finance and the Central Bank, it avoided becoming a "burden" on the state budget by earning its keep from a small margin

on the credit lines it disburses. Thus, institutional diversity (not to mention democracy), a critically important aspect of any successful reconstruction and development policy (Chang and Kozul-Wright, 1993), has been consistently precluded in South East Europe to the detriment of the local economy.

Business Support Centres

After 1991, but particularly after the end of the civil war in Bosnia in 1995, very substantial donor financial support has been channelled toward the establishment of networks of local Business Support Centres (BSCs).[54] Support for BSCs is primarily intended to help establish and grow large numbers of new privately-owned small enterprises. The design inspiration for the BSC networks can be directly traced back to the pioneering experiences of the Thatcher government in the UK in the 1980s, when rising unemployment, fiscal restraint and US-inspired work-fare ideas combined with radical free market ideological fervour to generate a major move to support petty entrepreneurship within poor and marginalised communities. When it quickly became apparent that support would be required in practise to facilitate the entry, survival and growth of so many untraditional, "poverty-push" entrepreneurs, the concept of the Local Enterprise Agency (LEA) was born. Following on from the then in vogue twin fashions for devising private sector solutions to all manner of problems and for all interventions to pay full heed to "full-cost recovery", the LEAs themselves were conceived as commercial operations. It was expected that as quasi-commercial bodies driven to "earning their keep on the market" they would serve better their assigned purpose than any local state-led or fully-funded institution.

Accordingly, and just as in the wider central and eastern Europe where BSCs were first established in Poland and Hungary through the EU's PHARE programme (see Bateman, 2000a), those working to establish the BSC networks that emerged in south-east Europe were under very strict instructions to ensure that they be structured as non-governmental, com-

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[54] The name of such agencies varied across countries – Enterprise Development Agency, Regional Enterprise Support Agency, Local Enterprise Agency, and so on - but the function and goals generally stays the same.

mercially oriented, private sector-driven, and should "earn their keep on the market" by eventually charging for the services they provided. All new proposals put forward by local governments and other bodies for new BSCs had to accord to these parameters, or else remain without donor funding. In a number of cases, notably in Slovenia, municipality-led local enterprise development agencies with a good track record of operation, but ideologically "off-message", were actually forced to close down and re-open in the approved non-governmental format in order to be eligible for donor funding that would allow them to expand (EC, 2000). Local governments were forced to recognise "the way the wind was blowing" and put aside any misgivings with the standard neo-liberal BSC model in the hope that desperately needed donor funding would still be forthcoming for a range of other project.[55] Importantly, many well-connected individuals confident of securing employment in the new donor-funded agencies, and others expecting to benefit from related donor funding streams disbursed via the BSCs (such as University economics and business department professors, private consultants, trainers), self-interestedly lobbied hard for the new neo-liberal non-governmental BSC model to be adopted.

A clear indication that embedding neo-liberal ideological and political imperatives were of far more importance than any possible negative results of so doing lies in the fact that there was almost no "learning by doing" or modification of the basic neo-liberal BSC model in the light of highly relevant experiences elsewhere. The initial results of the neo-liberal model in other parts of Central and Eastern Europe after 1990, for example, were very discouraging indeed. Most of the new BSCs simply could not "earn their keep on the market" and so quickly began to collapse after the donor funding came to an end, or else were given to their employees to manage as a private business (that is, privatised) which usually resulted in them dropping their work with the cash-starved SME sector (Bateman, 2000b). The very first EU-funded network of twenty BSCs in Hungary went into a "sus-

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[55] Slovenia was one of the rare transition countries where government officials were bold enough to openly disagree with the EU's proposed model for local enterprise development agencies. As a result, the EU's PHARE programme of support for new local enterprise development institutions was effectively cancelled (EC, 2000).

tainability crisis" within only three years of its establishment. Local businesses and entrepreneurs were simply unwilling to pay for the services provided by these BSCs, especially in the face of growing competition from other private service providers. Closure of the entire BSC network was only averted by an additional tranche of donor funding and urgent attention to developing new funding sources that would allow it to continue. Most of the BSCs look likely to be converted into Regional Development Agencies (RDAs), which became an increasingly popular way for the main donors to exit their original BSC programmes without significant embarrassment. Crucially, by linking the BSC to the provision of very simple revenue-raising business support services – business plan preparation, contact making, simple training, marketing advice, accessing finance, etc - it quickly became quite apparent that the substantive tasks involved in promoting sustainable local economic development were simply not going to be undertaken through this institutional structure (see Bateman, 2000a; EC, 2000). Though the neo-liberal imperatives built into the design of the BSCs essentially render them quite incapable of providing the sort of long-term support the local economy needs, this is not nearly as important as the fact that the BSCs are not going to be a financial burden on the state or (for very long) the donor community. The mistaken neo-liberal contention that commercialisation of the BSCS would provide a very simple and elegant solution to the problem of long term financial sustainability, proved to be very resilient indeed, and it was hardly abandoned at all in the face of the overwhelming tide of evidence that showed it was an unworkable principle in practise. Even sometime critics of the neo-liberal orthodoxy remain captivated by the attractive simplicity of the commercialisation approach and thus, perhaps unaware of the abject failures to date, continue to advocate such a solution (for example, Kolodko, 2003)[56]

In South East Europe, it very quickly became abundantly clear that the market for simple business services was also woefully inadequate, much more so than in central and Eastern Europe, and so it was very unlikely that any BSC would be able to "earn its keep on the market". Moreover, in

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[56] Kolodko (2003, p 163) notes that "(Local) development agencies may be started by central government financial transfers, but should later come to rely on their own commercial activities and fees collected from local SMEs".

many parts of previously market-oriented south-east Europe the capacity of private business support services providers was quickly increasing and providing strong competition for the few clients around. Most BSCs thus quickly went into head-to-head competition with private sector suppliers. Major "displacement" effects thus arose in some regions as the new well-funded (subsidised) BSCs took the very few clients willing to pay for business services, leaving the emerging private sector suppliers in jeopardy. In other regions, though, the absolute lack of clients meant all business services suppliers were in real difficulty right from the start. Essentially, however, most BSCs in south-east Europe have been quite unable to develop an income stream from commercial sources, and so began to degenerate almost as soon as they were established. Probably the best example of the intractable problems that have arisen relates to Bosnia, which has seen successive waves of quasi-commercial donor-funded BSCs of one sort or another, all geared up to surviving on income from the sale of their services. However, most of these BSCs have collapsed after the donor funding ended, leaving behind a trail of anger, despondency and frustration. And even though a small number of BSCs have managed to survive after converting themselves into a private company owned by their principal employees, this indicates very little return indeed on the vast sums of donor money committed to the original BSC programme. For one thing, these new fully private bodies now spend most of their time touting for any sort of work from the main donor bodies, rather than identifying and attempting to remedy the most pressing local economic issues. A similar fate befell Macedonia's five EU-supported Regional Enterprise Support Centres (RESCs), which over four years were quite unable to generate an income from activities related to small business development. They have been converted into the RDA format largely in order to save the EU's already substantial investment (as well as its local reputation perhaps). Croatia's faltering network of EU-supported Local Economic Development Agencies (LEDAs) are likely to have to go the same route in order to avoid closure. Serbia's large EU-supported network of BSCs is only a two years in operation, but already it is becoming clear that it will not survive in its current format. Finally, Montenegro's new Regional Business Support Centres appear to have been designed beforehand to fall into private hands once the core EU funding has ended.

Yet irrespective of these manifest failures on the ground since 1995, establishing the neo-liberal commercial model for a local enterprise develop-

ment agency still remains the top priority in South East Europe today. For example, support for enterprise development re-started for Serbia and Montenegro in the aftermath of the NATO intervention of 1999 has permitted almost no modification of the basic model to account for these previous difficulties. In Bosnia the pressure to persevere with the approved local model remains particularly strong and, because of the economic crisis, very effective. Many municipalities have fully registered the collapse of most BSCs to date and, as a result, many municipality officials are becoming increasingly resistant to a BSC model that has produced almost no results in their country/region, other than enriching the select few employed in a BSC that eventually ended up in their private hands. But even minor modifications to the "approved" BSC model to take into account such local knowledge and concerns are almost impossible.[57] Indeed, the huge pressure to

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[57] A very interesting example arose very recently in one Bosnian city involving one of the major donor agencies. After a previous failure in the region with the approved BSC model expensively established under an earlier donor project framework (it was taken over by its three employees and is now a private company offering interpreting, transport and conference management facilities to the donor community), a new donor has arrived to offer the region another chance to benefit from a functioning BSC focusing upon local economic development. However, the local government officials wanted to avoid mistakes and so wanted to learn from the collapse of virtually all of the donor supported BSCs established in Bosnia since 1995, and their own BSC not so long ago. They eventually began to express serious reservations over the wisdom of the standard neo-liberal model of a BSC and very much wanted to discuss modifications to the basic design to facilitate greater sustainability and its continued focus upon the key economic development issues facing the city. They were keen that the BSC not end up simply preparing and charging for business plans as a way of surviving, which they felt other local private companies could likely do better and more cheaply. However, though the local official of the donor agency in question has been very understanding of their predicament, it proved impossible to convince the senior donor officials involved to consider modifying the standard BSC design in any meaningful way. The preferred neo-liberal BSC model is thus being established at some considerable expense without any real local confidence in its operations, a situation hardly conducive to long run success no matter what the design (information supplied to the author by senior local government officials in the city in question, for which I offer many thanks).

persevere with the ideologically correct model is apparent also at the national level, in relation to national enterprise development agencies. For example, the World Bank and the EU remain adamant that even national agencies being established in the region can be self-funding through developing their own commercial revenue opportunities (see World Bank and EU, 2001, p 102). With no evidence whatsoever to justify making such a claim, it is as if the last ten years and more of failed attempts to commercialise development agencies have simply never happened.

Exactly as in central and eastern Europe, therefore, the need to "earn their keep on the market" has meant that most of the BSCs established in south-east Europe have all very quickly lost sight of the most important tasks and interventions that can benefit the local economy over the longer run. Their preoccupation with preparing business plans and credit applications for new entrepreneurial ventures – the mainstay of the majority of BSCs that manage to survive in practise – cannot be construed as local economic development. In too many cases, it not even a contribution to local economic development since it usually ends up substituting for existing private sector activities, meaning no additionality. Real local economic development, instead, involves inter alia a wide range of organisational and mobilisation (of finance, effort, etc) activities, pressure for policy and legislative change, long term capacity-building measures and institutional development programmes (such as technology transfer, sub-contracting and cluster development) that move the local economic base in the direction of sustainability. In some senses it can be considered as the local equivalent of what Weiss (1998) has termed in the context of central state activities as "transformative capacity". Accordingly, the focus upon the neo-liberal BSC concept meant that a local institutional vacuum arose; the micro-economic (local) parallel of the "state desertion" outcome noted by Standing (2002). Previously solidly functioning local government economic departments operating throughout the Yugoslav successor states, and indeed during the period of the worker self-management system as well (World Bank, 1981; Bateman, 1993), were ignored as possible dynamic facilitators of local economic development. Such departments, no matter how effective, were virtually all passed over for donor funding because of their unfortunate location within state structures (Bateman, 2000b). As noted above, this took place even in Slovenia, where the dynamism and efficient enterprise sup-

port operations of many municipalities prior to 1990 was probably the highest in all of central and eastern Europe (Petrin et al, 1988).

These examples of policy rigidity with regard to the BSCs clearly follow what Stiglitz (1999, p 22) has caustically noted as the crude tendency whereby the international assistance agencies "..seem to have seen themselves on a mission to level the "evil" institutions of communism and to socially engineer in their place (using the right textbooks this time) the new, clean, and pure "textbook institutions" of a private property market". It very much seems, therefore, that the large amount of support for non-governmental BSCs in South East Europe is quite unrelated to their actual performance as enterprise development instruments, and has much more to do with ensuring that the ideologically preferred institutional structure becomes accepted and embedded within the emerging post-communist society.

The social capital "industry"

The concept of social capital – that is, the value of social relationships, norms of reciprocity and trust-based interaction - is an ostensibly new source of value of particular relevance to local economic and community development. The concept was widely popularised by Putnam's (1993) analysis of regional economic success in Italy and the supposed role of social capital therein. Putnam's concept of social capital was energetically taken up by the World Bank and others, ostensibly as a way to rebuild the social and economic foundations of distressed communities through the linking together of the poor and disadvantaged in mutually beneficial ways. Three types of social capital were distinguished; "bonding" that binds together people within a particular group; "bridging" that links together different groups of people within the community; and "linking" that is supposed to connect particular groups to those outside of the community holding positions of power and influence. Such has been the impact of the social capital concept within development circles that the World Bank has gone so far as to term it the "missing link" (Grootaert, 1997). In south-east Europe a raft of new social capital projects has been established, each claiming to be either constructing social capital, or at least using social capital to underpin other important social, economic and community development initiatives and objectives. The World Bank has begun to sponsor a number of projects

that focus upon the role of social capital as an aspect of poverty reduction and community development (for example, World Bank, 2002).

However, the analysis of the new social capital "industry" is actually misleading and incomplete. In fact, the social capital "industry" may actually prohibit and, even worse, appears to have been designed to prohibit, the establishment of some of the key building blocks that underpin a sustainable local economic development trajectory. It is not going too far to say that the de-contextualised concept of social capital associated with Putnam's (1993) contribution has been largely de-bunked, devastatingly effectively by Tarrow (1996), Fine (2001) and Harriss (2002). Fine (ibid, pp82-96) has gone so far as to term Putnam's work on social capital a "benchkin", a reference to a widely discredited piece of research in the 1970s by Benjamin and Kochin that maintained the cause of mass unemployment in 1930s UK was high benefit levels relative to wages, and so mass unemployment actually reflected an option deliberately chosen by large numbers of lazy workers. Not surprisingly, this piece of research was comprehensively attacked from all quarters. But it nevertheless became the starting point for a wider literature on the same topic, though almost all of the subsequent research began with an attack on the original article as a starting point. Putnam's work on social capital is denoted to be a "benchkin" because it too has been universally trashed without any substantive reply to the many criticisms, and yet it too has failed to disappear from view as might be expected, but has instead served as the (false) starting point for a huge literature on the topic. So what is so wrong with Putnam's work on social capital, and thus, perhaps, by implication, the social capital "industry" too?

First, Putnam's social capital model is almost entirely context-specific, meaning that it can either have positive, negative or neutral value depending upon the context in which it is being described. Social capital can be a positive factor, such as when poor people link together in the community to achieve some common aim. But social capital can also be a negative phenomenon, as when elite groups use it to exclude those not within their circle of connections or when criminal gangs enforce loyalty and discipline via their close family or regional connections. We thus need to specify in what context social capital is to be deployed before we can conclude whether or not it is a positive development; it cannot just be seen as a positive factor to be constructed and maintained wherever it transpires in practise. But, as

Harris (2003) concludes, because of this indeterminacy the social capital concept surely has very limited analytical power. It cannot explain anything at all without an overlay of context so large as to make the context itself the object of enquiry.

Second, the emerging social capital "industry" is unjustifiably dismissive of the role of the state in both promoting and sustaining positive forms of social capital. Most communities have stocks of social capital. But it seems that well-functioning state structures are critical not only in being able to nurture such stocks into being, but also to convert them into meaningful action (Evans, 1996). This is also why social capital has declined everywhere where the state has withdrawn from the provision of important community support and development institutions and functions (Leys, 2001). And nowhere are these points more evident, paradoxically, than in northern Italy, the area in which Putnam first extensively researched. For electoral reasons the various post-war communist/socialist regional governments in northern Italy were determined to build a flourishing civic consciousness, a sense of social justice, a myriad of "grass roots" networks, forms of local co-operation and associations, and large numbers of self-employed and small enterprises embedded within supportive networks (see Brusco and Pezzini, 1990) – that is, they set out to build (or at least build the foundations of) local social capital. Social capital was very much an outcome of state mediated development processes in northern Italy, such as infrastructure provision, minimum wage structures, well paid public sector employment, numerous job creation and training programmes for all, and high quality education and social welfare provision. The regional and local state also took to supporting a host of other important institutions, such as laws, codes, professional standards, and the like, that also served to promote local trust, tolerance, commitment (to the goals of the local reconstruction plans) and a sense of fair play. However, Putnam entirely failed to capture the nature of the many underlying state-led processes and policies of social capital creation. Of course, as Harriss (ibid) notes, if Putnam had more thoroughly investigated the origin of social capital accumulation on the northern regions, he would have had to conclude that the communist/socialist administrations were often largely responsible, and this might perhaps have been an uncomfortable conclusion to arrive at. Such a conclusion might have invalidated the work in much of the US academic community and, for sure,

in the eyes of those – particularly the World Bank - who subsequently and so energetically ran with the concept from the mid-1990s onwards.

A closer look at the development of the co-operative sector in northern Italy helps to further illustrate the important role of the state in creating and maintaining high levels of local solidarity/social capital. In the aftermath of the Second World War, the elected communist/socialist regional and local state structures in Emilia-Romagna were very determined to promote the co-operative sector as an ideologically preferable middle ground between large capitalist companies (mainly based in Milan and Turin) on the one hand, and the old class of small private entrepreneurial ventures, traditionally reflexively hostile to any form of collectivism, on the other. The aim inter alia was to help to underpin the overall post-war goal of (re)building the confidence, tolerance, mutual support structures and solidarity (i.e., social capital) structures within the much larger working class in the region, which should eventually translate into wide electoral support for the communist and socialist regional governments. An extensive array of state policies were established to support co-operatives, including technical assistance through government economic development departments, a very favourable tax regime, dedicated financial support programmes, public purchasing programmes, and high quality training. These initiatives, and others, helped the co-operative movement to grow fast.[58] By the 1970s Emilia-Romagna had both the highest number of co-operatives in Italy and the highest proportion of economic activity in the co-operative sector in Italy (Birchall, 1997). As co-operative “anchors” within a wider sea of self-employed and investor-driven companies they helped to demonstrate the practical and ethical benefits of co-operation, participation, high wages, and mutual support, and they exerted strong pressure on other investor-driven enterprises to follow suit. In a variety of ways co-operatives became the lynchpin for the wider and successful construction of solidarity/social capi-

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[58] It also helped that the central government saw co-operatives as an important way to rebuild *inter*-class solidarity in Italy - the middle (management) class and the working class coming together once more - and so also took very clear steps to promote the co-operative movement. The most practical form of national support for the co-operative sector was the founding of a special branch of the *Banco Nazionale del Lavorio* dedicated to providing financial support packages for co-operatives (see Bartlett and Pridham, 1991).

tal within the northern Italian regions, and they were greatly supported by the state precisely because of this fact.

A third damning twist to the Putnam-ian social capital concept, as strongly emphasised by Harriss (2002), is that it is completely devoid of any reference to power. It fails to register the fact that very often powerful people have by far accumulated the most social capital - rich connections, club and board memberships, old school and University networks, and so on - and can retain their advantages, and block and/or undermine other social groups from achieving any progress within the community at their expense, through the judicious deployment of these very valuable assets. This aspect of social capital was at the core of Bourdieu's (1993) powerful exposition on the concept, but his pioneering work has largely been dropped by the new social capital "industry" because of it. Instead, the concepts introduced first by Bourdieu morphed into the much weaker notion of there being "linking" social capital – social connections between the poor and those in powerful positions within the community that might respond to the pressing needs of the former. "Linking" social capital was thenceforth portrayed as the best possible channel through which the poor and marginalised should work to remedy their plight. Importantly, the "linking" social capital concept very much implied that there was no need for state agency to be used as the channel through which poor people and communities could seek to redress poverty and inequalities. The twin notions of self-help and the delegitimisation of state agency thus made the social capital concept an exceptionally attractive idea within the IFIs, though it meant that the social capital concept had almost no connection to the situation on the ground. Harriss (2002) concludes that the "linking" social capital concept is "an extraordinary expression of the weakness of reasoning that takes no real account of the context of power and of class relations" (p 10).

The social capital concept translated into an "industry" over the 1990s, thanks to the promotional efforts and subsequent financial support of the World Bank and other development bodies keen to find an ideologically acceptable way to be seen to help the poor and disadvantaged. However, a number of more specific problems and contradictions also quickly began to arise that countered the heady claim that the concept could be sensibly applied to a range of local economic development issues on the ground.

First, a central policy aspect of the social capital "industry" is for the replacement of state capacity with non-governmental organisations (NGOs). The increasing NGO-isation of many transition and developing countries works to marginalise the local state in several ways. This is clear when it actually replaces state capacity, as when economic development departments are closed down and replaced by non-governmental bodies purporting to have an interest in developing the local economy. In addition, however, NGOs are increasingly linked into the public policy formulation process in order to reflect the views of business and private sector groups. Given that the local state can be responsive to the poorest groups via the electoral process, whereas community mobilisation operations and NGO sector are far less within the orbit of poor people and more the preserve of the middle class and elite groups, then it is difficult to argue that the process best serves the interests of the poorest and most marginalised. Such concerns clearly animate policy programmes in South East Europe too. Moreover, as Kekić (2001, p 22) argues, NGOs have some benefits but their massive expansion in south-east Europe will clearly "further weaken already weak states. It is also undemocratic to give precedence to self-appointed NGO guardians of the public good rather than to elected representatives". Simply inserting NGOs and voluntary citizen action can seriously undermine not only local state capacity per se but also democratic accountability.

Second, the practical goal of the key social capital advocates in wanting to establish high levels of local social capital as the basis of community renewal and revitalisation is in quite fundamental contradiction to the programmatic goals of their main IFI sponsors. There is an accepted link between inequality and social capital formation. People interact together more productively and generate trust, motivation, commitment and norms of reciprocity within a social context they see as dignified, just and equitable (for example, see Bowles, 1999). This is an important point that Putnam appears to fully agree with.[59] Yet we also know that World Bank and IMF policies are quite clearly and deliberately predicated on their being a major increase in inequality and social differentiation within the community (though these notions are, of course, rarely aired in such stark terms within

[59] For example, see Putnam, 2000, (p 294), where he concludes that "Inequality and social capital are deeply incompatible".

public discourse). Increasing inequality is an ideological fundamental of neo-liberalism (see Friedman and Friedman, 1980) as well as a perfectly reasonable programmatic outcome because it is seen as being the only way to galvanise the most entrepreneurial individuals into action. Such individuals, it is assumed, must be offered substantial incentives if they are to give of their best. Allied to these "top down" freedoms is for the enforced deterioration of wages and working conditions of those individuals at "the bottom of the ladder". The "flexible labour market" approach, as neo-liberal labour market policy is better known, holds out that in order to facilitate greater activity and investment by entrepreneurs and foreign investors, existing and potential employees must be encouraged to abandon all possible obstacles, such as reasonable wages, social benefits, decent working conditions, security of employment, and so on. Indeed, the growing support for the "flexible labour market" approach in South East Europe has seen much pressure to promote the reduction of employee compensation, job protection structures and social benefits packages; very much so in Croatia recently.[60] But how can this legitimation, sometimes outright celebration,[61] of extreme

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60 The government in Croatia is being encouraged from a number of directions to move toward the neo-liberal "flexible labour market" approach (Rutkowski, 2003; UNDP, 2003b). This pressure is being exerted in spite of little evidence that the "flexible labour market" thesis has achieved very much in the two countries – the USA and UK – where it has most ardently been operationalised. In terms of employment creation, Schmitt and Wadsworth (2002) found no meaningful correlation between increased flexibility and employment creation. Moreover, the greater freedoms given to employers may have been a factor in creating in both countries the highest levels of poverty and inequality for fifty years. Zweig (2000) notes that in the USA the declining level of real rewards accruing to labour over the 1980s and 1990s, rather than generating new job creation dynamics benefiting from relatively cheap labour, effectively precipitated an orgy of failed speculative activity in the "dot-com" sector and in an associated real estate boom.

61 The many glossy brochures advertising the "attractions" of particular regions and countries to foreign investors often glory in the *lowering* of social standards, working conditions and all round community liveability. For example, routinely claims are made to the effect that the wages or the "burden" of social contributions in country X or region Y are very attractive to businesses "because they are some of the lowest in the world", or else that the environmental

inequality and descent into poverty for many people, be reconciled with the supposedly determined efforts of the social capital "industry" to lay the foundations within the community for accelerated social capital accumulation? Surely the concept of social capital and the neo-liberal "narrow" model of development operationalised in South East Europe – development, to repeat, that primarily benefits local elites, does not address poverty and actually increases inequality (Addison et al, 2000) – are quite incompatible? And, indeed, in many parts of South East Europe we have ample evidence that high levels of inequality and social injustice quite clearly precipitate the breakdown of solidarity and trust – social capital – within many communities.[62]

A third inconsistency in the supposed goals of the social capital "industry", as we have already alluded to above, concerns the obvious, but unfulfilled, role of worker self-management, the co-operative sector and other form of participative enterprise structures in the social capital narrative. Social capital is well recognised as being exceptionally strong in co-operative and employee-controlled organisations and communities of co-operatives. Levels of "bonding" and "bridging" social capital are likely to be very high indeed. In the context of the increasingly adverse economic globalisation impacts upon local communities, this social capital building rationale is now being deployed by international agencies and some western governments as one of the main reasons why co-operatives urgently need to be more aggressively promoted and protected (see CEC, 2001; Parnell, 2001; ILO, 2002; Birchall, 2003). However, ideas to promote genuine worker-managed enterprise structures in South East Europe after 1990s,

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legislation in country X is "business-friendly" because it is essentially non-existent.

62 Croatia is one obvious example where the concentration of wealth in society achieved through so-called "tycoonisation" – many state assets were distributed shortly after 1991 to a handful of people close to Croatian President Franjo Tudjman – greatly undermined the level of solidarity, tolerance, concern and the general legitimacy of legal business methods in Croatia (see Bartlett, 2003). Such was the extent of financial, industrial and social destruction wrought by this artificially created class of business-men (there were very few business-women) that in common slang they are often referred to as the "typhoons", rather than tycoons.

such as worker co-operatives, were largely ignored by the main IFIs, and sometimes even equated to a desire to provide a life-line for communism. And, of course, the entire worker self-management system in the former Yugoslavia was forcibly broken up without any concern for the possible adverse implications in terms of a breakdown of residual trust, motivation, tolerance and mutual support within the enterprise sector. Here one need only reflect upon what Branko Horvat has argued (1982; 2002), that the worker self-management system actually performed a pivotal role in the extremely rapid and equitable reconstruction and development of the country after the huge devastation of World War Two precisely because it was able to construct a very high level of motivation, social solidarity, independent forms of mutual support, tolerance for others, and trust in government.

Fourth, paradoxically, the two aforementioned cornerstones of neo-liberal local policy - "new wave" MFIs and commercialised Business Support Centres – are intrinsically damaging to social capital accumulation processes. In general, by re-casting individual survival as a function of individual entrepreneurial success, the bonds of solidarity, trust and co-operation that traditionally exist within, and serve to bind together, communities are inevitably undermined. This is a truism. More specifically, whenever community development and support activities are recast as commercial operations – a central operating principle of both local models - the unavoidable consequence is the degeneration of the level of local solidarity, interpersonal communication, volunteerism, trust-based interaction and goodwill (see Leys, 2001). As commercial bodies increasingly operating to profit-maximising goals, the many "new wave" MFIs and Business Support Centres (BSCs) established in the region have so far been largely unable to build longer term local commitment, identification and trust within the community. There is ample evidence of this trend. For example, in Albania in 1991 "new wave" MFIs entering the poorest mountain and upland villages soon moved away in search of more profitable opportunities in the urban areas, leaving their unfortunate clients once more to go without support. When the already better off communities began to receive the additional attention of donor projects and a further injection of external funds, and when inequality between the communities grew even faster as a result (the injection of new money largely helped the urban-based traders and importers to increase their activity and get even richer), typically there was a

collapse of solidarity both within communities and across communities. That is, both “bridging” and “bonding” social capital were severely undermined by the entirely logical and to be expected development of “new wave” MFIs. In Bosnia and Montenegro, a number of the most successful “new wave” MFIs have already converted into commercial banks, and they too have largely abandoned working with very poor clients in favour of comparatively well-off individuals able to afford high interest rates and provide substantial collateral (and very often the loans go to projects that serve the consumption needs of the rich, further exacerbating the problem). There has also been significant resentment towards the very many BSCs in the region that were privatised by their employees as a way of securing personal enrichment. The quite reasonable presumption is that donor funding has once again been diverted away from the service of the wider community and into the hands of small groups of self-interested and well connected people. The donors have tolerated such obvious developments because not only is privatisation quite in keeping with the overall “grab what you can” philosophy permitted by neo-liberal policy in the region, but also because it presents a useful face-saving strategy for them – better a privatised BSC still in operation no matter if it is doing nothing at all for small business, than a very publicly collapsed BSC. Taking all this into account, it has to be noted that if social capital is construed as being critical to development, as the World Bank steadfastly maintains (see Grootaert, 1997) then it should surely be of real concern to the social capital “industry” that the two core local interventions supported by their very same sponsors undoubtedly serve to significantly undermine its local accumulation. To date, however, no such concern has been registered.

Fifth, and finally, one cannot but reflect upon the enormous pressures that have typically been placed upon developing and transition country governments to “change course” when they actually do opt to prioritise the needs of poor communities over the richer strata of local society, which we must assume would be seen as a very welcome development by the social capital “industry”. Yet it is very well documented (Veltmeyer et al, 1997; Hardstaff, 2003), that the World Bank and IMF have consistently sought to undermine the policy orientation of governments that choose, for whatever reason, to prioritise the immediate needs of the poor, rather than focus upon the needs of local elites and foreign investors. As Stiglitz (2002) has noted, aid conditionality and other pressures are quite routinely and forcefully ex-

erted upon governments across the world in order to avert all such heterodox policy directions. Structural Adjustment Programmes (SAPs) did the job very well indeed from the 1970s to the mid-1990s (Mohan et al, 2000), and since then the Poverty Reduction Strategy Papers (PRSP) process has largely taken on the task (SAPRIN, 2001). Moreover, it is also very well documented that the US government – undoubtedly the main driving force behind the policy prescriptions offered by both the World Bank and IMF - has historically seen it as a strategic foreign policy imperative to actually block, very often violently, the efforts of some governments seeking to prioritise the needs of the poor over those of local elites.[63] Thus, if the overarching foreign and economic policy imperatives of the social capital industry's main IFI and government supporters has been to consistently oppose

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[63] The US government's determined opposition to pro-poor governments is very well known in Central and South America. Perhaps the most obvious example concerns Nicaragua in the 1980s and 1990s. During the mid-1980s the government in Nicaragua was highly commended by many organisations, including by such as Oxfam (Oxfam America, 1985), for its comprehensive social and pro-poor development programmes, judged to be by far the best in Central America. However, the success of these emerging pro-poor programmes represented to the US government at the time the "threat of a good example", and with it the possibility of neighbouring countries also adopting development policies that prioritised the poor and marginalised rather than local business elites that traditionally allied themselves to Washington. The Reagan administration therefore targeted the elected Sandinista government for removal. Putting together a 12,000 strong terrorist army based in Honduras and Costa Rica – the "Contras" – the Nicaraguan government was put under enormous pressure, the cross-border attacks launched by the Contras killed many thousands and injured many tens of thousands, and by the early 1990s the economy was effectively destroyed. Even a comprehensive World Court ruling in June 1986 calling for the US-led aggression to end, and for the US government to pay substantial financial reparations to the Nicaraguan government, was unable to end the suffering - the US government simply ignored the World Court's decision. Against this unhappy background, and with the threat of more US-sponsored violence to come if they failed to heed the correct message this time, the Nicaraguan electorate finally voted in the 1990s to remove the Sandinista government and bring in an administration composed of key members of the local business elite and some former officials linked to the previous Somoza dictatorship (see Chomsky, 2002).

the poor when they manage to organise effectively and address their plight directly and legitimately through the democratic process, it thus requires some degree of explanation - to say the least - as to how workable/genuine is the social capital "industry's" proposition that poor communities can use their "linking" social capital to successfully petition those in positions of power to accept meaningful change.

In sum, a great deal of ambivalence surrounds the concept of social capital and the purported goals of the social capital "industry". On the one hand, it is for sure very clear that solidarity, trust, norms of reciprocity, mutual support and grass roots community organisations do matter and can very effectively advance the needs of poor communities in a number of socially constructive ways. But on the other hand, the social capital "industry" that has emerged to orchestrate matters on behalf of the poor in South East Europe may actually be doing more harm than good. By narrowly restricting their efforts to developing greater solidarity/social capital within poor communities, though latterly supporting the idea of initiating some weak connecting activity to those in positions of power, the social capital "industry" risks creating vibrant entrepreneurial ghettos and nothing more. All this much too conveniently serves the interests of those who do not wish to address the structural factors and institutional constraints that perpetuate poverty, inequality and under-development. In addition, far more direct strategies are on offer to poor communities to improve their position and at the same time construct social capital, such as, very simply, electing a government that puts a very high priority on the needs of the poor and marginalised. But in a number of countries these high social capital accumulation strategies have been deliberately and consistently blocked by the IFIs and key western governments. Arguably, what seems to be happening in South East Europe, therefore, is that to the extent that poor communities can accept the idea that they can improve their situation only through such weak forms of pressure as the Putnamian concept of social capital – "bridging", "bonding" and "linking" social capital - then the social capital "industry" is able to very neatly head off any serious "bottom up" challenge to systemic legitimacy and gross malfunctioning.

Conclusion

The three main local strands of neo-liberal policy supported by the IFIs in south-east Europe to date have probably contributed to the overall economic decline that has transpired since 1995 (and before). These local policies are, therefore, as problematic as their neo-liberal macro-economic counterparts. However, if the situation is so bad, one needs to explain why it is that such local policies are persisted with. Here I would agree with the broad conclusions reached by Chang (2002), reflected also in the earlier work of the conservative institutional theorist Douglass North (1990), that very often economically and socially inefficient institutions are reproduced because it is in the interests of the powerful for this to happen. As with the macro-economic counterpart, I conclude that local neo-liberal policies and programmes are crucial to the IFIs less because of what they are supposed to achieve on the ground - which has been very little to date - and more because they "lock in" core neo-liberal ideological/political policy and institutional imperatives within emerging post-communist societies. It thus remains to be seen whether continuing economic deterioration in south-east Europe combined with increasing local, national and international pressure for change can actually succeed to any great extent in changing the content and direction of either macro- or micro-economic policy.

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Promoting Democracy-Building and Security Through Private Investments

In principle, private investments can be domestic as well as foreign ones, having of course in many respects quite different effects on democracy-building and security. On the other hand, certain features are also common in general, and I will first try to make some remarks on general effects of private investments, regardless of their domestic or foreign contents. First of all, one can certainly state in general that in order to increase private investments, legislation, legal enforcement and public administration in the respective countries must become transparent and with regard to public administration also more effective. Labor market regulations must become flexible, liberalized for reducing the risk of investors to become chained to encrusted labor laws from former times.

Private investment strengthens the private sector. The smaller the public sector becomes, the more the population becomes aware that private entrepreneurship and civil society is now responsible for the community, and the less opportunities for corruption remain. Corruption is blossoming when lousily paid bureaucrats decide about the placement of public orders for infrastructure, public construction works, procurement with licenses and so forth. The private sector furthermore will develop cooperative bodies to lobby its interests. Foreign investors will bring more experience and more natural consciousness for those cooperative bodies, and will support the build-up of associations and other forms of lobbyism.

If we now turn to foreign direct investments which might be the more interesting part of investment activities with regard to fastening democracy-building and security, then, first of all, one must admit that FDIs do not necessarily go only into democracies or countries being already on the path towards democracy. Examples here are China and the former socialist countries in Eastern and South East Europe. If investments promise to be profitable then investors will go into any kind of state, may it be democratic or authoritarian. Sometimes even authoritarian states promise more micro-security than democratic ones since centralist control and strong dictatorial

police force can provide more security to persons and premises than weak infant democracies!

But the Central Eastern European experience shows very distinctly, on the other hand, that on a broad basis private capitalist investors seemingly prefer similar political and legal frameworks if the general circumstances, i.e. the basic legal framework, are sufficiently developed. The investor's rush into Poland, Czech Republic and Hungary in the 1990s prove this behaviour, whereby in these cases certainly the clear EU-membership perspective was and still is an additional supporting factor.

How far and how quickly economic reforms in target countries can transform the private sector – and so the entire economy – relies in part on the mind-set of today's business leaders in the recipient countries. State enterprise managers do not buy into new market-based principles of competition and frequent change. Thus, new types of managers are needed. FDIs provide job opportunities for a new generation of company managers who acquire and exercise training and job experience suitable for globalized markets in democratic environments. This kind of managers is urgently needed in the new societies in Central Eastern and in particular also in South East Europe for cementing the social-economic basis of the societies. Competition is not only a characteristic of a market economy but also is essential for democracies as such! Political parties and politicians have to learn that competition, and not antagonistic, hostile fights are the essence of normal democracies where bargaining and compromises are part of the game in politics as is the case in the economy.

FDIs provide job opportunities for talented young people, who otherwise are inclined to seek their fortunes elsewhere. What we observe today is a dangerous brain drain of the young, best people who not only seek their education abroad, but who also will decide to stay abroad as long as job opportunities at home are bleak and at best provide sub-standard employment. Jobs in FDI-enterprises not only provide better payment but also connections to the outside world, international connections and prestige. Needless to say, that for the future of the societies these talented young people are indispensable for the development and enforcement of the new democratic structures. Jobs with FDIs reduce the need for those people to turn to the illegal economy for making their living.

FDIs need continuation of reforms in the recipient countries, but these reforms will also be backed by the FDIs. That serves to make the region more stable and more predictable. The more similar and adapted laws, regulations and patterns of economic policies are to those of the countries of the investors, the more likely it is that numbers and engagement of the latter increase. Here again the example of the Central-Eastern economies Poland, Czechia and Hungary are striking in so far as most of the investors come from EU-countries following clearly the adaptation efforts of the EU-candidate countries. The majority of the investors in the candidate countries come from democratic countries with respective legislative and regulations backgrounds. Of course, large internationally operating enterprises can also cope with different legal and regulative conditions, but smaller and medium sized companies do not have the experience and the financial basis to face and overcome probable difficulties in their target countries. The advantage of similar backgrounds and legal frameworks is in particular valid for joint ventures where an investing Western entrepreneur tries to cooperate with an existing firm in the target country, but it also holds for so-called greenfield investments.

Foreign investors will also bring with them compatriots who will claim similar or even identical rights and legal protection (e.g. working conditions, health and sanitary protection at the work place, accident insurance etc.) as at home.

In the mother countries competitors as well as trade unions will insist that in the recipient countries the same rules, regulations and norms are applied. They are afraid of unfair competition, and many dumping accusations have proved that in fact uneven standards with regard to environment, security and other norms and standards can provide competitors with substantial competitive advantages. Of course, one can also observe that investors on purpose try to go into countries where those norms are weaker or even non-existent in order to profit from these cost-savings! However, the interesting markets of the EU and/or the United States will in most cases not allow the import of products that do not comply with certain standards or are produced under conditions that clearly violate certain standards at the work place for the workers. Naturally, there still exist many black boxes, and attempts to circumvent these rules and norms will occur also in future, but certain trends towards harmonization are clear, in particular when the recipient countries in the not too far future want to join the EU.

Last but not least, some easy basic facts do also speak for FDIs. FDIs are regularly registered which means that revenues for the state budget flow on a regular basis, in contrary to many other domestic economic activities which lack of this clear registration and oversight. State budgets in the democratizing countries need the steady inflow of income for improving the possibilities of the state administration to stabilize their societies by providing a more and more effective administration including the procurement of certain social services. In addition, for weak economies the inflow of foreign capital is extremely important for the build-up of the domestic capital stock. Only in the years 1998 through 2000 UNCTAD figures prove that for example in Croatia foreign capital participated with 28% in the build-up of the national capital stock. In Macedonia this figure was 29%, in the following two years it must have been ever higher! In Bulgaria the respective figure for 1998 to 2000 was even 42%! This inflow of capital and build-up of the domestic production basis contributes clearly to the standard of living, it helps to diminish poverty and takes away part of the argumentative support for undemocratic agitation that mostly is based on the critique of social hardships and economic miseries.

I am very well aware that this picture presented here in short might be too rosy, if one tries to evaluate the effects of FDIs in democratizing countries. However, press reports from Bulgaria recently back partly the herein assessment. In September, business papers from Sofia stated that FDIs are the most regular contributors to social security payments according to the National Insurance Institute (NOI) in the first half of this year. Lukoil-Neftokim, one of the leading foreign direct investors, is in first place of the top twenty of the best-behaved employers. The German firm SAP is stated as the most attractive employer among enterprises who employ between fifty and one hundred people. Shell Bulgaria is number three in this list. The fact that foreign investors also take out profits and repatriate them into their countries cannot be accepted as an argument against their engagement. Of course, investors always look for profits which is their good right. But they provide additional employment, they pay taxes in the countries where they engage, and they contribute to the build-up of modern economic structures and market economic societies. They are no angels, but at least they are active participants in the societies and fill holes which domestic investors due to the lack of capital and/or experience are not able to do. They try to

secure their interests, but also this is normal behavior which every domestic investors will also try to do.

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Concluding Comments

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The Economic Aspects of Security in South Eastern Europe

In the process of constructing a safety structure in the South Eastern Europe one must bear in mind the assumptions on which the new global safety structure is based, and those are:

1. Europe, and the surrounding area of the region, is becoming more stable and peaceful, and there are no indications that there will be any armed conflicts between states in the near future.
2. The situation of volatility and insecurity is spreading globally due to unconventional threats, like international terrorism, weapons of mass destruction, drug-trafficking, illegal immigration etc.
3. The EU, as an institution of international integration, and NATO, as an international organisation, are starting to see eye to eye and are co-ordinating their activities on the basis of compatible civilisation values against the stated threats and in attempt to further economic development of the EU.
4. The role and the importance of multilateral organisations are diminishing. The emphasis is being put on the importance of bilateral relations, especially by the last superpower, the USA, whose policy of unilateralism will surely dominate international relations for some time to come.
5. Other stakeholders in the domain of international relations, with the potential to become partners of the USA in the process of reaffirming multilateral relations. The EU, the People's Republic of China, the Russian Federation and the UN have just begun adapting to new relations and there are no indications that the position of the USA as the leading world power would be contested.

6. The globalisation process dominates all aspects of international relations on the basis of scientific and technological revolution, as well as revolution in the communication of information. It will be a consistent mechanism of transferring the model of liberal democracy internationally.

The EU has made increasing efforts lately to enforce its foreign policy, as well as its security policy, in the context of these assumptions, and thus attempts to become politically more influential participant in the global security structure. This will enable the EU to become a more relevant partner of the USA, at the same time contributing to the transformation of international relation paradigm from the present state unilateralism to multilateralism. One of the preconditions is the creation of the sub-regional security structure in the South Eastern Europe and involvement of the states of the region in the process of "the Eastern expansion". Bearing in mind armed conflicts, destruction, and bloodshed in the region of the past decade, this is a very complex task. However, a secure environment in "Europe's backyard" is one of the conditions for securing the EU area and beyond. The best guarantee for this would be adjusting these countries to EU standards and criteria, and subsequently giving them full membership. One of the precondition is suitable economic development, and in this context a suitable level of economic co-operation.

Therefore, we are talking about the economic aspect of security or interrelationship between economic development and security, which could also be interpreted as the security aspect of economic development. In this context, the region in question consists of five states (Albania, Bosnia and Herzegovina, Croatia, Macedonia and Serbia and Montenegro) that have already joined with the EU's stabilisation and association process (SAP), together with Bulgaria and Romania. Important guidelines for this process were established at the summit of the Council of Europe in Salonika in June 2003.

Although this was not the only item on the summit's agenda, the issue was thoroughly discussed. The summit's final document said that " the gates of Europe are open, and the prospect of entering the EU are encouraging" for the five countries. It was said that Bulgaria and Romania would be granted full membership by 2007. In this document all the states were mentioned as West Balkans countries for the first time, coining this term officially. In a way, this casts doubts on the truthfulness of "the open gates of

Europe" statement, because if European prospects of these countries are discussed, it would make more sense to keep the word "Europe" in the name of the region and name the region South Eastern Europe. The term West Balkans suggests that the region is somehow external to Europe, since reference to Europe is left out.

However, two messages that were given at the summit regarding the region are far more important than terminological connotations. The first message concerns the need to make a major change in the strategy of further financial co-operation or financial support to the region. The co-operation or the financial support should be directed at making the region capable of independent economic development, formulated as "from aid to self-sustainability". Unfortunately, this was not substantiated with concrete financial arguments, so the funds of the CARDS programme earmarked for these countries (for the period of 2002-2006 there are some 5 billion Euros allocated for this purpose) have been increased by a mere 200 million Euros. In addition to that, these countries are denied access to pre-accession funds, like the SAPARD or the ISPA, which would be very helpful in the process of adjusting some segments of these countries' economies to the EU criteria. For instance, the SAPARD fund is very valuable in the adjustment processes regarding agriculture. This is very significant, since it is well known that agriculture is very important for the EU, insofar as it represents an important issue in EU relations with associated member states. The ISPA fund is important for adjustment processes in the domain of transportation and ecology. In order to put this financial support in a more realistic perspective, we could use a quote from a letter sent by the representative of German Parliament Mr. Christian Schwarz Shilling to the German Parliament two years ago. Mr. Shilling was personally involved in the stabilisation process of the area and Bosnia and Herzegovina. He was very blunt when he said that the EU should not be so proud of its financial aid to the countries of the region. The funds allocated by the CARDS programme for the period of 2002-2006 amount to 5 billion Euros despite the fact that there are over 30 million residents in the area and that the area was devastated by war and its severe consequences. At the same time, funds allocated to Sicily, considered to be underdeveloped and with some 5 million residents, amounted to 30 billion Euros.

It is obvious that there is a tendency to reduce financial aid, and instead to provide more help through consultations and other forms of support,

leaving the securing of the funds to the countries themselves, that is, to the ability of their political and economic circles. Economic analyses show that none of the countries in the region, not even Croatia, despite being the most advanced among them, is economically and institutionally able to finance the desired development on their own. Each of them needs foreign capital. Now, the question is how to get it, what should each of these countries or what should they do together in order to attract foreign capital, preferably in the form of foreign investments in the region. Political stability is the first criterion on the list, on the basis of which the foreign investors are deciding to invest in certain area. The importance of this criterion was magnified in the past few years.

This is especially the case with South Eastern Europe, which was particularly unstable in the past years. Therefore, it is expected that it will become stable and thus more attractive for foreign investments through the process of stabilisation and association to the EU. Croatia has advanced the most in this process, followed by Macedonia. The three remaining countries have not yet started formal negotiations. Croatia has already filed an official application for acceptance, and sent the reply to the EU Questionnaire. It is expected that Croatia will get official candidate status in spring next year, which would enable the country to apply for pre-accession funds. Each country that has a part in this process has to provide a guarantee for certain inner stability, and thus for foreign policy that will contribute to the stability of the whole region, and beyond. In other words, each country has to prove that it will become a "manufacturer" of stability and security, and that it will stop being their mere "consumer". Hence is this agreement called the stabilisation and association agreement. This is the first time that the EU has signed a pact in whose title is the word stability. Therefore, the rule of law is an imperative for the countries, because this is a guarantee for their internal and outer stability. This constitutes the second important message of the EU summit in Salonika.

There are several aspects to the stabilisation process. The first aspect is political. There are constant changes in the field of politics, some of them are positive, but some are negative. The positive thing is that there have not been any armed conflicts in the area for a long time and that there probably will not be armed conflicts anymore, despite of the fact that there are several difficult problems certain states have to deal with. However, neither the EU, nor the international community can afford warfare in the area. This

would pose a threat to the entire EU area, and also to global stability and security in the light of the fight against unconventional threats, like weapons of mass destruction, terrorism, etc. Therefore, there is a lot to be done on the field of politics. The formal apology mutually issued by Mr. Mesić and Mr. Marović, the presidents of Croatia and Serbia and Montenegro, have had a positive impact on stability in the region. The apologies gave rise to various reactions, but from the regional, as well as from the global aspect, they had a positive connotation. However, a latent tension in Macedonia poses a definite threat to stability of the region. In Bosnia and Herzegovina several steps have been taken towards the improvement of the situation in the country. This can be best seen in the long awaited association of the armed forces and in the introductory attempts of democratic control over them. However, those are very modest initial processes, especially when compared to the work carried out in that field in Croatia. Regarding the democratic control over armed forces and security sectors, as one criterion of entering the EU and NATO in the field of internal stability, Croatia is more advanced than Bosnia and Herzegovina, but is still falling far behind many countries in transition.

Therefore, it can be said that a politically unstable situation should not represent an obstacle to foreign investments in the region, but foreign investments could be hindered by a poor economic situation. First of all, the fact is that the markets of those countries are rather small for a serious foreign investment, or for a foreign company. In Bosnia and Herzegovina there is no common market, and if there is no common market within a state, than the situation in the region is worrisome. Therefore the markets are too small for serious investment and this has a discouraging effect on potential foreign investors. If a certain form of co-operation is possible to attract foreign investments, that is another thing. However, here we encounter a delicate question concerning the level of that co-operation. Economic co-operation between the countries with such differences in economic development, even in development of democratic society could turn out to be counterproductive. The theory of integration and co-operation should be thoroughly examined. It starts with functional co-operation, than goes to functional integration, which then goes to institutional co-operation and ends in institutional integration. It should be carefully analysed which type of co-operation could be applied to the territory of the South Eastern Europe.

According to economic indicators, there are substantial differences in the development of Croatia and other countries in the region. In theory, as well as in practice, these differences could be overcome only by a free market approach, which forms the basis of all reforms of the countries in transition. Free markets emerge out of the interest of business units, or companies and not from political pressures to form associations at all costs, thus forming a unit with no real business interest. If Croatian companies are interested in buying certain factories in Serbia, and vice-versa, they should carry out their business proceedings on their own, free from government involvement. As far the State authorities are concerned, they could give their support to a particular type of functional co-operation. The State authorities could, for instance, give their support to co-operation regarding free trade zones. Any further co-operation, be that multilateral free trade zones, highly recommended by Brussels, or custom unions should be left in the hands of business experts. Therefore, this is a very delicate situation, which requires a subtle approach from all parties involved, including Brussels and stakeholders in the region, as well as careful decision making.

With regards to other factors of foreign investment attraction, it is very important to establish credible judiciary and effective government administration. The situation in Croatia concerning the two is catastrophic. The judiciary has completely misused the idea of democracy, according to which it should present one of the three independent pillars of the society. Instead, it locked itself into an impenetrable fortress, not allowing any objections to even the most ridiculous court decisions, claiming that they represent an attack on democracy, or independence of the judiciary. This happens in civil and criminal lawsuits, but also in business cases regarding foreign investment. Legal procedures regarding foreign investments are very complicated and long. Cases against corruption at this level and in privatisation cases are being postponed until the statute of limitations runs out. Everybody knows what crimes certain people have committed, but they remain free to defend themselves. Their lawyers always have something tucked up their sleeve to prolong the trial until the statute of limitations runs out. It is true that this kind of corruption can be found in liberal democracies, based on different postulates from those of totalitarian societies. It can be found in western countries, for instance in the USA where the "Enron" scandal broke out. This is in the roots of democracy, because it is a soft system that gives the right to legal defence to everyone. Stalin used to say that it is better to

convict a hundred of innocent people than to let a guilty man free. For liberal democracy the opposite is true – it is better to let a hundred guilty people free, than to convict an innocent man. This must not be abused. Some people believe that the government of the past decade has fired the entire judiciary only to replace it with new people who are now impossible to dismiss. Thus, ineffective judiciary and government administration are the main issues obstructing foreign investments.

Even the international community has singled this out as a problem. A large part of the funds of the CARDS programme were allocated for the reform of judiciary and government administration. This is a black hole that needs to be shut in order to attract more foreign investments. There are no orderly land registry books in Croatia, so when the investor asks from where are the borders of the land he had bought, no one knows. This is a vicious circle. Although the EU criteria lead to decentralisation, it has turned out that decentralisation in favour of the local level and decision making regarding these issues on the local level is worse than centralisation. This is because the chairmen of the municipalities are in collusion and in constant co-operation with all the people that buy and sell, so corruption is thriving. The Croatian minister for environmental issues Ivo Banac said that decision-making should be returned to the national level, but the chairmen of municipals confronted him by saying that that would be against the EU criteria. This is true, but there is no such abuse in the EU countries.

The quality of the work force, as a way of attracting foreign investments, meets the EU standard. The taxation system is a greater problem in Croatia, although this could be said of other countries as well. All countries of the region have undergone the difficult period of mayhem and destruction, and subsequently the process of renewal, returning of refugees, minority issues, all of which require more government and public spending. Government and public spending in Croatia still take up about 50% of the GDP. In the developed EU countries this takes up little over 40%. If government and public spending is so high, it is bound to represent a substantial financial burden for the economy, through taxation rates. The consequence is that domestic economy cannot be competitive on the foreign market. Therefore, the entire development of Croatia is based on domestic spending, which is not good in a long run for a country that has a small market where any production must be produced for export purposes. In Croatia, export is on the decrease, but this is compensated by tourism. Still, this is not enough to stop

the negative tendency regarding the balance of current payments and growing foreign debt. The foreign debt would not present a problem, if there were an increase of export. However, if this tendency continues, there will be major troubles.

So, if the chances of quicker accession to the EU are ruined and if the tendencies of simultaneous growth of debt and decrease of export are continued, the country, in the state of isolation from foreign market, is bound to reach a crisis, because it simply cannot repay the foreign debt by its own accumulation. In this case, even in Croatia, “the Argentinean syndrome” could be repeated. However, if the plan of entering the EU is carried out, this cannot happen. The plan goes as follows: in April 2004, Croatia will become an official candidate, then the negotiations between Croatia and the EU will end by 2006. In 2007, the EU would ask Croatia to become a full member, which would happen in 2008, so the Croatian voters would be able to vote for the European Parliament, which would provide a definite proof that democratic Croatia has entered the circle of the EU. Thus politically and economically enforced, Croatia would become a more important factor of the security in the region of the South Eastern Europe and contribute to quicker accession of the whole region to the EU. This is a precondition for the EU to become a more influential factor in the matters of international relations than it currently is.

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Economic Recovery and Security: Two Important Challenges for the EU in South East Europe

The main issue of the workshop was how economy can contribute to the stabilisation process in the region. A broad consensus could be reached that economic reforms, democratisation and strengthening of security are interactive processes, which strongly depend on each other. On the one hand it is difficult to imagine that a social market economy in South East European societies can evolve without creating stable political institutions in a secure environment. On the other hand the economic performance of the South East European countries and especially external economic influence seem to have a very strong impact on institution building and the bilateral and multilateral relations in the region.

One of the very positive impressions from this workshop is that despite of the last cruel wars, SEE countries have become aware of the fact that economic recovery of others in the region is also in their interest and that there is in general a necessity for regional ties.

But on the other hand panel 1, in which the macro- and micro-economic situation of the SEE countries was described, and also the presentation of H. Weinberger-Vidović showed that despite similar problems (like a high unemployment rate) and common goals (especially EU accession) we can not speak of South East Europe as one region in terms of trade and economic integration. Although it was stressed that economic relations between the SEE countries since the end of the war have developed better than anticipated, the economic data presented in the speeches mostly created a picture of trade diversity and intra-regional disparities. The most important trading and investment partners in the region are EU members. The logic consequence of this circumstance is that the EU will remain the most important engine for economic and political as well as juridical reforms in the region. Therefore it is probably better to look at ways how to integrate the countries of the region in the EU rather than to condition this integration on the prior integration in the Balkans.

The speeches in panel 2, 3 and 4 made clear that the process of economic recovery in the Western Balkans, a region which has gone through a series of permanent security and economic shocks during the last decade, still depends very strongly on the help of the EU and other important international organisations and initiatives. Some critical words were said about how this international engagement proceeds. Especially the presentation of Milford Bateman, who analysed the role of the International Financial Institutions, included the warning that the uncontrolled application of neo-liberal concepts can lead to destruction rather than to the recovery of the economic system.

The EU on the other hand, which since the end of the Kosovo war has increased tremendously her efforts to contribute to regional stability, still seems to have problems dealing with the structural heterogeneity in the region that results from differences between SEE countries' economic and political development. For example the two main instruments through which the European perspective is represented in South East Europe, the Stability Pact and the Stabilisation and Association Process are not always a perfect match. From a strategic angle the Stability Pact and the Stabilisation Process are partly based on contrasting principles. The priorities of the Stability Pact are regional co-operation, while the Stabilisation and Association Process stresses bilateral conditionality and a specific approach for every country aiming at EU accession. This contradiction could be overcome by sharpening the Stability Pact into an auxiliary instrument of the Stabilisation and Association Process. The Stability Pact should enforce functional co-operation in South East Europe in fields common for all countries (fight against organised crime, environmental policies and security issues). But it should be stressed that the framework of the Stability Pact and regional co-operation in general can not be a substitute for EU accession.

Although the EU summit in Thessaloniki sent positive signals to all countries of the so- called Western Balkans in terms of giving an accession perspective, it is realistic that the Stabilisation and Association Process almost causes and will cause even more fragmentation. This negative consequence unfortunately cannot be avoided, if the EU does not want to fall back in the old melting pot thinking to treat all the countries of the region alike despite important differences in political and economic development. Although the fragmentation of the region cannot be stopped, it can probably be softened. Therefore the Stabilisation and Association Process needs addi-

tional elements for those entities in the region, which can be imagined to become EU members only in a long term perspective. Maybe one solution would be to define a "Stabilisation and Association Agreement Minus" (as suggested by Wim van Meurs) for those unable to fulfil SAA admission criteria in the medium term, for instance due to unresolved status issues (like Kosovo).

Here the circle between economy and security closes. An unresolved status, in addition to a security vacuum causes negative economic effects in the form of scarce trade and foreign investments and will make EU membership more difficult. It is partly up to the EU to promote solutions for the open security issues (as for example for Kosovo) to facilitate and fasten the integration process.

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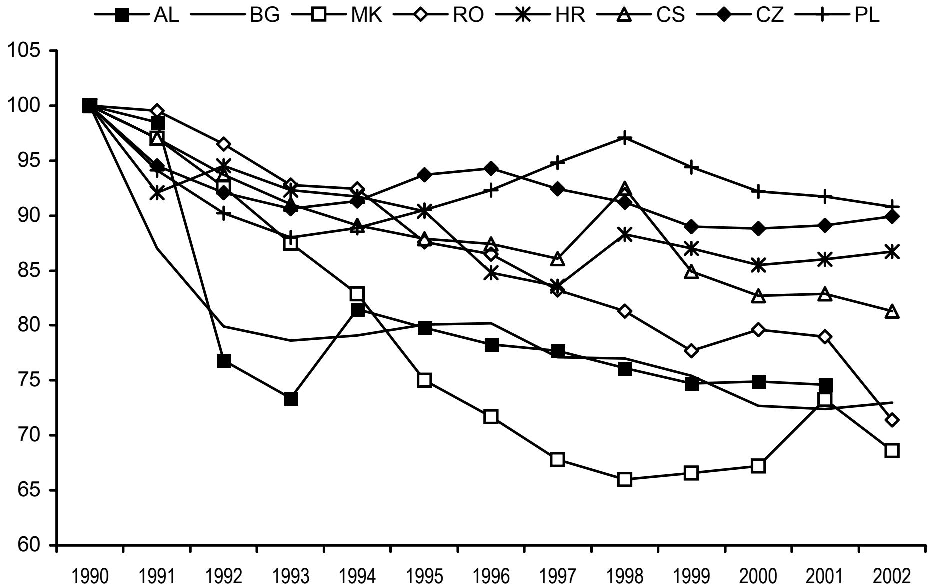
ANNEX

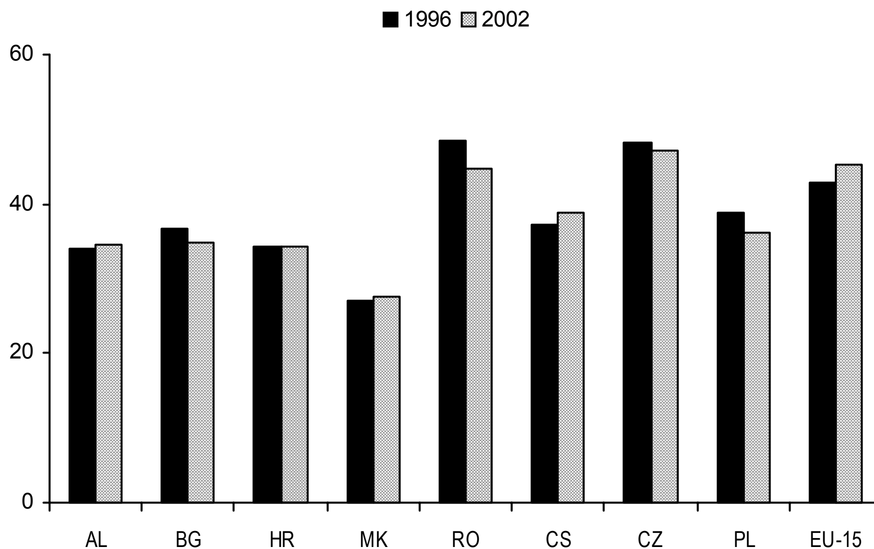
Figure 1: Employment trends

1990=100



Source: wiiw Database incorporating national statistics.

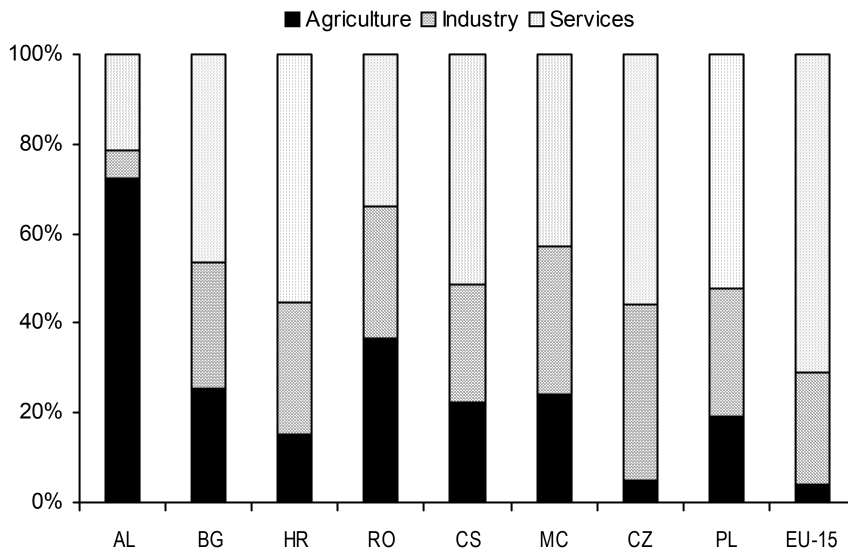
Figure 2: Employment population ratio
(employed in % of total population)



Source: wiiw Database incorporating national statistics.

Figure 3: Employment patterns 2002

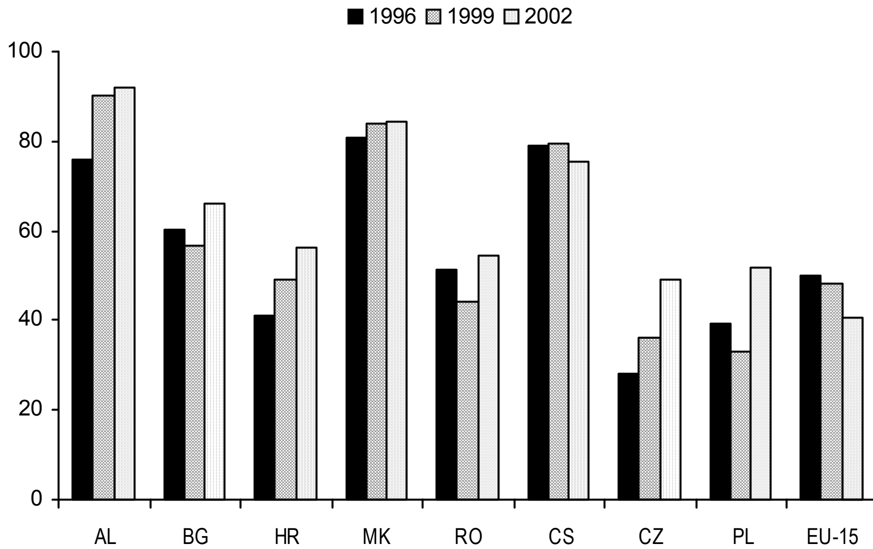
(in % of total employment)



Source: wiiw Database incorporating national statistics.

Figure 4: Long-term unemployment

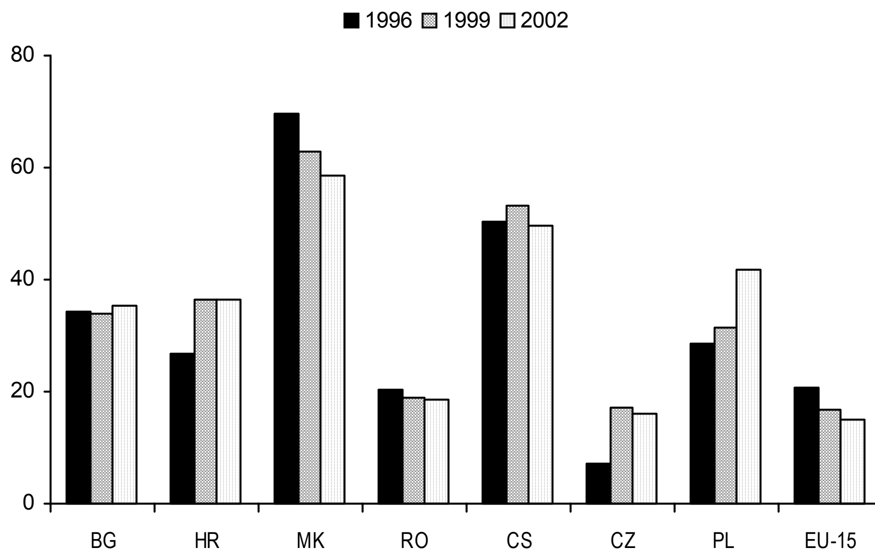
(unemployed 12 months +)



Source: wiiw Database incorporating national statistics.

Figure 5: Youth unemployment rate

(15-24 years)



Source: wiiw Database incorporating national statistics.

Table 1: Informal sector in SEE 2001

Tax avoidance and evasion by households as a share of GDP

Country	Share
Albania	59%
Bulgaria	35%
Croatia	12%
Macedonia	41%
Romania	37%
Serbia and Montenegro	38%
Kosovo	62%

Source: Christie, E. and Holzner, M. (2003)