Balkan Transition (1989-2002) Turbulent Past, Promising Future

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RÉSUMÉ

Le présent article porte sur la conjoncture économique des Balkans. Après une brève présentation historique sont exposées les données les plus récentes, qui permettent d'éclairer l'évolution de la Roumanie, la Bulgarie, l'Albanie, la Bosnie-Herzégovine, l'ex-Yougoslavie et la FYROM (ancienne République yougoslave de Macédoine).

ABSTRACT

This article deals with the current economic situation in the Balkans region. Some background and the most recent data are provided to highlight the evolution of Romania, Bulgaria, Albania, Bosnia-Herzegovina, Former Republic of Yugoslavia, and FYROM (Former Yugoslav Republic of Macedonia).

Introduction

The watershed events of 1989 marked the eclipse of the centralized planned model in the Balkans, Soviet Union and Eastern Europe and the beginning of a transitional course toward market-based economies and societies. The present study describes and assesses economic and financial developments in the Balkan countries during the period 1989-2002.

The Balkan economies started their transition course from highly disadvantaged and distorted economic structures that grew out of arbitrary central-planning decisions devoid of market criteria. The opening-up of these economies to international competition found them ill-prepared and vulnerable. During the Communist era, and for different reasons, they remained isolated from the European and international markets. Albania's subsistence socialism and Romania's

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self-contained economic experiment discouraged contact with the outside world. Whereas Bulgaria's interdependence with the Soviet industry and the Council for Mutual Economic Assistance (COMECON) countries kept self-sustaining growth in abeyance. Even Yugoslavia, which had forsaken the economic mold of the rest of the socialist economies, managed to stage only a meteoric appearance in Western markets in the 1970s. However, penetration, of these markets was short-lived, demonstrating the non-competitive nature of its products.

In addition to the challenge of transition which these countries have faced since 1989, the region has also experienced protracted geopolitical turmoil as a result of Yugoslavia's break-up. The Croatian, Bosnian and Kosovo military conflicts have inflicted direct or indirect consequences on the whole region. War expenditures and the consequent destruction of the economic infrastructure and productive capacity have created additional budgetary burdens and have frequently derailed fiscal and monetary policies. Economic conditions in the region were aggravated further by UN sanctions on Yugoslavia, which held in effect for most of the 1990s, the UN sanctions on Croatia in 1994, and the Greek embargo on FYR Macedonia in 1995-96. Yugoslavia, at the epicentre of all military conflicts, was affected more than any other country. Policies identifiable with the initial phase of transition were introduced in 2001 after the demise of the Milosevic régime. Even countries non-involved directly in military conflicts, like Albania, Bulgaria and Romania, have suffered indirect negative consequences due to the interruption of regional and international trade routes. The heavily trade-based and landlocked economy of the FYR Macedonia, or FYROM, has suffered greater harm than the other more diversified economies. In addition, protracted regional instability has deterred the flow of direct foreign investment into the region. Foreign firms have opted instead for the more stable central European economies like Poland, Hungary and the Czech Republic.

Before proceeding with our analysis, a word of caution is necessary. The transition policies introduced in the Balkan countries were neither uniformly planned in terms of timing and content nor were they similar in terms of their outcome. In each and every country, governments, institutions and people reacted differently to internal and external challenges. As has been already mentioned, to varying degrees all countries in the region have experienced political turmoil, ethnic tension, population dislocation and, in some cases, military conflict. These factors affected not only the economic conditions, the scope and nature of reforms but also the social fabric of these countries. Beyond these contingencies, there were other unavoidable obstacles that acted as constraints to the pace of transformation. The geographic disadvantage of the region in relation to European markets, the inherited economic distortions and their undeveloped internal market, created objective limits to what could be done. Despite these obstacles, the transition process in all countries has moved forward, confirming their commitment to the initial objectives to transform their economy and society to a market model, albeit, with different degree of speed, depth and continuity.

Reform and Restructuration

In all Balkan countries the first phase of reform was characterised by two main policies: privatization and price liberalization. It was expected that the introduction of market logic would in itself be sufficient to solve systemic distortions and inefficiencies in the spheres of production, consumption and distribution. It was also assumed that private ownership would create the kind of rational behaviour and practices observed in mature markets. It was thought that through these two policies, transition economies would swiftly restructure their production base with a moderate and manageable social cost. In the process, the economic and social consequences of these two policies proved much more severe and long-lasting than initially predicted. Their implementation often resulted in considerable destruction and social dislocation. Production assets became idle which left a very substantial part of the active work-force unemployed. These conditions were compounded further because in the uncharted waters of reform, untested fiscal and monetary policies were introduced as a remedy to the problem. Unfortunately they generated high budget deficits, high inflation rates, negative trade and current account balances and a significant rise in public debt. The initial experience of all Balkan economies was a harbinger of the complexity of the transition project.

The range of policies on privatization introduced in the Balkan countries, varied from an attempted swift transfer of ownership from the public to the private sector to more elaborate schemes requiring first a restructuring and often downsizing of State industries before transference to the private sector. In practice, most governments, after facing serious difficulties in applying these policies, and after repeated delays, opted for a compromise solution which involved the public offering of shares to managers and employees of the companies themselves. This method of privatization hardly met the initial objective of distributing public property 'widely and fairly'. Moreover, it failed to provide a sound base and fertile environment for the creation of viable, efficient and competitive enterprises. At best, the privatization policies implemented were ambivalent and were, more often than not, carried out without the proper transparency.

The first years of the transition process were marked by severe economic regression, shown clearly in the output decline figures. Albania's GDP dropped 27% in a single year (1991). At the time, Albania was experiencing a crisis of governmentability against a background of social chaos and conditions of economic anarchy. The FYROM faced a similar drop in GDP (21.1%) a year later, in 1992, when mining and trade contracted severely following the country's severance from the Yugoslav Federation. The country most implicated in direct military conflict, Yugoslavia, has suffered the deepest decline for the longest period. Military conflicts resulted in the disruption of transportation and supply routes, the interruption of production and, in some cases, the destruction of productive capacity. The UN-imposed sanctions compounded an already severe output problem. Bulgaria and Romania also experienced an annual decline in GDP in excess of 13% between the period 1990 to 1992. These two countries were not directly implicated in any military conflict, but policy ambivalence, internal labour strife and hesitant implementation of transition measures caused them the output contraction recorded.

In most Balkan countries, output decline was checked within three to five years. The pace by which this decline stopped and the pace by which recovery started, depended on each country's economic characteristics, its commitment to reform policies, the nature of its political institutions and the contribution of the international community in providing investment funds and financial aid. The years 1993-94 mark a turning point in terms of output. During that period, positive output figures were recorded in all but two countries: FYR Macedonia and Yugoslavia. Albania led this trend with a GDP growth of 9.6%, Romania posted a more moderate output growth of 1.5%, while Bulgaria had to wait for another year to register its first post-socialist GDP increase of 1.8% in 1994.

One important reason for the 1993-4 improvement in economic conditions was the involvement of international institutions. All Balkan countries, except Yugoslavia, entered into membership status agreements with the World Bank and the IMF in the 1991-92 period (Bosnia did so in 1995). These two international financial institutions negotiated a series of Systemic Transformation Facilities, Stand-by Agreements and Extended Fund Facilities with the Balkan countries, conditional on minimum monetary and fiscal requirements and the introduction of austerity and restructuring programmes. In order to gain accessibility to funding, these countries had to pursue more effective privatisation policies, wage and price controls as well as banking and financial reforms. These measures seemed to work, leading to output growth, resumption of trade and the cautious appearance of foreign investment, albeit, at very moderate levels.

The upward output trend, which began in 1993, receded temporarily in 1997-8 in most countries, due to a combination of internal and external factors. The largest declines occurred in Albania (-8%), Bulgaria (-7.4%) and Romania (-7.3%). FYROM posted a slight output increase (1%). The collapse of the pyramid schemes in

Albania and the banking and financial crises in Bulgaria and Romania, which were either triggered, or aggravated further, by the global financial turmoil initiated in Asia and Russia, were the main causes for this decline in output. The Balkan economies also found themselves affected by the decrease in global demand, the collapse of world prices for basic commercial and intermediate goods and the worsening of the global trade situation.

At the end of the 1990s, output in most countries (Bulgaria, FYR Macedonia, Romania, Bosnia) was still below 80% of the 1989 level, while in Yugoslavia it was estimated at 50%. Albania's output in 1998 approached 90% of its 1989 level. In addition, the end of the decade found these economies with an output composition different from that in the beginning of the decade. The prevailing forms of activity had shifted from mining, elementary manufacturing and raw material production to trade, services and agriculture. Both production and consumption trends were now driven more by market requirements than by state directives. In this sense, the transition process had accomplished an important implicit goal: the logic of the market was now becoming the key determinant of economic life.

Growth performance in all Balkan transition economies over the last three years has been very strong and future growth prospects look very promising. The GDP growth rate in 2000 and 2001 in most economies stood between 4.5% and 7.8%. The only exceptions were Romania, which recorded a rate of 1.8% in 2000; Bosnia/Herzegovina, which recorded a rate of 2.3% in 2001; and the FYR Macedonia, which recorded a negative growth rate of 4.1% the same year because of internal civil strife. The year 2002 is expected to be excellent with growth rates maintained at the same high level. Only Bosnia/Herzegovina and FYROM are expected to grow by around 3%. It has become apparent that the Balkan economies have shown strong resilience to the initial global slowdown after September 11, the significant fluctuations in the first three quarters of 2002 and the financial instability in some emerging markets. According to projections by the major international financial institutions and those made by national governments, growth prospects for all Balkan economies are very strong for the next three years at least. These growth projections are supported by an increasing flow of foreign direct investment and strong increases in public and private spending, all of which contribute to a rise in productive capacity and a constantly growing domestic demand.

Unemployment

The severe economic contraction following the socialist breakdown withered away a key assumption shared by most people in the Balkans: lifetime employment. The pursuit of transition policies shut out a great number of people from the labour force. The unemployment rates experienced by most Balkan countries since 1989 have surpassed all levels experienced by Western economies during this century.

Unemployment fluctuations in each country differed in magnitude and timing. Albania's unemployment rate reached its highest level of 27% in 1992. For the next four years, the country continued to decline, reaching 12.3% in 1996. The initial surge was partly a result of the destruction of manufacturing capacity and the significant movement of an agrarian population to urban centres. The anarchy and chaos prevalent in the countryside left peasants with no other options. The drop in the unemployment rate afrer 1992 can be explained by the gradual economic recovery, particularly in the service and retail sectors, and by the exodus of hundreds of thousands of Albanian migrants, mainly to Greece and Italy. During the past four years (1998-2002), the unemployment rate has remained around 18%. The collapse of the pyramid schemes and the temporary stall of the economy contributed initially to this increase. It also appears that unemployment has been kept at this level, in part, due to a gradual rationalization of the labour market.

In Romania and, less so, in Bulgaria, unemployment rates have been more moderate. Three years into the transition, the rates stood at 11%

and 17% respectively, and have been fluctuating at these levels up to the present. In the case of Romania, the slow pace of reform and a strong labour movement have been considered as the key factors in protecting employment much longer than in the other transition economies. Yugoslavia, FYR Macedonia, and Bosnia have been experiencing structural unemployment problems of abysmal proportions, with rates exceeding 30% during the whole transition period. These unemployment conditions reflect the massive destruction of production assets, labour dislocation and internal (refugee) migration. Fundamental changes are needed for this trend to reverse itself.

The high levels of unemployment in most Balkan countries have deprived a very large number of people of a subsistence level of income. In addition, inflationary conditions and currency devaluation have wiped out savings and have caused pension incomes to shrink. Bankruptcies of financial institutions have had a similar effect for uninsured depositors. Furthermore, the lack of a social safety net prevents even the barest minimum income generation for those most in need. The average *per capita* income in the Balkan transition economies, relative to the EU average, dropped from over 30% in 1990 to near 20% in 1998.

Restructuring imperatives have also led a very high percentage of unemployed people into conditions of permanent marginalization. A growing number of people have dropped out of the economy altogether. The institutional inability of most governments to retrain dislocated workers has turned them into an obsolete labour force. Even if labour market demand increases, it will be virtually impossible for these workers with eroding skills to perform tasks required by the new economy. There is a definite shift away from manufacturing labour toward services and trade where different kinds of skills are needed. Marginalization is indeed becoming an abiding feature of the Balkan transition economies that has to be addressed very seriously.

Another challenge faced by most Balkan economies is the perennial scourge known as the underground economy. It remains the consequence of institutional and public corruption compounded by the absence of an efficient tax collection structure. During the early critical and vulnerable transition years, it may have constituted a lifeline for the economy and a necessary survival strategy; however, in a growing and maturing market, this sort of activity becomes an institutional hindrance to sustainable growth. The magnitude of this problem becomes clear when we realize that income generated by underground activity, in most countries, is estimated to be above 30% of the GDP.

Unemployment, marginalization, poverty and the existence of a large underground economy are more than manifestations of passing economic conditions. They could potentially undermine the completion of the reform process itself because, altogether, they constitute a serious challenge to social stability. This kind of problem seems more acute in Albania, Yugoslavia, FYROM and Bosnia/Herzegovina.

Inflation

Inflationary and hyperinflationary conditions have been common features of all South-Eastern European transition economies. The countries stemming from the Yugoslav Federation carried into the first phase of their transition hyperinflation conditions of the Federation itself. In two of these countries hyperinflation reached around 1500%, in FYROM in 1992 and in Croatia in 1993, while Slovenia's rate reached its highest level, around 200% in 1992. Bosnia's hyperinflation rate in 1992-3 ranged between 30,000% to 60,000%. Bulgaria in 1991 and Romania in 1993 also experienced high inflation rates reaching 300% and 200% respectively.

Another common characteristic shared by all Balkan countries is the speed with which inflation was contained. By 1995, two countries, Albania and Bosnia, had rates below 10%. FYR Macedonia had reduced inflation to around 16%. Romania, Bulgaria and Yugoslavia had inflation rates dropped at a slower pace ranging between 40% and 70%. Inflation containment during this period was attributed to three main factors. Governments' commitment to deflationary monetary and fiscal policies, price stabilization through subsidies and effective support of national currencies. These policies were introduced after 1992 in all countries, except Yugoslavia, in collaboration with the IMF and the World Bank. Their successful implementation was a precondition for gaining access to foreign loan facilities and financial assistance for specific projects. It also carried the promise of foreign direct investment.

After 1995, inflation moved upward again in some countries, reaching in 1997 a level of 33% in Albania, 155% in Romania and around 1,100% in Bulgaria. The upward surge in Albania was caused mainly by the pyramid crisis while in the other two cases, it was brought about by acute financial crises related to the failure of the banking system in those countries. The concurrent turbulence in the international financial markets aggravated conditions even more. The inflation rate in Romania in 1998 started a downward trend. It was achieved through a high interest rate policy pursued by the central bank. This policy was not without ill effects. It affected negatively output, production costs and the competitiveness of Romanian exports. The inflation reduction objective, however, is gradually being reached. For the first time since 1990, inflation is expected to be below 20% at the end of 2002. Bulgaria posted an impressive deceleration of inflation from 1,082.6% in 1997 to 22.2% in 1998. This was accomplished by currency board policies, introduced in mid-1997. Price stability, however, was achieved at the cost of serious suppression of aggregate demand, which affected particularly the production of industrial goods. In Albania, exchange policies played a key role in the disinflation process. During the last two years, inflation rates in the above-mentioned three countries have been reduced to levels below 5% with further reductions expected in 2003.

Banking and Financial Reform

A key indicator of successful transition is the reform and development of a banking and financial sector appropriate to a market economy. This was truly the road less travelled in the region. The banking sector in the Balkan countries before 1989 was weak, undeveloped and undercapitalized in comparison to other sectors of the economy, which were inefficient, in general wasting resources and capital. All countries, except Yugoslavia, emerged from the Communist era with the legacy of a single-bank system which performed central bank functions and limited commercial transactions. A first step in banking reform was the creation of a two-level banking system, separating commercial from central banking functions. Most countries introduced a legal and regulatory framework that followed BIS standards and procedures.

Reform of the financial sector in its initial phase proceeded more in terms of quantity rather than quality. The first priority was the creation of a two-tier system. The number of financial institutions quickly multiplied through the privatization of state banks. In some countries the sector was immediately opened up to foreign institutions as well. The nascent banking system was faced with what, at times, seemed to be insurmountable problems. First, financial institutions were reformed with insufficient regulation and unclear focus. Frequently, expansion was associated with improprieties, scandals and fraudulent schemes. Second, the dubious reputation and unreliability of the new financial institutions limited their ability to attract deposits and prevented the growth of their loan portfolios. It was difficult, therefore, to develop extensive client networks. Third, state banks were compelled to carry a high number of none-performing loans, which had been accumulated by the government subsidisation programs to state run enterprises.

The initial phase of reform was marked by numerous bank failures, scandals and transactional irregularities, which questioned the very basis and viability of the emerging system. The emergence of too many private banks compelled most countries to quickly engage in bank consolidation, in restructuring of loan portfolios and in seeking sufficient recapitalization in order to meet minimum international standards. After a few stormy years, all countries took significant steps to once again reform the financial sector through extensive privatisation and foreign ownership participation. Some countries have gone further than others in modernizing their banking and financial systems, more often in concert with their corresponding transition pace.

Banking reform in Albania started at a slow pace. In the early 1990s, the country was characterized by very low financial intermediation, an inadequate legal framework for banking operations and an extensive money-laundering problem. The system allowed for the proliferation of unsound speculator investment schemes promising excessive returns on deposits. These investment practices become very widespread between 1994-96 leading to an acute crisis manifested itself at the end of this period. The shock waves caused by the collapse of the pyramid schemes in 1997 led to a gradual and systematic restructuring of the banking sector. Successive pieces of legislation introduced following the crisis strengthened the banking regulation and supervision frameworks significantly. Capital adequacy reached very high levels, 35% in 2001, compared to the required 12%. In a more recent measure, deposit insurance was introduced, guaranteeing deposits of up to US$ 5,000, which covers about 60% of all depositors. In terms of structure and ownership, the Albanian banking system consists of 13 banks of which only one, the Saving Bank (SB) is entirely state owned. There are two banks in which the state has a 40% share, while the remaining ten are privately owned. This description, however, is misleading if one considers that the SB, in 2001, accounted for 59% of the total banking assets, while its share of deposits was 64%. Two recent attempts to privatize the SB, in 2001 and 2002, have failed. The Albanian government is determined to proceed with SB's privatization in an effort to modernize the sector, increase financial intermediation and stimulate investment in the private sector.

In Bulgaria, new legislation introduced in January 1991, permitted the creation of new financial institutions with private domestic or foreign capital. Within two years after the liberalisation of the banking sector, 80 commercial banks were organised as self-managing joint-stock companies. The activities and lending practices of these new banks quickly became identified with serious irregularities and illicit financing. The lack of effective regulatory scrutiny allowed the problem to spread. During the same period, state-owned banks continued, under government pressure, to extend loan facilities to money-losing enterprises. It is estimated that in 1995 alone total losses amounted to 15% of the GDP. By the end of that year the system was insolvent. Many banks faced liquidity problems, temporarily alleviated through massive central bank refinancing. The consequent money creation affected the foreign exchange market, shook confidence in the national currency and led to devaluation from 10 *lev* to 1 US$ in December 1995, to 3200 *lev* to 1 US$ in February 1996. The annual inflation rate climbed to over 1000%. By January 1997, one out of every four banks was in receivership.

Following the advice of the IMF, the Bulgarian government introduced a currency board accompanied by a package of structural reforms. This package included strict control and financial supervision of money loosing state enterprises, the liberalization of trade and a more rigorous privatization policy. In July 1997, the board linked the *lev* to the Deutschmark, took measures to restrict government expenditures and the activities of the central bank, which was permitted to provide only three-month loans to commercial banks. The board was equally effective in containing inflation, which was reduced to 1% monthly by the end of the year. The policy of the board, however, did not come without cost. Bulgaria experienced a severe depression in aggregate demand, which manifested itself in GDP contraction. The GDP declined in 1997 by 7.4%, only to reverse itself with a 4.5% increase in 1998.

After four years of systematic restructuring, the banking sector in Bulgaria is well regulated and supervised; moreover, the credibility of its institutions has been improved through a series of mergers and consolidations. At present, 35 banks are operating in the country, 2 of which are publicly owned; the rest, private. Foreign investors control 21 banks and some 76% of total banking assets. Overall, the banking sector is fairly liquid, quite profitable and adequately capitalized. Banking intermediation, however, remains low in comparison not only to Western European countries but also to the other central European transition countries.

The banking sector reform in the FYROM was based on a policy of rehabilitation and privatization of existing entities. Banking institutions came under the supervision and guidance of the 'Government Sanction Agency', which became responsible for clearing their balance sheets and securing adequate capitalization. At the same time, the national bank made a consistent effort to create a regulatory and supervisory framework for the establishment of a viable banking sector. Strict capitalization requirements were introduced, money laundering was checked and measures for expanding credit to small and medium enterprises were implemented. New legislation introduced in 2000 and 2001 has created the legal framework for modernising and consolidating the banking sector along the lines of the European Union banking directives and international standards. At present, the banking system of the country consists of 21 commercial banks and 17 'saving houses'. There is only one state-owned bank. The sector is predominantly privately owned (84%), while the share of foreign ownership has increased to over 40%. Overall, the system is well regulated and supervised, while liquidity and capitalization conditions are adequate. Still, however, financial intermediation is low, and there are clear signs of high concentration with two banks controlling 50% of total banking assets.

The banking sector in Yugoslavia had to wait until 2001 for its own reform. Like all other sectors of the economy, it has suffered from the reluctance of the Milosevic regime in the 1990s to proceed with privatization and restructuring. Banking institutions remained effectively under state control and operated under soft budget constraints, mostly supporting money-losing enterprises. With an artificially maintained fixed exchange rate and official reserves estimated to be at very low levels, banking and financial conditions in Yugoslavia remained difficult until the democratic transformation in 2000.

The banking sector, which emerged from the Milosevic era, was deeply insolvent. In fact, it was also in the throes of a severe liquidity crisis. The National Bank of Yugoslavia (NBY), in collaboration with the World Bank and the IMF, embarked on an ambitious restructuring policy in May 2001. The proposed objective of this policy was to complete by March 2003, all necessary liquidation procedures for insolvent institutions and privatize the remaining banks, most of which were severely undercapitalized. The implementation of this policy is still under way. Initially, all banking institutions were categorized in three groups: healthy, solvent but undercapitalized, and insolvent. At present, 28 banks have been declared insolvent and have been closed, including four of the largest banks. The remaining 43 banks (including five foreign owned) have been declared as healthy. Some, however, are still facing serious capitalization problems. Concurrently, emphasis is placed on bank privatization, strengthening of banking supervision and enforcement of prudential rules and regulations. The intention of the NBY is to increase the minimum capital requirement to US$ 10 million by 2003, introduce new asset classification, improve internal auditing, control and credit policies and establish International Accounting Standards (IAS).

In Romania, the privatization and reform in the banking sector proceeded more slowly than in the rest of the region. For almost ten years (1990-1999) after the transition started, the level of intermediation was very low, the degree of concentration was very high (the largest four banks controlling more than 65% of total banking assets) and the problem of non-performing loans to state banks remained outstanding. Bold reform steps were taken after 1999 with the closure of a large state bank, Bancorex, the restructuring, recapitalization and eventual privatization of the Bank Agricola and the clearance of a substantial part of the non-performing loans. This year, the government is proceeding with the privatization of the largest of the three remaining state banks, the Banca Commerciala Romana, which holds a 30% share of the total banking assets. At present, another thirty private banking institutions are in operation, of which twenty have a majority foreign ownership.

Banking supervision and the legal and regulatory framework have also been strengthened in recent years. At the beginning of 2002, new regulations were governing the operations of saving cooperatives and the administration of the secondary treasury bills and money markets. After a decade of delays the banking sector in Romania is quickly catching up with the progress made in the other Balkan countries.

Public Finances

One critical challenge which all transition economies confronted was the establishment of adequate fiscal policies and institutions. The simple socialist tax model, based on easily collectible high tax revenues, was swept away and replaced by a more complex tax system with a wider tax base. This held true both for corporate and personal tax policy. This change, however, necessitated the founding of new legal and administrative structures and needed time to be implemented. It was also assumed that privatisation would create a key source of tax revenue because it would create private taxable assets. However, the way privatisation was implemented, mainly through the issuance of shares and vouchers, it failed to constitute such a tax base because the change in ownership proved to be rather formalistic. During the first phase of privatization, very few state-owned assets were sold for cash to the private sector. Tax revenue targets, therefore, were never met. This revenue shortfall was compounded further by the inability of public policy to shift away from a socialist habit identified with high levels of public spending relative to GDP. This socialist technique was used as a subsidy mechanism to offset ailing and inefficient state enterprises, and, in the name of ideological imperatives, to support universal social policies, often of dubious quality, beyond the means of the real economy. In addition, three other factors made state budgets inelastic. First, the new governments inherited an inflated and inefficient bureaucracy. Cutting the fat in the context of other radical structural changes would have led to even higher unemployment, thus aggravating an already serious problem. It must be noted, however, that for most new administrations, the support and maintenance of the state bureaucracy helped to strengthen their staying power and longevity. Second, the statecraft associated with independence and the institutional transformation associated with the economic transition, imposed additional fiscal demands. The establishment of new institutions and reorganisation of old ones, as well as, the assumption, in some cases, of military and policing expenditures, absorbed a considerable part of state budgets. Third, countries like Yugoslavia, Croatia and Bosnia were burdened with the additional cost of military conflict and the inherent damages.

Albania's public finances mirror the volatility and instability of its transition experience. It is estimated that in 1991 government expenditure equaled 60% of GDP and the deficit stood at 30% of GDP. The fiscal situation was better controlled after 1992. Price controls were maintained for transportation and utilities services, while the government and the trade unions agreed to index-linked salary increases. This reduced government expenditures quite significantly. At the same time, the privatization of land and dwellings provided the initial base for personal and property tax collection. The gradual improvement in Albania's fiscal position came to an abrupt end with the outbreak of the pyramid crisis. The collapse affected at least 75% of the population, which lost some 95% of its investment. The fallout from this collapse was widespread. Damage alone inflicted from civic unrest, looting and ravaging amounted to about US$ 1 billion. Fiscal deficits for the next three years increased to over 10% of GDP.

The pyramid crisis, in many respects, was a cathartic experience. After the crisis, the government implemented a restructuring program in close accordance with the IMF. The foundation was thus laid for a more viable and efficient fiscal control and management system. The expenditure needs of the Albanian government still exceed its revenues but since 2000, fiscal deficits have been declining, expected to be 8.6% this year and 7.6% of GDP in 2003.

Romania's public finances have been characterized by chronic tension with the IMF. The large trade and current account deficits of the early period forced Romanian governments to comply, very reluctantly, with IMF conditions. In November 1991, the government announced a strict fiscal policy and introduced internal convertibility of the *leu*, a necessary measure enabling companies to have access to foreign currency. This policy was abandoned in May 1992, which provoked the suspension of IMF assistance. However, later that same year, IMF conditions were once again met and measures were implemented to promote macroeconomic stability, restructure financial institutions and eliminate subsidies. The lack of real commitment by the government to advance such measures within a specific time period increased friction with IMF, which once again suspended its stand-by agreement with Romania in early 1996.

By late 1996, however, the Romanian government was once again in consultation with the IMF. This time it was pursuing a disciplined fiscal course. Its policies included the elimination of soft credits by the central bank to agriculture and industry, lifting of price controls, liberalization of the foreign exchange market and removal of trade controls. Again in 1997 and 1998 the protracted tension between Romania and the IMF manifested itself, this time over the manner in which privatization was proceeding, the delays in shutting down money-losing businesses and the unacceptably generous lay-off agreements negotiated between the government and the unions. These government actions jeopardized the macroeconomic stabilisation program which the government had agreed to pursue; hence, the IMF suspended its assistance program. Over the past few years, the fiscal stance of Romania has improved as a result of a systematic government effort to proceed with reforms. Since 2000, the fiscal deficit has been contained to 3% of GDP annually — the best performance in ten years.

Bosnia's public finances are unlike those of any other country in the Balkans. According to the Dayton and Paris Agreements, the governments of the two entities, the Muslim Croat federation and the Serb federation, have full control over fiscal matters within their respective territories. The central government is entirely dependent upon transfer payments from the two entities, with no direct revenue of its own. Only in 1998 was significant progress made in creating the conditions for the future fiscal sustainability of the central government. A new law on customs and tariffs which guarantees the central government a steady stream of revenue was introduced.

For the period up to 1998, the international community covered Bosnia's budget deficit, which exceeded 30% of the country's GDP annually. After that year, the IMF made international financial assistance conditional upon budgetary restrictions. These restrictions were applied to fiscal deficit policy in the public sector, as well as the ability to maintain monetary stability. The IMF specifically requested the implementation of a fixed exchanged rate for the *dinar* (1 DM = 100 BHD or *dinar*) and the creation of a currency board. The IMF also imposed limits on central bank credits to the commercial banking sector and strongly recommended the prevention of any significant accumulation of new domestic arrears. Since then Bosnia has managed to maintain its monetary stability and improve its fiscal stance. Its fiscal deficits have been dramatically contained in recent years reaching 13% of GDP in 2001. This year the deficit is expected to be below 5% of GDP — the lowest it has ever been.

The FYROM has managed to maintain budgetary balance and price stability far better than most other transition Balkan economies. It has achieved this delicate state in adverse conditions. The FYROM emerged as one of the poorest new states in the region, heavily dependent upon foreign trade and its interaction with Serbia. In addition, it suffered indirectly the consequences of the UN embargo on Serbia and directly the Greek embargo directed at the FYROM during the 1994-5 period. Despite this, the country maintained its fiscal stance at a satisfactory level. The International Community has responded positively to FYROM's cautious fiscal and monetary policy.

Its membership in the IMF and the World Bank since 1992, its co-operation with the EBRD, and its inclusion in the EU's PHARE program have enabled former Macedonia to receive extensive financial assistance. Initially, most of the funds were channelled to infrastructure projects, and only in recent years has that assistance been provided for the development of economic activity within the private sector. These changes improved the country's fiscal position, which showed a surplus in 2000. The following year, however, the fiscal deficit returned rather large at 6% of the GDP. The deficit was caused by the protracted internal turmoil following the uprising of the Albanian minority. In 2002, the fiscal deficit is expected to be approximately 3% of the country's GDP.

The disintegration of the old Yugoslav federation through armed conflict led to a dramatic collapse of production, hyperinflation, high unemployment and large trade and current account deficits. Measuring these magnitudes with accuracy is a real problem, given the secrecy with which the Milosevic regime was treating its public finances and given the exclusion of the Federation from the IMF and the World Bank. The fiscal situation of Yugoslavia up to 2000 was a reflection of the broader economic picture of the country. The effective halt of privatization, the general drop in economic activity plus the absence of a credible and reliable taxation system must have minimized state revenue. The very same conditions had given rise to an underground economy, which has been estimated to account for 50% of all economic activity. The Kosovo conflict, in addition to the physical destruction of Yugoslavia's infrastructure, also caused further economic deterioration. The democratic transformation has reversed this trend. The fiscal deficit in 2001 was less than 2% of the GDP. In the current year, and as the restructuring effort is getting under way, the fiscal deficit is expected to increase, reaching 6% of GDP, which is considered moderate in light of the task ahead.

Trade and Current Account Conditions

Most of the countries under consideration have experienced trade and current account deficits throughout the transition period. The opening up of their markets after a long period of suppressed domestic demand gave a tremendous boost to the importation of foreign products of superior quality. The slow restructuring pace of domestic manufacturing units would not allow domestic production to respond to this sudden surge in demand, nor could the slowly changing production structure match the quality of imported products. Exports of manufacturing goods and agricultural produce were further curtailed when price liberalization was introduced. The comparative advantage such commodities enjoyed mainly due to subsidized prices, disappeared, as was the case with the network exporting goods to the other former Eastern bloc countries. Exports of raw materials and intermediate goods continued as long as stock supply lasted. Replenishment could not keep up with demand, because of generally deteriorating labour conditions and the many forms of interruption caused by conflict, population transfers, lack of machinery repairs and lack of innovation. Countries like Albania, Yugoslavia, Bosnia and FYROM were particularly affected by these conditions.

Albania's trade deficit between 1989 and 1992 increased by almost six times. From that point onward, fluctuations were much more moderate, in the range of 10% to 20% annually. There is one anomalous year, however, 1997, when trade deficit increased by almost 60% from the previous year to reach the highest lever ever. It is interesting to note that in the same year output contracted by 8% due to the general economic crisis caused by the pyramid scheme collapse. Since 1998 and up to the present, trade deficits amount to over 20% of GDP per year, a clear sign that in spite of a relative fiscal and monetary stability, the production capacity of the country has not been adequately revitalized. During the whole transition period, the current account deficits have been much smaller amounting to less than 40 % of the trade deficit of the corresponding year. The principal cause for this is the inflow of remittances from the large number of

Albanian workers who had immigrated after 1992 mainly to neighbouring countries Italy and Greece. Any improvement in Albania's trade and current account balances in the future will depend on development of its unexploited mineral resource sector. Albania is rich in chromate (with the world's fourth largest deposits), copper, iron, nickel, bauxite and an array of other minerals. After the crisis of 1997, privatization reform and investment in the mining and quarrying sectors has started again. In recent years, foreign investors have shown a keen interest for creating joint-ventures with state-owned operators.

Until 1989, trade in Bulgaria was monopolized by the state through a series of specialized foreign trade organisations. Compared to all other Eastern bloc countries, Bulgaria had the largest proportion of trade conducted with COMECON countries and particularly with the Soviet Union. The collapse of this trading bloc affected Bulgaria more than any other country in the region. For this reason, the current account balances were very erratic, particularly until 1993. After an adjustment period, Bulgaria's trade and current account deficits were dramatically reduced, recording small surpluses in 1997 and 1998, despite the country's financial crisis during that same year. After 1998, trade interaction has increased steadily particularly between the Russian Federation, Germany, Italy and Greece. Trade deficits during the last four years range between 9% and 12% of the GDP per year, while the current account deficit for each of the corresponding years is almost half that.

Romania started its transition posting trade deficits between 1990 and 1993, exceeding 4% of the GDP per year. The current account deficit followed a very similar trend. This was an expected development given that a debt repayment policy had been put into place before the collapse of the Ceausescu régime, thus suppressing consumption, restricting imports and promoting exports of food and energy. The new, democratic government reversed this policy. It allowed for import increases to satisfy urgent needs. In 1994, both trade and current account deficits were reduced to very moderate levels reaching 2.5% and 1.2% of the GDP respectively. The trend changed again after 1995, when both deficits reached the levels of the earlier period and quickly moved higher. During the last four years, the trade deficit ranges between 5% and 7.5% of GDP while the current account deficit ranges between 3.8% and 5.7% of GDP per annum.

Bosnia, due to special circumstances, has experienced very high trade and current account deficits. From 1995 to 1998 they, exceeded 30% of GDP per year. After 1999, deficits have steadily decreased and dropped below 20% of the GDP in 2001. These deficits have been financed mainly by foreign aid and, to a lesser degree, by remittances.

Despite the trade and current account deficits recorded by the Balkan transition economies since 1989, they are still considered low to moderately indebted countries. By 2001, Romania, Albania and the FYROM had an external debt that was 40% of their respective GDP, which is low by international standards. Bulgaria and Yugoslavia (adjusted after the democratic transformation), had an external debt under 70% of their respective GDP, which places them on the moderate scale of indebted nations.

Conclusions

The initial phase of the transition project was characterised by price liberalisation and the introduction of privatization policies. It gradually gave way to stabilisation programs supported by the IMF and the World Bank. Fiscal and monetary stability concerns dominated the economic agenda of all Balkan governments leading eventually to very positive results during the last few years, particularly after 1998. Current account deficits on average are smaller than trade deficits. This trend is expected to continue, mainly because immigrant remittances are becoming very stable sources of foreign currency. Countries like Romania, Bulgaria and Yugoslavia are expecting to further increase their revenues from tourism and transportation payments.

The key focus of transition has now shifted to institution-building changes and the implementation of appropriate market practices in the name of efficiency, profit maximization and market rationalization. Efforts are also made for the enhancement of capital formation from domestic and foreign investors. At times, however, concern about the stabilization programs and commitment to fiscal or monetary discipline seem to hide another reality, which is more relevant to people's lives. The *per capita* income in the Balkan transition countries is less than 30% of the average *per capita* income in the European Union. An additional fact not to be overlooked is that in spite of improvements in the fundamental economic indicators, the economies of these countries remain fragile. Not only are they susceptible to international monetary crises and vulnerable to internal political instability but, in some cases, they are also still exposed to the dangers of ethnic conflict.

Notwithstanding progress, in all areas of economic activity weaknesses exist and demand immediate attention. The financial system in all the countries mentioned remains underdeveloped in comparison to Western standards. This leads to very low financial intermediation and limited credit facilities. The investment climate remains poor and unable to attract much-needed foreign direct investment at the desired level. The Balkan economies have the lowest *per capita* foreign direct investment (FDI) in comparison to all other transition economies.

Public finances also remain in a precarious state. The tax base and tax collection mechanisms still require reform while the size and magnitude of the underground economy, which by definition escapes taxation, remains very large. A tax revenue policy that has been applied with considerable success is the introduction of a Value Added Tax (VAT) ranging from 8% to 18% in all Balkan economies.

The uneven but nevertheless large trade deficits of the Balkan economies reflect their limited capacity to respond quickly enough to the needs of a market economy. Most of these economies are experiencing serious difficulties in creating new products at competitive prices and comparable quality. They also face similar problems in reorienting their exports to new markets which are much more demanding than those of former Eastern bloc countries, their previous traditional trade partners. Obviously, their economies must become more productive and more competitive as they move toward European integration.

The transition process has also resulted in the severe dislocation of people. Income inequalities have widened more than in the EU countries and even in the transition countries of central Europe. Four main factors have contributed to this widening gap:

- First, the large number of unemployed people without any social assistance;
- Second, the increasing disparities in salary between the private and public sector;
- Third, the size of pension incomes compared to the average income of labour market participants;
- Fourth, disparities created by unequal access to new property-generated income.

While income inequality widens, the problem becomes more acute, because access to basic social goods is scarce and costly. Therefore, the transition process has created a pattern of social marginalization and conditions of sustainable, acute income inequality. These are issues which must be addressed effectively by all Balkan governments. In other words, real conversion, in addition to nominal, should become a priority on the economic agenda. The growth rates recorded during the last few years, which are much higher than the EU average growth rates for the corresponding period, give us the best indicator that the Balkan transition project is moving forward, completing its restructuring agenda and creating viable conditions for sustainable growth and development.

The completion of the main transition objectives and challenges that lie ahead still depend, to a great extent, on the state. The role of the state and that of governments, at this stage, need to be redefined. Not only the market has to be protected from excesses, abuses and improprieties, but also its corporate and individual participants. This protection can only be provided by the reinforcement of rules and regulations within an economic environment that fosters private initiative and serves the broader economic and social objectives of the nation. The viability of the economic project will depend on governments' ability to develop a comprehensive, cost efficient, manageable social safety net.

From now on, the ultimate measure of success for the transitionary Balkan economies will be their competitive participation in the international markets and their degree of integration with the European Union. Bulgaria and Romania are accession countries expected to join the EU in 2007. It is assumed that other Balkan countries will soon thereafter follow the same path. Of course this path presents new challenges and new opportunities, which all Balkan economies will be obliged to confront. Their experience during the last decade or so, gained while transforming their economies and societies, will be a very useful asset in facing these challenges successfully and hopefully seizing opportunities.

APPENDIX

BANK OF GREECE
ECONOMIC RESEARCH DEPARTMENT
Section of International Economic Developments

BALKAN ECONOMIES:

Current Account Balance (% of GDP)

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001*	2002*
ALBANIA	-	-	-	-30,1	-14,4	-7,2	-9,1	-12,1	-6,1	-7,2	-6,9	-7,4	-8,0
BOSNIA & HERZEGOVINA	-	-	-	-	-14,1	-10,3	-27,3	-31,0	-18,9	-21,4	-20,9	-17,9	-18,3
BULGARIA	-8,2	-1,0	-4,2	-10,1	-0,3	-0,2	0,2	4,2	-0,5	-7,5	-7,4	-10,2	-12,6
FR YUGOSLAVIA	-	-	-	-	-	-	-11,6	-7,7	-4,2	-7,5	-7,4	-10,2	-12,6
FYR MACEDONIA	-9,1	-5,5	-0,8	0,6	-5,3	-5,0	-6,5	-7,7	-10,1	-3,4	-3,1	-9,9	-9,0
ROMANIA	-9,6	-3,5	-8,0	-4,5	-1,4	-5,0	-7,3	-6,1	-7,0	-3,7	-3,7	-6,1	-6,1

* Data for 2001 are preliminary actuals, mostly official government estimates. Data for 2002 are EBRD projections.
Source: EBRD. *Transition Report Update*, May 2002.

BANK OF GREECE
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Section of International Economic Developments

BALKAN ECONOMIES:

Real GDP growth

	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001*	2002*
ALBANIA	9.8	-10.0	-28,0	-7.2	9,8	9.4	-0.9	19.8	-7,0	8,0	7.3	7.8	6,5	6,0
BOSNIA & HERZEGOVINA	-	-23,2	-12,1	-30,0	-40,0	-40.0	32.4	85,8	39,9	10,0	10,0	4.5	2,3	2,3
BULGARIA	0,5	-9.1	-11.7	-7,3	-1,5	-3.5	-1,8	-8,0	-5.6	4,0	2,3	5,4	4,0	4,0
FR YUGOSLAVIA	1,2	-7,9	-11,6	-27,9	-30,8	2,5	6,1	7,8	10,1	1,9	-15,7	5,0	5,5	5,0
FYR MACEDONIA	0,9	-9,9	-7,0	-8.0	-9,1	-1,8	-1,1	1,2	1,4	3,4	4,3	4.5	-4.1	2.5
ROMANIA	-5,8	-5,0	-12,9	-8.8	1,5	3.9	7,3	3,9	-6,1	-4,8	-1,2	1,8	5,3	4,3

* Data for 2001 are preliminary actuals, and data for 2002 represent IMF projections.
Sources: EBRD, *Transition Report Update*, May 2002 and IMF, *World Economic Outlook*, Sept. 2002.

BANK OF GREECE
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Section of International Economic Developments

BALKAN ECONOMIES:

Unemployment (% of labor force)

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001*	2002*
ALBANIA	9.5	8,9	27,9	28.9	18.1	13,9	9,3	14,9	17,8	18,0	16,8	19,0	
BOSNIA & HERZEGOVINA	-	-	-	-	-	-	-	37.0	38,0	40,0	40,1		
BULGARIA	1,7	11,1	15,3	16,4	12,8	11.1	12,5	13,7	12,2	16,0	17,9	17,4	
FR YUGOSLAVIA	-	21,0	24,6	24,0	23,1	24,9	25,8	25,8	25,1	28,5	27,3		
FYR MACEDONIA	18,5	19,2	27,8	28,3	31.4	37.7	31,9	36,0	34,5	32,4	32,1	30,5	
ROMANIA	-	3.0	8.2	10,4	10,9	9,5	6,6	8,9	10,3	11,8	10,5	8,6	

* Data for 2001 estimates and for 2002 projections.
Source: EBRD, *Transition Report Update*, May 2002.

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BALKAN ECONOMIES:

General Government Balance (% of GDP)

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001*	2002*
ALBANIA	-6,1	-20,7	-23,1	-15.5	-12,8	-10,1	-12,1	-12,6	-10,4	-11,4	-9,1	-9,2	-8,6
BOSNIA & HERZEGOVINA	-	-	-	-	-	.0.3	-4.4	-0.5	-19,3	- 2,0	-20.4	-12,8	-3,7
BULGARIA	-8,1	-4,5	-2,9	-6,7	-3,9	-5,7	-10,4	-2,1	0.9	-1,0	-1,1	-0,9	-0,8
FR YUGOSLAVIA	-	-	-	-	-	-4,3	-3,8	-7,6	-5,4	-	-0,8	-1,9	-5,6
FYR MACEDONIA	-	-4,5	-9,8	-13,4	-2,7	-1.0	-1,4	-0,4	-1,7	0.0	2,5	-6,0	-3,4
ROMANIA	-	-	-4,8	-0,4	-2,2	-2.5	-3.9	-4,6	-5,0	-3,5	-3,7	-3,5	-3,0

* Data for 2001 are preliminary actuals, mostly official government estimates. Data for 2002 are EBRD projections.
Source: EBRD, *Transition Report Update*, May 2002.

BANK OF GREECE
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BALKAN ECONOMIES:

Trade Balance (% of GDP)

	1994	1995	1996	1997	1998	1999	2000	2001*	2002*
ALBANIA	-23.7	-19.3	-25.7	-22.7	-20.4	-23.0	-21.6	-21.9	-22.4
BOSNIA & HERZEGOVINA	-64.0	-49.6	-56.4	-51.4	-46.9	-40.6	-37.2	-31.3	-29.6
BULGARIA	-0.2	0.9	2.4	3.7	-3.1	-11.8	-12.4	-16.2	-23.2
FR YUGOSLAVIA	-	-	-15.7	-12.4	-12.6	-15.9	-22.1	-23.9	-22.4
FYR MACEDONIA	-5.5	-5.0	-7.1	-10.3	-11.7	-10.7	-15.5	-11.4	-11.1
ROMANIA	-1.3	-4.4	-7.0	-5.7	-6.3	-3.1	-4.6	-7.7	-7.4

* Data for 2001 are preliminary actuals, mostly official government estimates. Data for 2002 are EBRD projections.
Source: Bank of Greece' s calculations based on data from EBRD, *Transition Report Update*, May 2002.

BANK OF GREECE
ECONOMIC RESEARCH DEPARTMENT
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BALKAN ECONOMIES:

Trade Balance (in millions of US dollars)

	1994	1995	1996	1997	1998	1999	2000	2001*	2002*
ALBANIA	-480	-475	-692	-518	-621	-846	-814	-912	-1 008
BOSNIA & HERZEGOVINA	-803	-930	-1 546	-1 758	-1959	-1 852	-1616	-1 442	-1 550
BULGARIA	-17	121	168	380	-381	-1 081	-1175	-1 566	-1 716
FR YUGOSLAVIA	-413	-1 135	-2 260	-2070	-1 736	-1619	-1788	-2517	-2710
FYR MACEDONIA	-186	-221	-317	-366	-419	-392	-556	-397	-418
ROMANIA	-411	-1 577	-24 4	-1 980	-2625	-1 092	-1 684	-2969	-3063

* Data for 2001 are preliminary actuals, mostly official government estimates. Data for 2002 are EBRD projections.
Source: EBRD, *Transition Report Update*, May 2002.

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BALKAN ECONOMIES:

Inflation (annual % change of CPI)

	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002*
ALBANIA	0.0	0.0	35,5	226,0	85,0	22,6	7,8	12,7	32,1	20,9	0,4	0,0	3,1	5,3
BOSNIA & HERZEGOVINA	-	-	-	-	-	-	0,2	-13,7	9,5	0,6	3,2	5,6	3,3	2,3
BULGARIA	6,4	26,3	333,5	82,0	73,0	96,0	62,1	123,0	1061,2	18,8	2,6	10,4	7,5	6,4
FR YUGOSLAVIA	-	593,0	121,0	9237,0	11,7xE+13	3,3	78,6	94,3	21,3	29,5	37,1	60,4	91,3	24,2
FYR MACEDONIA	1 246,0	608,4	114,9	1 664,4	338,4	126,4	15,8	2,3	2,6	-0,1	-0,7	5,8	5,3	3,5
ROMANIA	1,1	5,1	170,0	210,0	256,0	136,7	32,3	38,8	154,8	59,1	45,8	45,7	34,5	24,2

* Data for 2002 represent IMF projections.
Sources: EBRD, *Transition Report Update*, May 2002 and IMF, *World Economic Outlook*, Sept. 2002.

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