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**The Western Balkans in transition**

by
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This is the third issue of the “Western Balkans in Transition”, which was prepared by staff within the Unit “Economic affairs of Mediterranean and Western Balkan non-member countries” in the European Commission’s Directorate-General for Economic and Financial Affairs - Directorate for International Matters[*].

The main purpose of this publication is to give an overview of recent macroeconomic and structural developments for the countries of the Western Balkan region. The structure of this issue is as follows:

- A broad overview of macroeconomic trends in the region and EU relations.
- A section on Foreign Direct Investment in the Western Balkans;
- A section on macroeconomic developments, structural reforms and international relations for each of the Western Balkan countries.

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[*] The previous issues of the Western Balkans in Transition are available on the Europa website at: http://europa.eu.int/comm/economy_finance/publications/externalrelations_en.htm

## Abbreviations

| | |
|---|---|
| AC | Acceding Countries |
| ACC | Acceding and Candidate Countries |
| ALL | Albanian Lek |
| ATMs | autonomous trade measures |
| BiH | Bosnia and Herzegovina |
| CARDS | Community Assistance for Reconstruction, Development and Stabilisation |
| CAS | Country Assistance Strategy |
| CEEC | Central and Eastern European Countries |
| CEFTA | Central European Free Trade Agreement |
| CEM | Country Economic Memorandum |
| CPI | Consumer Price Index |
| DIN | Serbian Dinar |
| EBRD | European Bank for Reconstruction and Development |
| EC | European Community |
| ECHO | European Community Humanitarian Office |
| EIB | European Investment Bank |
| EU | European Union |
| EUR | Euro |
| FBiH | Federation of Bosnia and Herzegovina |
| FDI | Foreign Direct Investment |
| FIAS | Foreign Investment Advisory Service |
| FIPA | Foreign Investment Promotion Agency |
| FTA | Free Trade Agreement |
| fYRoM | former Yugoslav Republic of Macedonia |
| GDP | gross domestic product |
| GNP | gross national product |
| HRK | Croatian Kuna |
| IDA | International Development Association |
| IFC | International Finance Corporation |
| IFIs | International Financial Institutions |
| ILO | International Labour Organization |
| IMF | International Monetary Fund |
| ISG | Infrastructure Steering Group |
| KFOR | Kosovo Peacekeeping Force |
| KM | Convertible Mark |
| MFA | Macro-financial assistance |
| MFN | Most-favoured nation |
| MKD | Macedonian Denar |
| MoU | Memorandum of Understanding |
| MTEF | Medium-Term Expenditure Framework |
| NATO | North Atlantic Treaty Organization |
| NIS | Newly Independent States |
| OBNOVA | EC reconstruction programme for the Western Balkans (superseded by CARDS) |
| OECD | Organisation for Economic Co-operation and Development |
| OHR | Office of the High Representative (BiH) |
| OJ | Official Journal of the European Union |
| OSCE | Organization for Security and Co-operation in Europe |
| PIP | Public Investment Program |
| PPP | Purchasing power parity |
| PRGF | Poverty Reduction and Growth Facility |
| PRSP | Poverty Reduction Strategy Paper |
| RS | Republika Srpska |
| SAA | Stabilisation and Association Agreement |
| SAp | Stabilisation and Association Process |
| SBA | Stand-by Arrangement |
| SCG | Serbia and Montenegro (Srbija I Crna Gora) |
| SDR | Special Drawing Right |
| SEE | South-East Europe |
| SMEs | Small and Medium sized Enterprises |
| SMP | Staff Monitored Programme |
| SOEs | Socially owned enterprises |
| STM | SAp Tracking Mechanism |
| T-bill | Treasury bill |
| TSA | Treasury Single Account |
| UN | United Nations |
| UNCTAD | United Nations Conference on Trade and Development |
| UNMIK | UN Interim Administration Mission in Kosovo |
| UNSCR | United Nations Security Council Resolution |
| USD | United States Dollar |
| VAT | Value Added Tax |
| WB | World Bank |
| WTO | World Trade Organization |
| yoy | year on year |

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## Part A. Regional overview



## Part B. Country analysis

# Part A

# Regional overview

# 1. Main Economic Trends in the Western Balkans[1]

- **The Western Balkans achieved another year of good economic performance in 2003, with expected GDP growth of around 4%, slightly below the 2002 growth. Inflation continued to decline in 2003 and is expected to have been below 5% for the first time since the disintegration of the former Yugoslavia in the early nineties.**
- **Public finances are expected to show a slight improvement in 2003, maintaining the positive trend of fiscal consolidation since 2000. The general government deficit in the region is expected to reach around 4% of GDP on average.**
- **External imbalances remain fairly large in all the Western Balkan countries. For the whole region, the 2003 current account deficit is expected to average around 8% of GDP, whereas the trade deficit is expected to reach 28% of GDP.**
- **Although the countries of the region made some steps forward in the process of market-oriented reforms and in approaching EU standards, further progress is still needed.**

***Macroeconomic overview.*** The economies of the Western Balkan region continued to grow in 2002 and are expected to maintain the momentum in the course of 2003, in spite of a weak external environment, which was affected by the slowdown of the EU economy. In 2002, the GDP of the region increased by 4.5% on annual basis, owing mainly to the economic performance of Croatia (5.2%) and Bosnia and Herzegovina (BiH), which recorded the highest growth rate (5.5%). In 2003, the GDP of the Western Balkans is estimated to have grown at a similar pace, recording for the fourth year in a row an annual rate slightly above 4% (see tables 1 and 2).

**Table 1. Western Balkans – Macroeconomic trends. 1998 - 2003**

| | | 1998 | 1999 | 2000 | 2001 | 2002 | 2003[p] |
|---|---|---|---|---|---|---|---|
| Real GDP growth (1) | *%* | 6.3 | -3.3 | 4.3 | 4.6 | 4.5 | 4.2 |
| Inflation (average) (1) | *%* | 18.3 | 15.2 | 26.3 | 29.4 | 7.4 | 4.4 |
| General government balance (1) (2) | *% of GDP* | -5.6 | -10.3 | -5.8 | -5.5 | -4.9 | 4.1 |
| Exports (3) (4) | *billion EUR* | 8.8 | 7.8 | 9.8 | 10.3 | 10.8 | 11.1 |
| Imports (3) (4) | *billion EUR* | 16.8 | 15.1 | 18.7 | 21.8 | 25.0 | 25.4 |
| Trade balance with the EU (3) | *billion EUR* | -4.4 | -4.2 | -5.1 | -6.2 | -7.9 | *-2.6* (7) |
| Current account (1) (5) | *% of GDP* | -6.1 | -6.5 | -4.2 | -6.8 | -9.0 | -7.8 |
| Foreign Direct Investment (6) | *billion EUR* | 1.1 | 1.7 | 1.7 | 2.8 | 2.1 | 2.9 |

[p] Projections. (1) Weighted average. (2) Excluding Serbia & Montenegro and Kosovo (SCG) in 1998 and 1999. (3) Excluding Kosovo (SCG). (4) Including intra-regional trade. (5) After grants (6) Inward flows, including intra-regional flows. (7) First five months of 2003. *Sources:* National authorities, IMF and European Commission.

[1] The Western Balkans include Albania, Bosnia and Herzegovina (BiH), Croatia, the former Yugoslav Republic of Macedonia (fYRoM), Serbia and Montenegro (SCG) and Kosovo (SCG). Unless otherwise indicated, throughout the text SCG data do not include Kosovo (SCG), which is since 1999 under the special mandate of the UN Mission in Kosovo (UNMIK), according to the UN Security Council Resolution 1244. All averages for the region are weighted by nominal GDP, unless otherwise indicated.

**Table 2. Country summary - Macroeconomic indicators. 2002 – 2003p**

| | Population *million* | Real GDP growth % | | Inflation (end period) % | | General govt. balance (1) *% of GDP* | |
|---|---|---|---|---|---|---|---|
| | **2002** | **2002** | **2003p** | **2002** | **2003p** | **2002** | **2003p** |
| Albania | 3.4 | 4.7 | 6.0 | 1.7 | 2.8 | -6.9 | -5.6 |
| Bosnia and Herzegovina | 4.3 | 5.5 | 3.5 | 0.3 | 0.4 | -7.1 | -3.4 |
| Croatia | 4.4 | 5.2 | 5.0 | 2.3 | 1.5 | -4.8 | -4.5 |
| former Yugoslav Rep. of Macedonia | 2.0 | 0.9 | 3.0 | 1.0 | 2.4 | -5.7 | -1.5 |
| Serbia and Montenegro | 8.1 | 4.0 | 4.0 | 14.2 | 8.0 | -4.5 | -4.5 |
| Kosovo | 1.8 | 3.9 | 4.7 | 3.6 | 0.0 | 7.5 | 4.1 |
| *Western Balkans* | *24.0* | *4.5* | *4.2* | *5.4* | *3.4* | *-4.9* | *-4.1* |

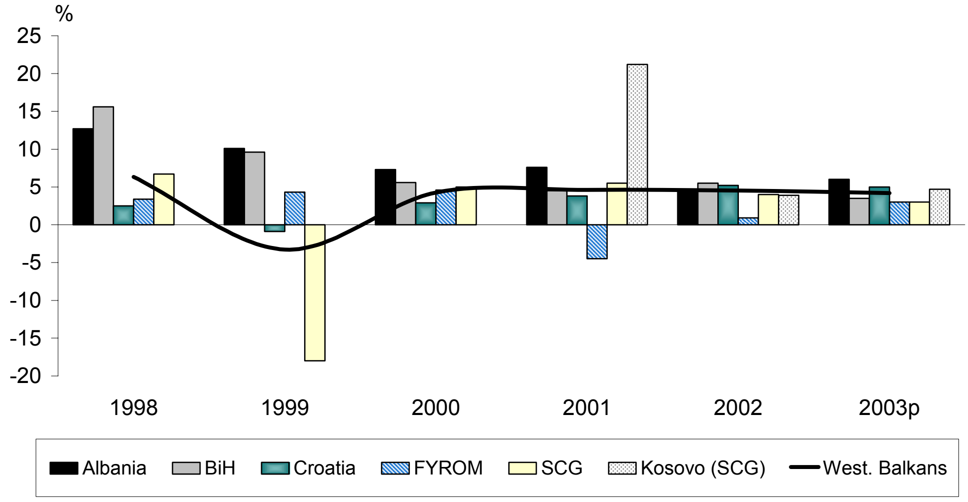
| | GDP per capita (2) *EUR* | Trade balance *% of GDP* | | Current account *% of GDP* | | FDI (3) *% of GDP* | |
|---|---|---|---|---|---|---|---|
| | **2002** | **2002** | **2003p** | **2002** | **2003p** | **2002** | **2003p** |
| Albania | 1602 | -23.9 | -22.8 | -6.6 | -6.3 | 2.8 | 2.7 |
| Bosnia and Herzegovina | 1383 | -36.8 | -36.6 | -18.5 | -17.5 | 4.4 | 4.9 |
| Croatia | 5420 | -23.5 | -27.2 | -7.2 | -5.4 | 4.6 | 6.2 |
| former Yugoslav Rep. of Macedonia | 1972 | -20.7 | -17.2 | -8.6 | -6.2 | 2.1 | 1.1 |
| Serbia and Montenegro | 2055 | -25.0 | -25.1 | -8.8 | -8.1 | 3.6 | 6.3 |
| Kosovo | 710 | -89.2 | -95.4 | *-33.5* | *-32.9* | *0.0* | *0.0* |
| *Western Balkans* | *2380* | *-27.2* | *-28.1* | *-9.7* | *-8.4* | *3.9* | *5.4* |

pProjections. (1) Before grants. (2) Nominal GDP at current exchange rates. (3) Foreign Direct Investment (inward flows). *Sources:* National authorities, IMF and European Commission. Data for Kosovo are preliminary estimates, which may be subject to significant corrections.

Growth rates in the Western Balkans converged over the past two to three years, due to similar policies of economic stabilisation and a period of relative political stability (see chart 1). Overall, the continued growth over the past four years is an encouraging sign for the Western Balkans. Assuming a more favourable external environment and the continuation of market-oriented reforms, the Western Balkan economies have the potential to grow at a faster pace over the medium-long term. This would allow the countries of the region to recover the GDP levels which they had before the break-up of the former Yugoslavia[2], reduce the large official unemployment and lift living standards of the population.

[2] So far, Albania is the only country of the region having reached a level of GDP which is above the level in 1989.

## Chart 1. Western Balkans - Real GDP growth. 1998 - 2003p

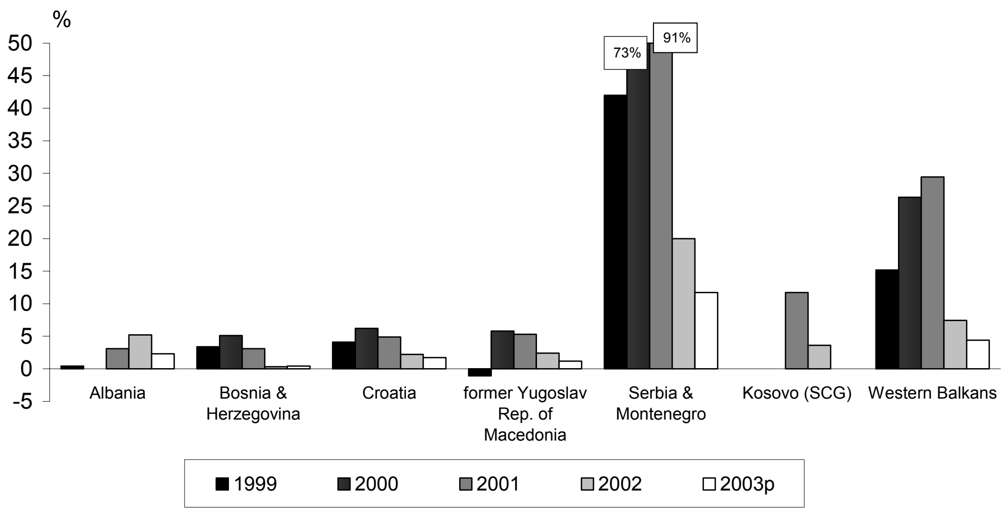



Source: IMF and national statistics

p Projections

The process of gradual disinflation in the region made further progress, due mainly to policies based on external anchors and prudent macroeconomic frameworks, which in turn were supported by the Bretton Woods institutions and frequently also by EC balance of payments assistance (see below). In 2002, the average regional inflation rate decreased to around 7% in 2002 from almost 30% in 2001, including the outlier Serbia and Montenegro (see table 1 and chart 2). Inflation is expected to remain under control in 2003, with an end-year estimated rate of increase of consumer prices ranging from 0.4% in Bosnia and Herzegovina to around 8% in Serbia and Montenegro, where the process of price and exchange rate liberalisation started late in 2000. For the whole region, the inflation rate is estimated to have remained below 4% by the end of 2003 (see table 2).

## Chart 2. Western Balkans - Average inflation. 1999 - 2003p

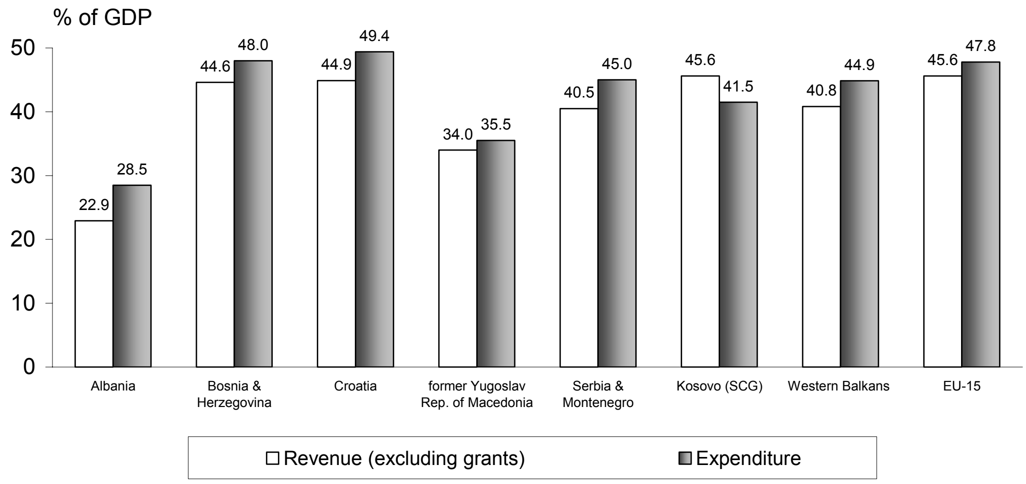



Source: IMF and national statistics

p projections

***Public finances.*** Public finances showed some improvement in the course of 2002, which is expected to be consolidated in 2003. In 2002, general government deficit (before grants) declined in most of the Western Balkan countries with respect to the previous year, reaching a (weighted) average level of 5% of GDP. In 2003, the average general government deficit for the whole region is expected to have decreased to around 4% of GDP, largely due to significant fiscal adjustments by more than three percentage points of GDP in Bosnia and Herzegovina and former Yugoslav Republic of Macedonia. The latter is estimated to have recorded the lowest public deficit in the region (1.5% of GDP). For comparison, the size of government deficits in the Western Balkan region is close to that of the ten acceding countries – an average deficit of 4.7% of GDP in 2002 - and significantly higher than in the EU-15 – an average deficit of around 2% in 2002.

**Chart 3. Western Balkans - Revenue (excluding grants) and expenditure. 2003p**




Source: IMF, national statistics, European Commission

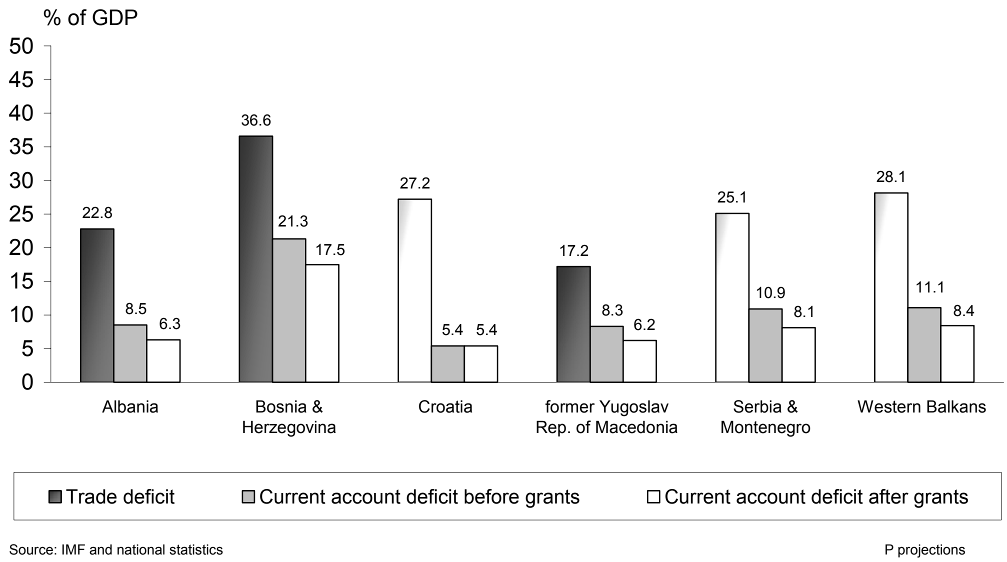
P projections

On average, the revenue-to-GDP ratio is estimated to have dropped from 41.5% in 2002 to 40.7% in 2003, leaving the burden of the expected fiscal adjustment to cuts in public expenditure. According to IMF projections, public expenditure as share of GDP - on a weighted average basis for the whole region excluding Kosovo - is expected to decline from almost 47% in 2002 to around 45% in 2003. The average size of the public sector remains however large, hindering private sector development as a source of growth, even though the average expenditure to GDP ratio in the Western Balkans is three percentage points lower than the same average in the fifteen EU countries (see chart 3).

***External sector.*** In 2002, foreign trade continued to increase, with import growth in nominal terms outpacing export growth. The trade deficit of the Western Balkans with the EU reached EUR 7.8 billion or more than 13% of regional GDP. Generally, large trade deficits also reflect the need to satisfy growing imports for domestic consumption and investment, a common feature of several transition economies. More specifically, the trade deficit shows that the Western Balkans, at least until the end of 2002, had not yet taken full advantage of the asymmetric trade measures granted by the EU, due chiefly to the lack of productive capacity, but also to insufficient ability to comply with EU quality standards. In 2003, total exports are expected to grow faster than imports, posting an annual increase by around 2.5% in nominal (euro) terms against an increase by 1.6% of imports[3]. However, trade deficits remained large across the whole region and are expected to average around 28% of GDP at the end of 2003 (see tables 1 and 2).

Current transfers and positive balances of services contributed to limiting current account deficits (after grants), which in 2002 ranged from 6.6% in Albania to 18% in Bosnia and Herzegovina. In 2003, these deficits are likely to have declined in most of the Western Balkan countries, bringing the regional average down to 8.4% of GDP from around 9.7% in 2002. Private transfers are particularly important in all countries of the region and mostly represent workers' remittances, even though they may partly hide unrecorded transactions. Balances of services are positive throughout the region, but their size is significant only in Croatia, owing to a strong tourism sector. Official transfers continue to be an important source of foreign currency earnings. In 2003, grants are expected to have reached 2.1% of GDP in the former Yugoslav Republic of Macedonia, 2.2% in Albania, 2.8% in Serbia and Montenegro, and could exceed 40% of GDP in Kosovo[4] (see table 2 and chart 4).

**Chart 4. Western Balkans - External sector. 2003[P]**




In 2002, inward Foreign Direct Investment (FDI) towards the Western Balkans declined and reached a level of EUR 2.1 billion. A resumption in FDI inflows is estimated in 2003 (almost EUR 3 billion), largely driven by the privatisation process in Croatia and Serbia and Montenegro. The average regional ratio of FDI to GDP is estimated to have risen to 5.4%, which is equivalent to around EUR 130 in per capita terms (see tables 1 and 2). For comparison, over the period 1997-2002, the ten acceding countries had an average FDI to GDP ratio of almost 5%, corresponding to an average annual per capita inflow of about EUR 230. The next section provides a more detailed analysis of current FDI trends in the region and the obstacles to their potential further growth.

[3] In dollar terms, 2003 total regional exports (including intra-regional trade) are expected to increase by almost 24% compared to the previous year, whereas the year-on-year growth of imports is expected to be around 22%.

[4] Statistics concerning Kosovo are subject to large revisions and should be taken with particular care.

Overall, the level of external debt of the region is projected to average around 56% of GDP in 2003 and deserves constant monitoring. Albania has the lowest ratio of external debt to GDP in the region (around 24%), whereas Croatia has the highest ratio (74%). The latter, however, is the only country in the Western Balkans having a good access to international capital markets.

***Structural reforms.*** The Western Balkan countries took further steps in the process of market-oriented reforms. Substantial progress has been made in the area of the privatisation of SMEs, which is almost complete in most of the countries and is continuing at a good pace in Serbia and Montenegro.

Another area where good progress was achieved is trade liberalisation. In the context of the Stability Pact for South East Europe (SEE), a Memorandum of Understanding on Trade Liberalisation and Facilitation was signed in June 2001 by Albania, Bosnia and Herzegovina, Bulgaria, Croatia, the former Yugoslav Republic of Macedonia, Romania, and Serbia and Montenegro. The signatories of this document have now completed a network of FTAs in the region (see table 3), even though almost half of these FTAs still need to be fully implemented. So far in fact, intra-regional trade remains rather limited, with only three countries (Bosnia and Herzegovina, the former Yugoslav Republic of Macedonia and Serbia and Montenegro) importing from their SEE neighbours for more than a quarter of total imports. The EU is the main trading partner for the Western Balkans (accounting for around 50% of exports); moreover, the countries of the region have a very similar specialisation pattern (mostly in labour-intensive and basic products) which further limits the intra-regional trading opportunities. The formation of a regional free trade area, as well as the rehabilitation of key infrastructures, such as a regional network of transport and energy, are crucial to establish an integrated economic space, which in turn represents an important stimulus to attract FDI in the Western Balkans.

However, considerable progress is still needed to establish an attractive framework conducive to investment and sustainable growth, driven by private sector development. There are several areas where the scope for improvement is still large. The completion of the privatisation process of large state or socially owned enterprises continues to be a common problem for all of the countries. The reform of the public administration and the management of public finances also pose important challenges over the medium term. Significant improvements have been recently recorded in this area, e.g. the reform of customs and tax administration in Bosnia and Herzegovina, or the establishment in all countries of a Single Treasury Account (in an interim form for Serbia). The countries of the region should also improve the access to finance for small and medium sized enterprises, promoting competition in the banking sector. The respect of the rule of law, the establishment of a transparent legal framework and its enforcement, remain key conditions for the promotion of a business-friendly environment. The reform of the cadastre and the clear definition of ownership rights over land is still an outstanding issue in most of the countries of the region.

***International relations.*** The relations of Western Balkan countries with the *EU* are progressing in the framework of the Stabilisation and Association process (SAp)[5] (see

[5] See SAp Second Annual Report: COM (2003) 139 final of 26 March 2003, which is available on the Europa website at: http://europa.eu.int/comm/external_relations/see/sap/rep2/index.htm.

table 4). Two countries, the former Yugoslav Republic of Macedonia and Croatia, have already signed Stabilisation and Association Agreements (SAAs) with the EU- in April and October 2001, respectively - which are now in the process of ratification[6]. Negotiations with Albania were launched in early 2003 and a feasibility study is in preparation for Serbia and Montenegro. For Bosnia and Herzegovina, the feasibility study was finalised in November 2003. It identifies a number of measures in which Bosnia and Herzegovina needs to make significant progress within the next year, if the Commission is to recommend to the Council opening negotiations for a SAA. Croatia submitted in February 2003 an application for EU membership and - following an invitation from the Council - the Commission is now preparing its opinion on this matter. In June 2003, the European Council confirmed in Thessaloniki the EU commitment towards the region and endorsed the Council's conclusions to introduce European Partnerships, inspired by the Accession Partnerships for candidate countries. These partnerships will identify priorities for action in supporting efforts to move closer to the European Union. They will serve as a checklist against which to measure progress, and to provide guidance for Community and Member State financial assistance, reflecting the particular stage of development of each country.

The EC assistance provided under CARDS[7] accompanies the Stabilisation and Association process notably through institution building and rapprochement with the *acquis communautaire*. The EC is expected to commit about EUR 5 billion during 2000-2006. In addition, the EC macro-financial assistance finances exceptional balance of payments needs and supports reforms in the context of IMF programmes. Since 1992, when the first operation in the region in favour of Albania was approved, the EC committed around EUR 1 billion for macro-financial assistance, of which EUR 863 million had been disbursed by the end of December 2003. At present, there are two ongoing operations: in Bosnia and Herzegovina (EUR 60 million) and Serbia and Montenegro (EUR 200 million after a recent Council decision to increase the assistance by EUR 70 million)[8]. In December 2003, the Commission adopted a proposal for a Council decision to provide macro-financial assistance to Albania for a maximum amount of EUR 25 million.

The Western Balkans, along with Bulgaria, Romania and Moldova are also supported by the Stability Pact for South Eastern Europe. This Pact, launched in June 1999 on the EU's initiative, is a political declaration of commitment and a framework agreement on international co-operation to develop a long term strategy for stability and growth in South Eastern Europe. In particular, the Stability Pact, through its Working Table II on Economic Reconstruction, Development and Co-operation, promoted the modernisation of infrastructures, particularly energy and transport, on a regional basis, as well as the establishment of a network of free trade agreements between the countries of the region. In particular, the Stability Pact and the Commission launched a joint Regional Electricity Market initiative to enhance electricity trading. Participants in the initiative signed a "Memorandum of

[6] Interim Agreements on trade and trade-related matters with the former Yugoslav Republic of Macedonia and Croatia entered into force in June 2001 and March 2002, respectively.

[7] Community Assistance for Reconstruction, Development and Stabilisation.

[8] A detailed account of the implementation of EC macro-financial assistance to third countries is provided by the Annual Report of the European Commission to the European Council and European Parliament. The 2002 Report is available on the Europa website at: http://europa.eu.int/comm/economy_finance/publications/external_relations/macrofinancial_en.htm.

Understanding on Regional Electricity Market in South East Europe and its integration into the European Union Internal Electricity Market" in November 2002.

The European Investment Bank (EIB) assists the countries of the region focussing on projects in the area of basic infrastructure (both energy and transport). Over the medium-term, the EIB expects to expand into other areas such as local municipalities, environmental protection, health and human capital, and the private sector in support of the local countries' attempts to align themselves with EU trade policies, guidelines and directives. Over the period 2000-2002, the EIB signed operations in the region for almost EUR 900 million. In the course of 2003, the Bank approved projects in support of the Western Balkan countries for EUR 419 million.

The process of stabilisation and structural reforms has also been extensively supported by the IFIs through macroeconomic support and technical assistance (see table 4). IMF programmes are currently in place in all countries of the region – on a precautionary basis in the case of Croatia – and have played a very useful role in their macroeconomic stabilisation. The World Bank has been also very active in the Western Balkans, providing technical and financial assistance with a wide array of structural adjustment programmes. The European Bank for Reconstruction and Development (EBRD) finances mainly private sector development, except for Bosnia and Herzegovina and Serbia and Montenegro where most of the commitments concern the public sector. The EBRD approved commitments in the region for around EUR 554 million in the course of 2002. In 2003, new commitments of the EBRD in support of the Western Balkan countries are expected to have reached more than EUR 450 million.

## Table 3. Free Trade Agreements in South East Europe as of 13 November 2003

| | Albania | Bosnia-Herzegovina | Bulgaria | Croatia | former Yugoslav Republic of Macedonia | [Moldova]* | Romania | Serbia & Montenegro** |
|---|---|---|---|---|---|---|---|---|
| **Albania** | | Signed 28/04/03 Ratified by Albania 10/07/03 | Applied 01/09/03 | Applied 01/06/03 | Applied 15/07/02 | Signed 13/11/03 | Signed 21/02/03 Ratified by Albania 10/07/03 To be Applied 01/01/04 | Signed 13/11/03 |
| **Bosnia-Herzegovina** | Signed 28/04/03 Ratified by Albania 10/07/03 | | Signed 16/10/03 | Applied 01/01/01 | Applied 01/07/02 | Signed 23/12/02 Applied 01/01/04 | Signed 08/04/03 Applied by 01/01/04 | Applied 01/06/02 |
| **Bulgaria** | Applied 01/09/03 | Signed 16/10/03 | | CEFTA 01/03/03 | Applied 01/01/00 | Preliminary Consultations | CEFTA | Signed 13/11/03 |
| **Croatia** | Applied 01/06/03 | Applied 01/01/01 | CEFTA 01/03/03 | | Applied 11/06/97 Revised 11/06/02 Applied by 11/07/02 | Under Negotiation | CEFTA 01/03/03 | Signed 23/12/02 Ratified by Croatia 07/05/03 |
| **former Yugoslav Republic of Macedonia** | Applied 15/07/02 | Applied 01/07/02 | Applied 01/01/00 | Applied 11/06/97 Revised 11/06/02 Applied by 11/07/02 | | Under Negotiation | Signed 07/02/03 Applied by 01/01/04 | Applied 7/10/96 |
| **[Moldova]*** | Signed 13/11/03 | SIGNED 23/12/02 Applied by 01/01/04 | Preliminary Consultations | Under Negotiation | Under Negotiation | | Applied 17/11/94 | Signed 13/11/03 |
| **Romania** | Signed 21/02/03 Ratified by Albania 10/07/03 To be Applied 01/01/04 | Signed 08/04/03 Applied by 01/01/04 | CEFTA | CEFTA 01/03/03 | Signed 07/02/03 Applied by 01/01/04 | Applied 17/11/94 | | Initialled 13/12/02 |
| **Serbia & Montenegro**** | Signed 13/11/03 | Applied 01/06/02 | Signed 13/11/03 | Signed 23/12/02 Ratified by Croatia 07/05/03 | Applied 7/10/96 | Signed 13/11/03 | Initialled 13/12/02 | |

*Source*: Stability Pact for South Eastern Europe

* Moldova is associated to the process with an extended timeline. ** Serbia and Montenegro started negotiation process when it was known as FR Yugoslavia; therefore, both names may appear in the agreements.

## Table 4. The Western Balkans - Relations with EC, World Bank and IMF (as of December 2003)

| Country | SAp Status | EC Assistance | World Bank | IMF |
|---|---|---|---|---|
| **Albania** | SAA: negotiations opened on 31 January 2003 | CARDS 2003: EUR 46.5 million<br>MFA: proposal for EUR 25 million | PRSP: yes (November 2001) covering the 2002-2004 period.<br>IDA status: eligible<br>CAS: June 2002 | Programme: 3-year PRGF approved in June 2002. Latest review: July 2003. |
| **Bosnia and Herzegovina** | SAP: feasibility study finalised in November 2003. It identifies a number of measures in which BiH needs to progress during 2004, before the Commission can recommend opening negotiations on an SAA. | CARDS 2003: EUR 63 million<br>MFA: current operation EUR 60 million | PRSP: "interim" submitted in December 2001; 2nd PRSP draft presented in June 2003.<br>IDA status: eligible until June 2004. | Programme: 15-month SBA approved in August 2002 (SDR 67.6 million, around EUR 100 million).<br>Latest review: June 2003.<br>SBA extended through December 31, 2003. |
| **Croatia** | SAA: signed on 29 October 2001, pending ratification.<br>Interim Agreement on trade and trade-related measures: entered into force on 1 March 2002. | CARDS 2003: EUR 62 million<br>MFA: no | PRSP: no<br>IDA status: not eligible<br>Country Economic Memorandum (CEM) published in September 2003 | Programme: 14-month precautionary SBA (SDR 105.9; around EUR 129 million) approved in February 2003.<br>Latest review: November 2003. |
| **former Yugoslav Republic of Macedonia** | SAA: signed on 9 April 2001, pending ratification.<br>Interim Agreement on trade and trade-related measures entered into force on 1June 2001. | CARDS 2003: EUR 38.5 million<br>MFA: latest operation of EUR 98 million completed in December 2003 | PRSP: no<br>IDA status: graduated on July 2002.<br>CAS: September 2003, covering the period 2003-2006. | Programme: 14-month SBA approved on April 2003 (SDR 20 million, equivalent to around EUR 25 million).<br>Latest review: October 2003. |
| **Serbia and Montenegro** | SAP: Feasibility study is currently being prepared and expected to be finalised in 2004. | CARDS 2003: EUR 255 million<br>MFA: current operation EUR 200 million | PRSP: yes<br>IDA status: temporarily eligible<br>CEM and CAS: planned for 2004 | Programme: Extended Arrangement approved in May 2002 (SDR 650 million)<br>Latest review: July 2003 |
| **Kosovo** | SAP Tracking Mechanism (STM) established; 2nd STM meeting in November | CARDS 2003: EUR 53 million<br>MFA: no | PRSP: no<br>World Bank plans to draft comprehensive economic study | Programme: no<br>Co-operation with UNMIK and the PISG in preparing a policy statement on the medium-term economic strategy |

EC: Stabilisation and Association process (SAp). Stabilisation and Association Agreement (SAA). Community Assistance for Reconstruction, Development and Stabilisation (CARDS). Macro-financial assistance (MFA). World Bank: International Development Association (IDA). Poverty Reduction Strategy Paper/Process (PRSP). Country Economic Memorandum (CEM). Country Assistance Strategy (CAS).
IMF: Poverty Reduction and Growth Facility (PRGF). Stand-by Arrangement (SBA). Special Drawing Right (SDR).

# 2. Foreign Direct Investment in the Western Balkans[9]

- **FDI inflows in the Western Balkans have shown an upward trend since 1997. However, they have been significantly affected by one-off transactions linked to privatisation. While the Western Balkans attracted on average per year much less per capita FDI (EUR 80) than the acceding countries (EUR 236) in 1997-2002, in terms of annual average FDI to GDP ratio (3.9%) they come close to the average of the acceding countries (4.9%).**
- **In 2003, FDI flows in the region are expected to reach almost EUR 3 billion, which is equivalent to around EUR 130 per capita or 5.4% of regional GDP. Croatia remains the leading country of the region in attracting FDI, also in per capita terms or as percentage of GDP**.
- **Although the size of the markets is small, proximity to the EU, successful macro-economic stabilisation and the prospects of a regionally integrated trade area have the potential to attract foreign investors. Moreover, appropriate FDI legislation has been passed and foreign investment promotion agencies have been created.**
- **However, progress has been insufficient on the 'basic' elements of a friendly business environment, entailing streamlined business procedures, flexible labour markets, and effective contract enforcement. Efforts in these areas require a strong commitment from the countries, since, together with the fight against corruption, they are necessary pre-conditions for unlocking the much-needed flows of FDI.**

Given the still rather low level of GDP per capita, a crucial aspect of any growth strategy for the Western Balkans is the capacity to attract Foreign Direct Investment[10] (FDI). FDI will continue to be an important source of financing of large trade and current account deficits, also in the light of declining foreign assistance for the years to come and growing import needs. Moreover, it is acknowledged that there are many positive effects associated with the presence of foreign investors (see Box 1). These positive spillovers of FDI flows range from the transfer of technology and know-how, with beneficial effects on productivity, to increased local competition, as well as the creation of employment opportunities. FDI can also improve the international market-access of local producers, hence increasing a country's export capacity.

[9] In this section, the Western Balkans include Albania, Bosnia and Herzegovina (BiH), Croatia, the former Yugoslav Republic of Macedonia (fYRoM) and Serbia and Montenegro (SCG). Because of the lack of reliable data, Kosovo (SCG) is excluded. However, anecdotal evidence and unofficial estimates do not indicate any significant inflows of foreign direct investment in Kosovo (SCG).

[10] Investment involving a long-term interest and control (usually above 10%) in an enterprise resident abroad (OECD (1993)). This definition captures both 'green-field' investment (i.e. when a new plant is built in the host country) and 'brown-field' investment (i.e. the partial or total acquisition of existing local firms).

**Box 1. The impact of FDI on the Western Balkans**

The several positive effects of FDI on the host economy are widely recognised in the economic literature[a]. At the microeconomic level, direct technological transfer, contagion and knowledge diffusion all improve productivity and efficiency in local firms, hence growth. As a result, foreign firms often increase the general level of competition in the host country. In the Western Balkans, this efficiency and competition effect is particularly evident in the banking sector, characterised by a large presence of foreign banks. The role of linkages between foreign and local firms is also important: local suppliers benefit from foreign investors' management skills, and they may also have to meet higher standards of quality. Research has shown though that a minimum level of 'absorptive capacity' is necessary to benefit from such transfer[b]. In this respect, although the Western Balkans may have been better endowed with human capital and skilled labour compared to other lower and middle income countries, this comparative advantage could have been eroded by the armed conflict in the nineties and its consequences, notably owing to emigration. Large worker remittances may imply a 'brain-drain' phenomenon. Statistics show for example that three countries of the region (Albania, Bosnia and Herzegovina and Serbia and Montenegro) are among the world top 20 recipients of such remittances, worth around 10% of GDP[c].

At the macroeconomic level, FDI mostly impacts on domestic investment, employment and the balance of payments. The relationship between FDI and domestic investment is clear: joint-ventures allow local firms to gain the much needed financial and physical resources for new projects, especially when access to financial markets is limited. Both through acquisitions and green-field FDI, foreign investors bring new capital into the economy. On the labour market, the establishment of foreign firms often creates new employment opportunities in the host country, usually offering higher wages than in the rest of the economy. However, in transition countries FDI linked to privatisation (i.e. acquisition of companies) may also bring restructuring, including for the labour force[d].

As far as the balance of payments is concerned, several effects are at play. FDI could lead to a deterioration in the trade balance of the host country, for example because foreign firms may need to import intermediate goods, when unavailable locally. However, this is often more than offset by exports of final products back home or to third countries, which obviously have a higher value than intermediate goods. Moreover, dynamic spillovers may arise because export-oriented foreign firms benefit local firms through backward linkages, i.e. by purchasing some domestically produced intermediate products and hence by improving their 'market-access' capability at an international level, eventually leading to increase in exports from local firms. Overall, the empirical evidence has found that FDI impacts positively on the balance of payments[e]. In this sense FDI can prove to be a sustainable way to finance current account deficits, since it can be seen as a circle of self-sustaining economic activity.

a. Blomstrom and Kokko (1997); b. Borensztein et al. (1998); c. World Bank (2003a); d. Djankov and Murrell (2002); e. UNCTAD (1999).

## Main trends of Foreign Direct Investment in the Western Balkans

This section provides an overview of the inflows of Foreign Direct Investment in the Western Balkan region over the period 1997-2003. Its purpose is to examine to what extent the countries of the region have been successful in attracting foreign investment, in particular when compared to other, candidate or transition, countries[11].

The analysis of FDI trends at regional and country level offers some interesting insights but does not provide a clear-cut picture of the situation. Table 5 and chart 5 show that the FDI inflows in the Western Balkans started taking off in 1999, soared in 2001 and are expected to peak in 2003. Overall the trend is positive. However, large

[11] The dataset is mainly based on the UNCTAD World Investment Report (2003). Figures may be slightly different from other sections of this paper; 2003 data are projections.

one-off transactions linked to privatisation in the service sector – banking and telecommunication – may distort the picture. Therefore, one should be cautious in extrapolating current trends into the future, and avoid taking for granted further growth of FDI in the Western Balkan region.

**Table 5. Western Balkans – FDI Inflows. 1997 - 2003**

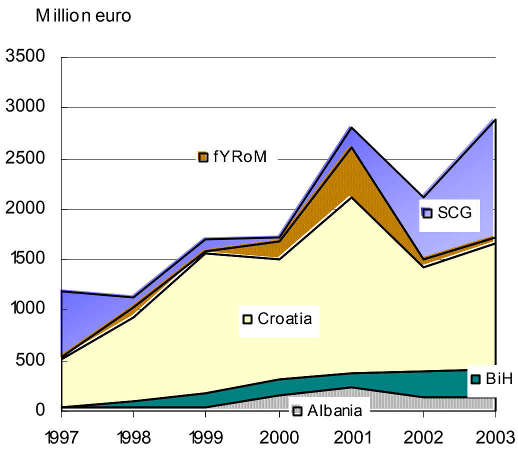
| | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 | 2003[p] | Average 1997-2003 |
|---|---|---|---|---|---|---|---|---|
| | | | | *Level - million euro* | | | | |
| Albania | 42 | 40 | 38 | 155 | 231 | 144 | 132 | 112 |
| Bosnia and Herzegovina | 1 | 50 | 145 | 159 | 145 | 244 | 282 | 147 |
| Croatia | 470 | 832 | 1378 | 1182 | 1745 | 1043 | 1256 | 1129 |
| former Yugoslav Rep. of Macedonia | 14 | 105 | 30 | 192 | 494 | 82 | 41 | 137 |
| Serbia and Montenegro | 653 | 101 | 105 | 27 | 184 | 597 | 1169 | 405 |
| *Western Balkans (1)* | *1180* | *1129* | *1696* | *1715* | *2801* | *2110* | *2880* | *1930* |
| | | | | *Per capita - euro* | | | | |
| Albania | 14 | 13 | 12 | 50 | 74 | 46 | 42 | 36 |
| Bosnia and Herzegovina | 0 | 13 | 36 | 40 | 37 | 61 | 71 | 37 |
| Croatia | 106 | 187 | 310 | 266 | 392 | 234 | 282 | 254 |
| former Yugoslav Rep. of Macedonia | 7 | 53 | 15 | 96 | 247 | 41 | 20 | 68 |
| Serbia and Montenegro | 81 | 12 | 13 | 3 | 23 | 74 | 144 | 50 |
| *Western Balkans (1)* | *55* | *52* | *78* | *79* | *129* | *98* | *133* | *89* |
| | | | | *% of GDP* | | | | |
| Albania | 2.2 | 1.5 | 1.1 | 3.7 | 4.9 | 2.8 | 2.7 | 2.7 |
| Bosnia and Herzegovina | 0.0 | 1.3 | 3.3 | 3.2 | 2.7 | 4.4 | 4.9 | 2.8 |
| Croatia | 2.6 | 4.3 | 7.4 | 5.9 | 8.0 | 4.6 | 6.2 | 5.6 |
| former Yugoslav Rep. of Macedonia | 0.4 | 3.3 | 0.9 | 4.9 | 12.9 | 2.1 | 1.1 | 3.6 |
| Serbia and Montenegro | 4.4 | 0.8 | 1.1 | 0.3 | 1.4 | 3.6 | 6.3 | 2.6 |
| *Western Balkans (1)* | *2.9* | *2.7* | *4.3* | *4.1* | *5.7* | *3.9* | *5.4* | *4.1* |

[p] Projections. (1) Including intra-regional flows. *Sources:* UNCTAD World Investment Report 2003; IMF World Economic Outlook Database and IMF International Financial Statistics; national sources and European Commission.

Large privatisations in the services sector were behind the two upsurges in FDI in 1999 and 2001. In 1999, the year of the Kosovo crisis, the bulk of inflows in the region – around 80% - was directed towards Croatia. This was largely the result of only two operations: one in the banking sector – the sale of 66% of a Privredna Banka Zagreb to the Italian BCI for around EUR 300 million - and one in the telecommunication sector - the sale of a 35% stake of the Croatian telecommunication company to Deutsche Telekom for an amount of around EUR 800 million. In 2001, the same German telecommunication company bought another 16% stake in Croatia telecom for around EUR 500 million, while the Hungarian company Matav bought the majority stake in the former Yugoslav Republic of Macedonia telecom operator, investing almost EUR 350 million. It is worthwhile to note that the latter investment alone represents more than one third of the inflows of FDI in the former Yugoslav Republic of Macedonia over the period 1997-2003. Privatisation in the telecom sector was also the main driving force of the large inflow of FDI in Serbia and Montenegro in 1997, when the Italian company STET and the Greek company OTE bought 49% of the Serbian telecom operator.

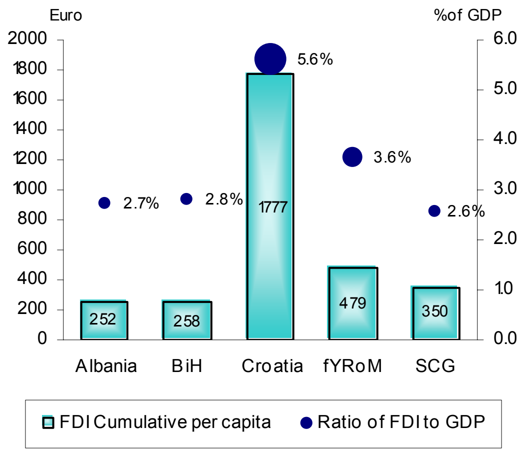
In 2003, the volume of FDI directed towards the Western Balkan countries is expected to reach around EUR 2.9 billion. This level corresponds to around EUR 130 per capita, or 5.4% of the regional GDP, and represents an increase in nominal terms by around 40% compared to the previous year. Serbia and Montenegro is expected to post the largest increase, with FDI almost doubling compared to 2002, due to an intensive privatisation activity across several sectors of the economy (oil, tobacco). Bosnia and Herzegovina and Croatia have also shown positive FDI trends in 2003 (some +50% and +16% expected year-on-year, respectively). Bosnia and Herzegovina, in particular, is expected to have received FDI for around EUR 280 million, twice its average annual flow since 1997, and seems to benefit from its recent efforts in improving the business environment (see also specific country section). On the other hand, in Albania and the former Yugoslav Republic of Macedonia, FDI inflows are on a declining path since 2001. In these two countries, the absence of recent large deals linked to privatisation and a generally poor business climate are presumably the main causes of this lacklustre performance in attracting FDI.

**Chart 5. Western Balkans**
**Annual FDI inflows. 1997 - 2003P**




Sources: UNCTAD, IMF, EC P projections for 2003

**Chart 6. Western Balkans**
**FDI inflows. Cumulative per capita and as ratio to GDP (annual average). 1997 - 2003P**




Sources: UNCTAD, IMF, EC P projections for 2003

The total cumulative inflow of FDI in the region since 1997 is equal to EUR 13.5 billion[12], which corresponds to an annual average inflow of around EUR 2 billion. Croatia – the largest economy of the region - received the lion's share of FDI, around EUR 7.9 billion or 58% of the total, followed by Serbia and Montenegro - the second largest economy – which received around EUR 2.8 billion or around 21% of the total. Albania, Bosnia and Herzegovina and the former Yugoslav Republic of Macedonia - the other three smaller economies of the region – together attracted around EUR 2.8 billion of FDI, 21% of inward foreign investment in the whole region, sharing this amount almost evenly among them.

In per capita terms, Croatia attracted almost EUR 1800 of cumulative inward FDI since 1997. The other Western Balkan countries lag behind with significantly lower per capita figures: EUR 480 in the former Yugoslav Republic of Macedonia, EUR 350 in Serbia and Montenegro, EUR 260 in Bosnia and Herzegovina, and EUR 250 in Albania. The ranking remains almost identical when taking the ratio of FDI to GDP as a measure of the success in attracting FDI. However, countries' differences are smoothed, which confirms the existence of a positive relationship between per capita

[12] Data including 2003 projections.

FDI and per capita GDP in the region[13]. Croatia still ranks first with an annual average FDI to GDP ratio of 5.6% over the period 1997-2003. It is followed by the former Yugoslav Republic of Macedonia (3.6%), whereas Serbia and Montenegro slips at the bottom with a FDI to GDP ratio of 2.6%, which is however very close to Bosnia and Herzegovina (2.8%) and Albania (2.7%) (see chart 6).

FDI represents an essential source of foreign currency earnings and plays a significant role in financing current account deficits. This role becomes particularly important in transition countries, where the ability to raise domestic saving is often limited and where large current account deficits reflect the need to finance increasing consumption and investment. Since FDI is more difficult to reverse compared to other short-term capital and allows the recipient country to raise productivity and generate future income to service the debt, it makes it easier to sustain an external deficit. In the absence of access to international capital markets, as is the case in most of the Western Balkan countries, a large current account deficit, if not financed by FDI or foreign official assistance, results in lower consumption, investment and growth.

**Table 6. Western Balkans – FDI Inflows as share of current account deficits. 1997 - 2003**

| | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 | 2003$^{p}$ | Average 1997-2003 |
|---|---|---|---|---|---|---|---|---|
| | | | | *% of current account deficit* | | | | |
| Albania | 17.8 | 21.3 | 14.2 | 52.7 | 79.4 | 30.8 | 32.3 | 35.5 |
| Bosnia and Herzegovina | 0.1 | 15.3 | 38.6 | 24.5 | 16.7 | 23.3 | 27.0 | 20.8 |
| Croatia | 21.2 | 64.3 | 105.3 | 236.4 | 216.3 | 64.1 | 105.8 | 116.2 |
| former Yugoslav Rep. of Macedonia | 5.5 | 38.3 | 30.0 | 85.2 | 156.8 | 18.3 | 12.5 | 49.5 |
| Serbia and Montenegro | 57.9 | 16.9 | 14.6 | 4.1 | 15.0 | 28.0 | 58.2 | 27.8 |
| *Western Balkans (1)(2)* | *28.1* | *38.7* | *56.7* | *114.9* | *116.3* | *42.3* | *68.9* | *66.5* |

$^{p}$ Projections. (1) Including intra-regional flows. (2) GDP weighted average. *Sources:* UNCTAD World Investment Report 2003; IMF World Economic Outlook Database and IMF International Financial Statistics; national sources and European Commission.

Over the period 1997-2003, FDI inflows financed around two thirds of the Western Balkans' current account deficits on GDP-weighted average basis. However, country differences are large. In Croatia, the only country that does not rely on balance-of-payments assistance, FDI inflows were on average larger than the current account deficit (116%). In the former Yugoslav Republic of Macedonia, FDI financed almost half of the current account deficit since 1997, owing in particular to the large inflow in 2001, which allowed the country to build up some room of manoeuvre in financing external deficits in the following years. In the other three Western Balkan countries, the average ratio of FDI to current account deficit ranges from one third in Albania to one fifth in Bosnia and Herzegovina (see table 6). Even though FDI does not necessarily reflect physical investment, it is worth noting that over the period 1997-2001 the former Yugoslav Republic of Macedonia had the highest average ratio of

[13] If we plot the average annual inflow of FDI per capita and the average GDP per capita over the period 1997-2002 in a chart, the five countries basically lie on a straight line with a positive slope. The adjusted $R^2$ of an indicative regression of the two variables, adding other acceding and transition countries and bringing the sample to 20 countries, is equal to 0.75. Slovenia is the most significant outlier, with a high GDP per capita and relatively low FDI. Once Slovenia is eliminated from the sample the $R^2$ of the regression increases to 0.89.

FDI to gross fixed capital formation (30%), even larger than Croatia (25%). The same ratio was equal to 15% in Albania and 10% in Bosnia and Herzegovina[14].

Table 7 and chart 7 compare over the period 1997-2002 FDI flows towards the Western Balkan countries, as a whole and excluding the outlier Croatia, against flows towards the ten acceding countries (AC-10)[15], the two other south-east European candidate countries (SEE-2)[16], and three Western Newly Independent States (Western NIS)[17], which will border the enlarged European Union. The ten acceding countries as a whole had a remarkable performance in attracting FDI with respect to the other regions in the sample. From 1997 to 2002, they attracted more than EUR 100 billion of FDI, which corresponds to around EUR 1400. Inward FDI in all the Western Balkans is relatively lower than in the AC-10, corresponding to a cumulative per capita level of EUR 490, around one third of the level in the acceding countries. However, given the significant difference in GDP, the annual average FDI to GDP ratio of the Western Balkans (3.9%) comes close to the AC-10 average (4.9%). Overall, the Western Balkans received more FDI than the SEE-2, when measured in per capita terms, and approximately the same annual average when measured as percentage of GDP.

**Table 7. Western Balkans and other selected transition and acceding countries – FDI Inflows as share of GDP. 1997 - 2002**

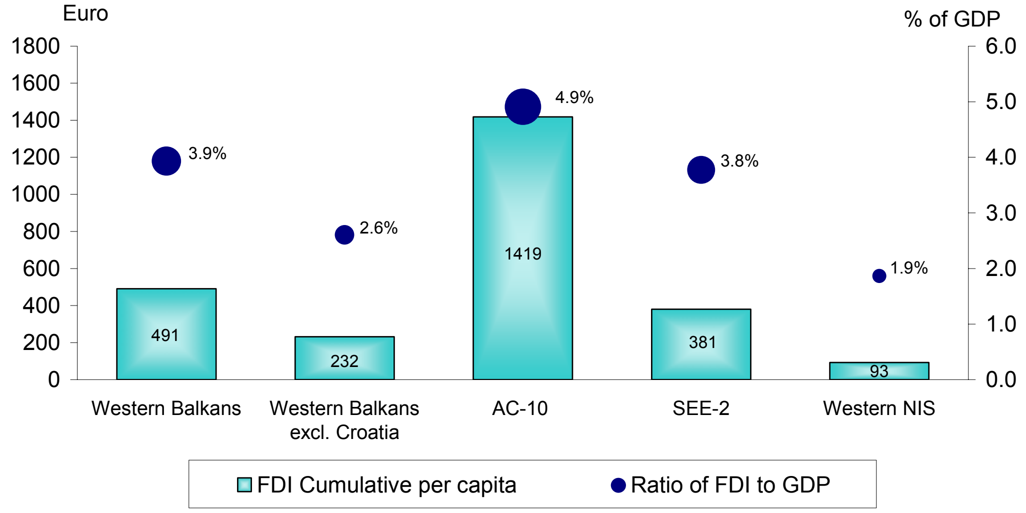
| | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 | Average 1997-2002 |
|---|---|---|---|---|---|---|---|
| | | | | *% of GDP* | | | |
| Western Balkans | 2.9 | 2.7 | 4.3 | 4.1 | 5.7 | 3.9 | 3.9 |
| Western Balkans excl. Croatia | 3.0 | 1.3 | 1.5 | 2.4 | 3.9 | 3.4 | 2.6 |
| AC-10 | 3.3 | 4.5 | 5.5 | 6.1 | 4.9 | 5.2 | 4.9 |
| SEE-2 | 3.8 | 4.7 | 3.9 | 4.1 | 3.7 | 2.6 | 3.8 |
| Western NIS | 1.6 | 1.7 | 2.2 | 1.9 | 2.0 | 1.8 | 1.9 |

*Note:* data do not net out intra-regional flows and slightly overestimate the actual inward flows from outside a certain region. In particular, even assuming that 100% of the outflows were directed within the same region, overestimation of inward flows would *at most* be around 5 percentage points. According to a more realistic, still conservative, guess, only maximum 30-40% of FDI outflows remains within the same region; implying that reported figures could overestimate actual inward flows by *at most* 2 percentage points. *Sources:* UNCTAD World Investment Report 2003; IMF World Economic Outlook Database and IMF International Financial Statistics.

However, once Croatia is excluded from the Western Balkans, FDI figures for the remaining countries of the region show a different picture[18]. The subgroup of Western Balkan economies was relatively less appealing to foreign investors compared to Bulgaria and Romania, receiving only about EUR 230 of cumulative per capita FDI from 1997 to 2002, which corresponds to an annual average of 2.6% of GDP. Hence, the ability to attract FDI of the Western Balkan countries, with the exception of Croatia, was rather limited, even though still remained superior to that of the Western NIS.

[14] Source UNCTAD (2003). Data not available for SCG.
[15] Czech Republic, Cyprus, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovak Republic, Slovenia.
[16] Bulgaria and Romania.
[17] Belarus, Moldova and Ukraine.
[18] From 1997 to 2002, Croatia received cumulative FDI equivalent to around EUR 1500 per capita, which corresponds to an average annual inflow of 5.5% of GDP. Both figures are slightly higher than the average in the ten acceding countries.

**Chart 7. FDI inflows by region. Cumulative per capita and as ratio to GDP (annual average). 1997 - 2002**




Sources: UNCTAD, IMF, EC

## Factors determining Foreign Direct Investment in the region

The previous analysis has shown that FDI in the region is extremely skewed towards Croatia, which, even after scaling the FDI figures by GDP or population, attracts the bulk of it. This high concentration could be symptomatic of structural weaknesses in the other countries of the region. This phenomenon of high concentration has been pointed out in the empirical analysis on other transition countries, which found that, over the nineties, three countries alone - Czech Republic and Hungary, which were at the forefront in the transition process, and Poland - received two thirds of total FDI in that region[19].

Understanding the factors behind the FDI performance of the Western Balkans can therefore be a useful exercise in order to identify some policy recommendations. First and foremost, it is clear that many of the determinants of FDI are beyond the control of potential government policies: these include the geographical position (e.g. vicinity to the EU), the country (market) size, or availability of natural resources (such as oil or gas). In this respect, of what could be labelled *external determinants*, the Western Balkans position is mixed: they are all relatively well placed in terms of proximity to a large potential investors source, the EU; they are not individually attractive in terms of market size, even though a truly integrated market of around 22 million people could – if achieved- offer stronger incentives to foreign investors; they are not particularly well-endowed with natural resources (such as oil, gas or mineral resources). The available empirical evidence shows that indeed, based only on these *external* determinants, the countries of the region did not yet exploit their full potential in terms of attracting FDI[20].

Beyond these *external determinants*, there are other conditions that are necessary to attract FDI. These include economic, political and regulatory fundamentals that

[19] See Bevan and Estrin (2000).
[20] Christie (2003); the analysis is based on end-1998 FDI data and covers Croatia, the former Yugoslav Republic of Macedonia and BiH, as well as Bulgaria and Romania.

ensure a friendly environment for foreign investors, and can play an important role especially for transition economies[21]. These *internal determinants* are the direct responsibility of national or local governments and can be improved through appropriate actions and reforms.

A sound and stable macroeconomic environment and expectations of sustained growth represent an important incentive to FDI. In the Western Balkan region, the macro-economic situation has continuously improved and has reached a higher level of stability. Inflation has continuously declined, also owing to monetary policies mainly based on external anchors, the average GDP growth rate is above 4%, and fiscal consolidation continues. However, as mentioned in the previous section, further progress is still needed with market-oriented structural reforms to establish an attractive framework conducive to investment and sustainable growth, driven by private sector development. Implementation of structural reforms would also have an impact on input costs, such as labour, energy, telecommunication or raw materials costs, all factors that can determine the decision to invest in a country.

The degree of trade liberalisation constitutes another important element for 'FDI-attractiveness'. Either because foreign investors need to import inputs, or because they use the host country as a platform for exporting, in both cases a liberalised trade regime would be more attractive. Albania, Croatia and the former Yugoslav Republic of Macedonia are already members of the WTO, while Bosnia and Herzegovina and Serbia and Montenegro are in the process of acceding. Moreover, the Western Balkans enjoy duty-free access to the EU market thanks to the asymmetric Trade Measures granted since the end of 2000 (even though some delays with certification procedures could have so far hampered the full impact of such preferences). In addition, as already mentioned, given the limited market size of each of the Western Balkans, the existence of a truly integrated market in the region becomes crucial. The countries have now completed the network of bilateral Free Trade Agreements (FTAs) between each other, under the auspices of the Stability Pact. However around half of these FTAs have only been signed and still have to be implemented. Moreover, two countries in particular (Bosnia and Herzegovina and Serbia and Montenegro) have not yet fully integrated their *domestic* market (which may have influenced negatively foreign investors), although a number of steps have been recently taken in this direction.

Another relevant factor determining FDI is political stability and security. Progress should be acknowledged in this respect: security has improved and all countries have democratically elected governments. However, at different degrees, political influence on the judiciary and the media is still exerted; parliaments do not yet operate in the most efficient and competent way, and organised crime and corruption are endemic to the region[22]. As a result, and despite all efforts made, the investors' perception of the region may still be rather negative, but this should slowly change with a continuous commitment by the authorities to reform.

As far as the regulatory framework is concerned, the situation is more complex. On the one hand, a country can set up some FDI-specific elements that can favour foreign investment: an *FDI legislation*, which guarantees non-discrimination, protection

[21] See Garibaldi *et al.* (2002).
[22] Second Annual Report of the European Commission on the SAP, COM (2003) 139.

against nationalisation or expropriation, as well as the possibility of repatriation of profits; a *Foreign Investment Promotion Agency* (FIPA), a one-stop shop concept which should provide information on procedures and opportunities to foreign investors; *FDI incentives* (tax holidays/subsidies), which however raises the issue of distortion of competition, 'race to the bottom', as well as FDI competition among the countries of the region; and finally legislation on *restrictions on foreign ownership*, which usually covers sensitive sectors. In this respect, a simple observation of the situation on the ground is rather positive. All countries of the region have an appropriate FDI legislation (as early as in 1998 in the case of Bosnia and Herzegovina), FIPAs exist in Albania, Bosnia and Herzegovina and Croatia, while internal Free Trade Zones have proliferated in all countries and offer many potential incentives to foreign investors. Restrictions on foreign ownership exist and concern sensitive sectors such as land property (e.g. the former Yugoslav Republic of Macedonia) or agricultural land (e.g. Albania, Croatia).

There are however other aspects of the regulatory framework, which have to do with establishing general elements of a friendly 'business environment' that in fact apply to both domestic and foreign investors. These elements include the legal environment (such as property rights protection and the rule of law), business registration procedures, as well as employment and/or taxation regulations. Failure to address these issues can be an important factor hampering FDI (as well as local investment), either because they increase risk or reduce profitability. To illustrate the situation in the Western Balkans, Table 8 below looks at a series of indicators on the 'business environment' country by country. These have been derived from a World Bank survey exercise across a sample of 133 countries, which includes both developed and developing countries.

**Table 8. Indicators on the business environment in the Western Balkans and other regions**

| | Starting a business | | Hiring & firing[1] | | Contract enforcement | | |
|---|---|---|---|---|---|---|---|
| (as of January 2003) | *N. of procedures* | *Days* | *Flexibility of hiring index* | *Flexibility of firing index* | *N. of procedures* | *Days*[2] | *Cost (in $)* |
| Albania | 11.0 | 47.0 | 33.0 | 15.0 | 37.0 | 220 | 794.0 |
| BiH | 12.0 | 59.0 | 53.0 | 31.0 | 31.0 | 630 | 260.0 |
| Croatia | 13.0 | 50.0 | 76.0 | 31.0 | 20.0 | 330 | 305.0 |
| fYRoM | 13.0 | 48.0 | 65.0 | 32.0 | 27.0 | 509 | 750.0 |
| SCG | 10.0 | 44.0 | 51.0 | 29.0 | 40.0 | 1028 | 200.0 |
| *W. Balkans* | *11.8* | *48.6* | *55.2* | *28.0* | *29.4* | *579.5* | *347.0* |
| *ACCs*[3] | *9.6* | *48.6* | *39.1* | *34.0* | *19.4* | *624.1* | *469.2* |
| *EU* | *8.3* | *40.4* | *59.1* | *33.4* | *18.5* | *235.3* | *1073.5* |

Source: World Bank (2003b) "Doing Business in 2004" and own calculations.
Notes: Regional figures are averages weighted with GDP share in the respective region, except for the Hiring & Firing measures, which have been weighted with active population, a proxy for employment; (1) Indices go from 0 to 100, with higher values indicating less flexibility. The hiring index covers the availability of part-time and fixed-term contracts, while the firing index focuses on the legal protection against dismissal (grounds, procedures, notice period and severance payment); (2) includes the waiting periods between actions for contract enforcement; (3) Acceding and Candidate Countries: includes Bulgaria, Czech Rep., Hungary, Latvia, Lithuania, Poland, Romania, Slovak Rep., Slovenia (no data available for Cyprus, Estonia, Malta and Turkey).

The first indicator, ‘Starting a business’, measures the number of procedures and days before being able to operate a new business. While the number of procedures is practically the same across the countries, the number of days needed to comply with them is rather different, ranging from a minimum of 44 days in Serbia and Montenegro to a maximum of 59 in Bosnia and Herzegovina.

The second indicator, ‘Hiring & Firing’, is a proxy for labour market flexibility (higher values indicate less flexibility). While all the Western Balkans (with possibly the exception of Albania) show relatively high rigidity compared to other transition economies on the hiring side, this is much less evident on the firing indices, with again Albania as an outlier for its flexibility.

The third indicator, ‘Contract enforcement’, tries to measure the efficiency of the judicial system on the enforcement of commercial contracts, especially to resolve a payment dispute. ‘Number of procedures’ refers to all procedures that demand an interaction between the parties; the number of days is counted from the lawsuit filing until actual payment; the cost covers court costs and attorney fees. For this last indicator the dispersion of values across the five countries is more evident, both within and between measures (procedures/days/cost). For example Albania has the lowest number of days needed until re-payment, but rather numerous procedures bearing the highest cost. Similarly, in Serbia and Montenegro full contract enforcement is achieved at the lowest cost, but with the highest number of procedures and by far the longest period.

To better understand the relative position of the Western Balkans, table 8 also shows weighted averages and compares them with those of the Acceding and Candidate Countries (ACCs) available in the survey, as well as with those of the EU.

The table indicates that it is especially in the ‘procedural’ aspect that the Western Balkans score worse compared to the ACCs, as well as in the flexibility of hiring index. One can argue though that it is precisely the complexity of the ‘procedural’ aspect, which somehow is at the beginning of any business activity that can discourage the decision to invest in the countries of the region. Moreover, if Poland is excluded from these calculations (since its high weight and high indices drive the averages up) the Western Balkans score worse than this reduced sample of ACCs in all indicators (except for the ‘firing index’). The comparison with the EU shows that, except for labour market legislation, entrepreneurs in the Western Balkans systematically have to undergo more procedures, and which last much longer.

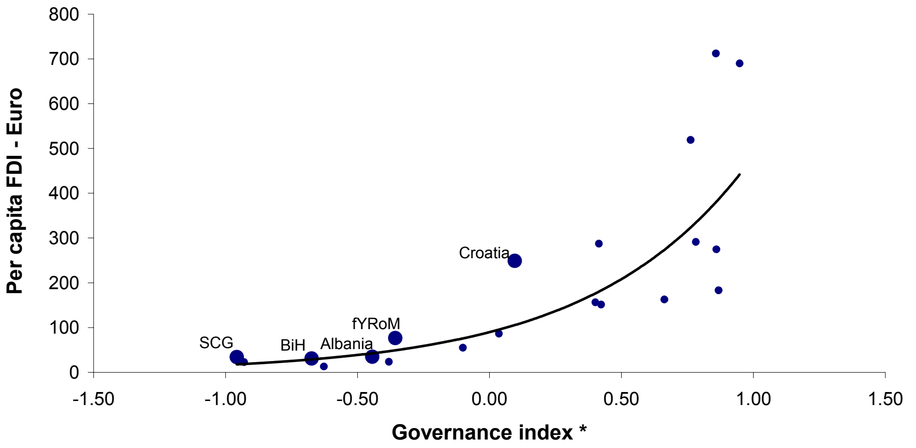
To complete the picture on the business environment, it should be recognised that in the recent past several efforts have been made by the countries to improve the business environment and render it more attractive to FDI. The series of FIAS[23] studies identified the main regulatory barriers to investment in the region. The recommendations have often been included in governments’ action plans and new legislation has been passed or amended. In Bosnia and Herzegovina for example the ‘Bulldozer Committee’ has followed a bottom-up approach, whereby it is the business community itself that brought the necessary reforms to the attention of politicians.

[23] Foreign Investment Advisory Service, part of the World Bank group.

**Box 2. Good Governance and FDI**

Several empirical studies show that corruption, complex and non-transparent regulatory frameworks, as well as weak property rights are all factors that hamper FDI[a]. These factors may be summarised by a unique heading: *good governance*. A recent study by the World Bank indeed calculates a synthetic indicator of good governance for a large sample of countries[b]. It covers six dimensions of governance: i) voice and accountability; ii) political stability and absence of violence; iii) government effectiveness; iv) regulatory quality; v) rule of law; and vi) control of corruption. The index ranges from -2.5 to +2.5 with higher indices indicating better governance. Chart 8 below plots the annual average per capita FDI over the period 1997-2002 for a sample of 20 transition countries, including the Western Balkans, against the index of good governance, which is calculated as the simple average across the six dimensions and over the period 1996-2002.

**Chart 8. Western Balkan, Acceding and selected transition countries. Per capita FDI (annual average) and governance. 1997 - 2002**




Sources: UNCTAD, Kaufmann *et al.* (2003), own calculations. * A higher value indicates better governance

The chart shows a non-linear exponential relationship between these two variables; moreover, it is also evident that a minimum level of 'good governance' is needed before FDI can take off. The relative position of the Western Balkans shows that Albania, Bosnia and Herzegovina, the former Yugoslav Republic of Macedonia and Serbia and Montenegro are clustered at the bottom-left corner of the chart with poor governance and low FDI. Croatia is instead an outlier with a level of FDI which is similar to, or higher than, other countries that have better governance. A simple regression of the per capita FDI (in logarithm) as dependent variable, the governance index as explanatory variable and the per capita GDP (in logarithm) as control variable gives some empirical support to the relationship. Both coefficients associated with the independent variables are positive and highly significant (at 1% level). The adjusted $R^2$ of the regression is equal to 0.90.

[a] Drabek and Payne (2000), Hoekman and Saggi (1999), Wei (2000). [b] As described in Kaufmann *et al.* (2003).

Overall, it appears that efforts to introduce the more 'sophisticated' measures to attract FDI (such as specific FDI legislation or a FIPA) can be virtually meaningless if they are not accompanied (and in fact, preceded) by the 'basic' elements of a friendly business environment, entailing streamlined business procedures, flexible hiring and firing legislation, and effective contract enforcement. This result can explain the relatively poor FDI performance in the region (with the exception of Croatia). These more 'basic' elements of friendly business environment, which can be summarised by the concept of 'good governance' (see Box 2) may indeed require a stronger commitment and effort from the country, but, together with the fight against corruption, they are necessary pre-conditions for attracting the much-needed flows of FDI.

**Concluding remarks**

FDI has the potential to contribute to self-sustaining economic growth in the Western Balkans, especially in the light of declining foreign assistance and persistent current account deficits. Its benefits range from technological transfer, to employment opportunities, as well as promoting the export capacity of the host countries. The analysis on the main developments in the region has shown that although the overall trend is positive, FDI flows have been widely affected by one-off transactions linked to privatisation, especially in the service sector; it is therefore difficult to extrapolate past performance into the future. Indeed, the challenge ahead will be to attract more green-field FDI, once the main privatisation investment opportunities are exhausted.

Another clear result is that Croatia has managed to attract most of the FDI in the region, in absolute amounts and both in GDP and per capita terms. On a broader regional perspective, since 1997 the cumulative level of per capita FDI in the Western Balkans was around one third that of the Acceding Countries, but higher than in the SEE-2 (Bulgaria and Romania), or the Western NIS (Belarus, Moldova, Ukraine). However, when Croatia is not included, the figures show that the remaining countries have been relatively less appealing to foreign investors than the SEE-2.

Several factors are behind the Western Balkans FDI performance. The markets are undoubtedly small, and not yet completely integrated; a fully implemented regional trade area could indeed widen the markets to a size of around 22 million people. Although formal political stability has been restored in all countries, the investors' perception of the region may still be rather negative, given political influence on the judiciary, the media, as well as the endemic issue of corruption. On the regulatory side, it appears that the countries of the region have, at different degrees, all implemented FDI-specific policies, which *in theory* provide the necessary guarantees and protection to foreign investors. However, *in practice* such policies appear to be ineffective, since they are not preceded by more 'basic' elements of a friendly business environment, entailing streamlined business procedures, flexible labour markets, and effective rule of law. These general 'basic' elements are still largely missing.

Overall, the Western Balkans need to continue with political and economic stabilisation as well as with structural reforms, in order to lower country risk and to increase profitability. This would enhance the reputation of the region as a destination for foreign investment. The recent efforts in this sense are encouraging and should be pursued with vigour, so that the full potential of FDI in the region can be realised.

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# Part B

# Country Analysis

## ALBANIA

- **Following the reduction in GDP growth in 2002 (4.7%), the economic situation points to a sustained growth in 2003 (6%). Potential political instability, uncertain electricity supply and delays in structural reforms could however weigh on the current performance.**

- **The external sector remains characterised by an important trade deficit (some 23% of GDP), which is partially compensated by large remittances. In 2003, the current account deficit is expected to slightly decrease to 8.5% of GDP, from 9.1% in 2002, as a result of improved export performance. The unfavourable business climate is hampering Foreign Direct Investment.**

- **The process of structural reforms has so far been limited in 2003. The privatisation of the remaining large state-owned enterprises, including the Savings Bank, has encountered delays. Some limited progress was registered in the management of public expenditures and revenues.**

- **The negotiations for a Stabilisation and Association Agreement between Albania and the EU were officially launched in January 2003. The outcome of the negotiations, and more particularly the timing for their conclusion, will to a large extent depend on the ability of the Albanian authorities to implement their commitments on a number of key reforms and on assurances that Albania will be in a position to implement the Agreement it has negotiated.**

**Table 9. Albania - Main Economic Trends. 1998 - 2003**

| | | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 p |
|---|---|---|---|---|---|---|---|
| Real GDP growth | *Percent* | 12.7 | 10.1 | 7.3 | 7.6 | 4.7 | 6.0 |
| Inflation rate | *Percent (average)* | 20.9 | 0.4 | 0.0 | 3.1 | 5.2 | 2.3 |
| | *Percent (end-of-period)* | 8.7 | -1.0 | 4.2 | 3.5 | 1.7 | 2.8 |
| Unemployment rate | *Percent of labour force* | 17.8 | 18.0 | 17.1 | 13.5 | 15.8 | 14.9 |
| General govt. balance (1) | *Percent of GDP* | -11.4 | -12.1 | -9.2 | -8.2 | -6.9 | -5.6 |
| General govt. balance (2) | *Percent of GDP* | -10.9 | -9.3 | -8.2 | -7.6 | -6.3 | -5.0 |
| Trade balance | *Percent of GDP* | -22.8 | -19.3 | -22.3 | -24.2 | -23.9 | -22.8 |
| Current account balance (1) | *Percent of GDP* | -7.1 | -7.9 | -7.4 | -6.2 | -9.0 | -8.5 |
| Current account balance (2) | *Percent of GDP* | -3.9 | -3.9 | -4.4 | -3.2 | -6.5 | -6.3 |
| External debt | *Percent of GDP* | 31.8 | 29.1 | 31.8 | 28.2 | 24.4 | 23.9 |
| | *Billion EUR* | 0.9 | 1.1 | 1.3 | 1.4 | 1.1 | 1.2 |
| Debt–export ratio | *Percent* | 358 | 187 | 166 | 143 | 129 | 128 |
| Foreign direct investment (3) | *Percent of GDP* | 1.5 | 1.4 | 3.7 | 4.8 | 2.6 | 2.7 |
| | *Million EUR* | 40 | 48 | 155 | 228 | 144 | 132 |

p Projections. *Sources*: National authorities, IMF, EC estimates. (1) Before grants. (2) After grants. (3) Net.

Albania can be considered as a small economy. In 2002, its nominal GDP reached some EUR 5.4 billion, which represents around 9% of the regional GDP and 0.06% of EU GDP, for a population of some 3.1 million (according to the 2001 Census) representing respectively some 16% and 0.9% of the Western Balkans and the EU population. GDP per capita amounted to about EUR 1600. The 2002 GDP breakdown by sectors showed an increasing share for sectors having recently benefited from investments, such as construction (11%), transport and other services (43% altogether). On the other hand, the share of agriculture, while remaining very important, is decreasing: it is indeed projected to represent 28% of GDP in 2003, compared to 33% in 2002. The Albanian economy is moderately open to trade, given its low size. Indeed, the sum of exports and imports of goods and services is equal to around 45% of GDP, which is almost half of the regional average of 88%. The EU is Albania's main commercial partner, representing about 75% of Albania's total imports and around 90% of the total exports.

**Macroeconomic developments**

Real GDP growth reached 4.7% in 2002, compared to 6.8% in the previous year. The reduction in growth reflected the continuing impact of the energy crisis on most sectors of activity, as well as a modest 2% expansion in agricultural output, as a result of flooding in September 2002. On the demand side, the slower economic growth resulted mainly from a decline in public investment – partly because of failed privatisations, which deprived the authorities from important revenues – and private investment. The average inflation rate rose to 5.2%, compared to 3.1% in 2001. This was due to specific factors such as energy shortages, the euro changeover and the September floods. End-of-year inflation was limited to 1.7% in 2002, against a 2-4% target.

Data for the first half of 2003 point to a higher level of economic activity, compared to the corresponding period of the previous year. A higher industrial sales index in almost all major sectors, as well as an increase in machinery imports, was registered for the first six months of the year. These developments, which are in line with the 6% GDP growth projected by the authorities for the whole year, remain however subject to downside risks, such as political instability, uncertain electricity supply and possible delays in structural reforms, more particularly as regards privatisation of large enterprises. Inflation is expected to stay within the same 2-4% target in 2003, supported, as in the recent years, by cautious monetary policies. The year-on-year inflation rate reached 3.4% in November 2003. According to the Albanian statistical office (INSTAT), unemployment reached 14.9% at end-September 2003, compared to 15.8% at end-2002.

***Fiscal situation.*** The fiscal deficit, excluding grants, reached 6.9% of GDP in 2002, compared to a 7.7% target (the deficit was 6.3% of GDP after grants). Lower-than-expected collection of tax and customs revenues - mainly due to the slowdown in GDP growth and the changes in government and in fiscal administrations - were more than compensated by spending cuts, which were designed to minimise the impact on poverty alleviation efforts.

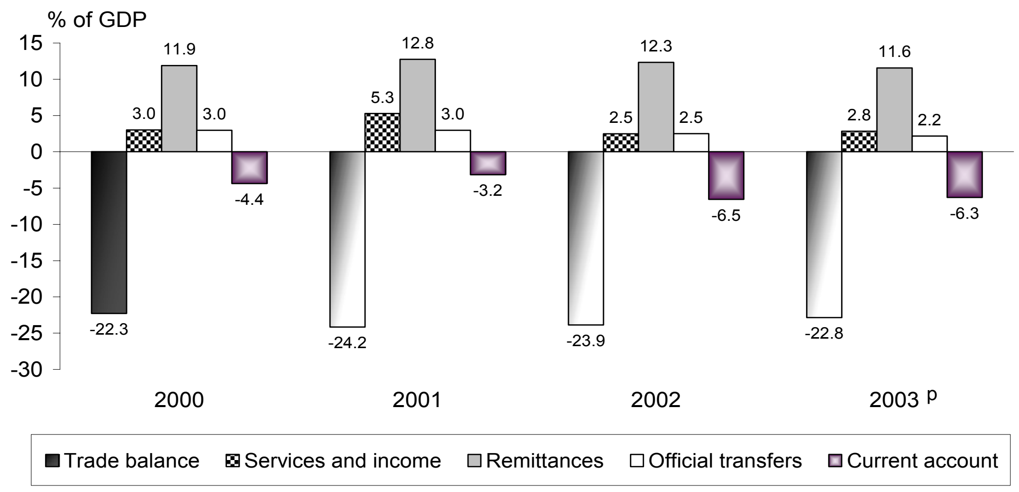
According to data available for the first three quarters of 2003, despite the implementation of some agreed measures aiming at increasing fiscal revenues, tax collection was slightly below the budget. For 2003 as a whole, the budget deficit was initially targeted at 6.6% of GDP, on the basis of expected improvements in the tax and customs systems, through an expansion of the tax base and intensified efforts to combat tax evasion, fraud and smuggling. The authorities also prepared contingency plans, which would allow them not to endanger the overall deficit ceilings, in case the budget revenues targets were not met. In order to accommodate the ¾% of GDP tax shortfall registered in September, the authorities adopted actions on the expenditure side, in line with the contingency plans, consisting mainly of savings in electricity subsidies and personnel spending. It also appeared that the disbursement of foreign project financing was lower than expected, which added to the resources constraints. The budget deficit projection has been revised downwards, at 5.6% of GDP. Public debt reached 63% of GDP in 2002 and is estimated to have slightly decreased to 62% in 2003.

***Monetary policy.*** Concerns about the rising inflation, essentially in the first half of 2002, pushed the central bank to tighten its monetary policy, through an increase in its repo rate from 7 to 8.5 %. This allowed end-of-year inflation to be close to the lower limit of the 2-4% target. The declining trend in inflation was confirmed in the first months of 2003, which encouraged the central bank to ease its monetary policy through a lowering of its repo rate by 1 percentage point to 7.5%, in two steps. A further lowering took place in October, bringing back the policy rate to its early 2002 level.

As referred to above, the key instrument of monetary policy continues to be the repurchase agreement rate; its impact on market rates should be improved through open market operations. Given the quasi monopolistic character of the banking sector (see below), the authorities are developing a new marketing channel for treasury bills outside the banking system, which should contribute to a diversification of the demand and, thereby, a reduction over time of the important interest margin relative to deposit rates.

***External situation.*** The 2002 current account deficit, excluding official transfers, widened to 9.0% of GDP, from 6.2% in 2001. This worse-than-expected outcome was due to a larger trade deficit (reflecting adverse supply shocks, more particularly in the energy sector), a lower surplus in the balance of services and a slight decline in remittances, which nevertheless remain, as it has been the case for years, the main source of foreign currency inflows - some 12.3% of GDP, compared to 12.8% in 2001 (see chart 9).

**Chart 9. Albania - Current account balance. 2000 - 2003$^{p}$**




Source: National authorities, IMF and EC

p Projections

In 2003, the current account deficit is estimated to have decreased to 8.5% of GDP. This slight improvement should be based on a corresponding change, relative to GDP, of the trade balance. It is indeed estimated that the improved domestic supply of electricity supported export performance already in 2003. The balance of services is also estimated to have improved, more particularly because of increased receipts from tourism, however without significant impact on the current account, given its small size relative to GDP. Albania’s trade deficit with the EU is estimated to be around EUR 900 million for 2003, with industrial products representing the bulk of EC/Albania bilateral trade.

At end-2002, owing to debt forgiveness related to a debt restructuring agreement with Russia, external debt slightly decreased in USD nominal terms and reached 24.5% of GDP (compared to about 28% of GDP in 2001). For 2003, the external debt situation is projected to improve further, to about 24% of GDP. This debt level can be considered as relatively low by international standards and in comparison with other Western Balkan countries. In 2002, the debt service reached the equivalent of 6.4% of exports of goods and services, a figure which is estimated to have decreased to 5.5% in 2003.

**Structural reforms**

Progress in the implementation of structural reforms has slowed down in the recent past. The privatisation process of remaining large state-owned enterprises has seen limited progress. Some restructuring measures have taken place. Little progress has been made as regards the management of public finances.

***Public administration reform – Management of public expenditures and revenues.*** Key challenges concerning public expenditure management include (i) improving the usefulness, quality, and timeliness of information upon which budget decisions are made and (ii) enhancing budget transparency and accountability mechanisms, including audit. To meet these challenges, the authorities have continued to make the Medium-Term Expenditure Framework (MTEF) the centre-piece of the budgetary process to prioritize expenditures more efficiently and to strengthen the links between policy objectives and budget planning. A closer link between the MTEF and the NSSED (National Strategy for Social and Economic Development, the official name of the Albanian PRSP) would however be desirable.

Concerning revenues, the authorities have revised their strategy, in light of recent disappointing revenue collection. This revised strategy, now based on more specific tax policy measures, remains focused on improving collection and increasing the tax base over the medium-term. These measures include an improvement in the collection of social security premiums – a function which will be transferred to the General Directorate of Taxation, according to the law adopted by Parliament in September 2003 - as well as the gradual introduction of some local taxes to promote decentralisation. A new excise tax was introduced in July and a law on the taxation of agricultural land entered into force in January 2003. Some progress was also made in the reform of the customs department, in particular concerning the simplification of procedures, which resulted in some increase in revenues collection. In this context, the implementation in October 2003 of the ASYCUDA (Automated System for Customs

Data) computer system in a pilot site in the Tirana Customs House must be considered as a significant progress. A strengthening of the tax administration reform also remains at the core of the fiscal strategy, as a narrow tax base and extensive tax evasion provide ample scope for raising collection over time.

As far as control functions are concerned, a positive development was the adoption, in February 2003, of a new internal audit law. In August, the Government approved the second one-year anti-corruption plan. The plan covers five main sectors, including public administration reform as well as the improvement of public finance management and audit mechanisms.

***Enterprise reform – Enterprise restructuring and privatisation.*** Excluding the agricultural sector, around 57.000 companies are estimated to exist in Albania, out of which 99% are private and 95% are small enterprises. Particular attention is therefore paid to private sector development, more particularly to SMEs. Several measures are being taken by the authorities to support the SME strategy: a strengthening of the institutional framework through the setting up of different agencies (a foreign investment promotion agency, an export promotion agency and a small business development agency), the creation of a more predictable legal and fiscal framework, the setting up of training modules for managers and the improvement of the credit system for SMEs. At the Thessaloniki Summit in June 2003, Albania endorsed the European Charter for Small Enterprises, which calls upon participating countries authorities to take action to support and encourage small enterprises in ten key areas. Land reform, which should contribute to the overall economic development, and in particular that of the agricultural sector, is also expected to progress with the completion of land registration by end-2004 and the adoption of a long awaited new legislation addressing claims for restitution and/or compensation of land expropriated during the communist period. This would contribute to progressively settling the overall issue of land ownership.

Enterprise privatisation/restructuring essentially concerns large utilities. Albania’s policy is, first, to restructure and, only thereafter, to privatise state-owned companies. The electricity company KESH is still in the restructuring phase, a first step having been achieved with the split of the company into three entities responsible for distribution, generation and transmission. The Italian company Enel, which has provided management assistance to KESH since September 2000, expressed interest in participating in the liberalisation and the privatisation of the Albanian energy sector and also in supporting the integration of the country in the energy market of the Balkan region and the European Union. The situation is somewhat more advanced in the oil sector, as the privatisation process of Albpetrol (production), Armo (refinery) and Servcom (distribution) has already started. No significant progress has been made concerning Albtelekom, the telecommunications company, whose privatisation had to be postponed given the lack of interest from international potential bidders. In this context, the state has recently issued a mobile license to Albtelekom to make the company more attractive for prospective buyers, since Albtelekom privatisation tender will include the GSM license.

***Financial sector reform.*** The Albanian banking sector currently consists of one state-owned bank, the Savings Bank, two joint-venture banks, 11 foreign-owned private banks and one domestic private bank. As a consequence of the failure to privatise the remaining state-owned bank in 2002, the Albanian authorities have decided, in consultation with the International Financial Institutions, to streamline and strengthen the bank in preparation for a second privatisation attempt. Following the transfer of the Savings Bank's pension functions to Albapost, other specific measures include further efforts to move the bank's fiscal functions to other banks, a reduction in quantity and improvement in quality of staff, as well as a further consolidation of its rural offices so as to ensure the provision of basic banking services in remote areas after the bank's privatisation. Prospects are now for a privatisation of the Savings Bank in 2004. Given the dominant position of the Savings Bank – which accounts for close to 60% of banks' deposits and more than 80% of the treasury bills' market - the competition in the Albanian banking sector remains very limited. In this context, the authorities have indicated that they plan to promote the sale of treasury bills outside the banking system, with a view to reducing the important interest margin compared to deposit rates.

The first stage of the privatisation process of the Albanian insurance company INSIG took place in October 2003, when 39% of the company's shares were officially transferred to the International Finance Corporation (IFC) and to the European Bank for Reconstruction and Development (EBRD). The IFC and the EBRD will supervise INSIG for a transitional period of 1-2 years, with the objective of attracting strategic investors.

***Trade liberalisation.*** Albania is a WTO member since 2000. Its schedule agreed with the WTO provides for gradual trade liberalisation until 2007. However, some delays in implementing its commitments to the WTO have occurred. The maximum MFN tariff rate remains at 15%, although many industrial products are already fully liberalised or with a very low tariff (2%). The most protected sector continues to be agriculture. In 2003, Albania has concluded negotiations on FTAs with neighbouring countries, i.e. Croatia and the former Yugoslav Republic of Macedonia.

Albania has been benefiting from EU trade autonomous concessions since 2000. These concessions imply that all Albanian industrial products and most Albanian agricultural and fishery products can access EU markets duty and quota free. However, to date, Albania has not been able to take full advantage of these autonomous trade preferences. As an attempt to partly overcome this problem, Albania has adopted an export promotion strategy and established an export promotion agency. However, in order to be able to increase its export capacity, Albania will have to make progress in a number of areas such as overall product quality, quality control and certification, implementation of EU standards, enhancing veterinary and phytosanitary rules, developing trade channels, etc.

## International relations

***Stabilisation and Association Process (SAp).*** Albania has been participating in the SAp since its very beginning. It benefited from the overall Sap co-operation framework, including preferential trade concessions, financial assistance and the prospect for an enhanced, far-reaching contractual relationship with the EU through a Stabilisation and Association Agreement (SAA). This Agreement will replace the current Trade and Cooperation Agreement, which entered into force on 1 December 1992. Following the EU decision in June 2001 to proceed with SAA negotiations with

Albania and the adoption by the Council in October 2002 of the Commission negotiating mandate, the negotiations for an SAA were officially launched on 31 January 2003. The timing for the conclusion of these negotiations will depend to a large extent on the ability of the Albanian authorities to implement a number of key reforms and their commitments in the context of this exercise. The last Annual Report on progress made by Albania in the context of the Stabilisation and Association process was released by the Commission in March 2003[24].

***EC assistance.*** Since 2001, the Community Assistance for Reconstruction, Development and Stabilisation (CARDS) programme has been the main EC financial instrument of co-operation with the Western Balkan countries, and with Albania in particular. For the period 2001-2004, EUR 187.4 million have been earmarked for Albania, including a EUR 6 million increase in the 2004 allocation, as a result of the June 2003 Thessalonica Summit. The main priorities for CARDS assistance are justice and home affairs, administrative capacity building, economic and social development, environment and natural resources, and democratic stabilisation. The 2003 CARDS annual programme foresees commitments of EUR 46.5 million for Albania.

In December 2003, the Commission adopted a proposal aiming at providing macro-financial assistance to Albania for a maximum amount of EUR 25 million, including EUR 16 million of grants and EUR 9 million of loans. Before starting with the implementation of this assistance, a decision on this proposal is expected by the Council, after consultation of the European Parliament.

Since 1998, the *European Investment Bank* has signed loans worth EUR 130 million, essentially in transport infrastructure and the energy sector. In 2003, a project for the extension and the rehabilitation of municipal water infrastructure was signed (EUR 27 million).

***Relations with IFIs.*** In June 2002, the *IMF* approved a new 3-year programme covering the period June 2002-June 2005 and supported by a PRGF arrangement for a total of SDR 28 million (some EUR 40 million). In its first year, this programme was to address in particular problems in the energy sector and in tax collection. Reviews under this programme were successfully completed in January and July 2003. In April 2003, in the context of second review discussions, the IMF staff mission agreed with the authorities that the second year of the programme (June 2003-June 2004) be given a strong focus on strengthening governance and the integrity and competence of public institutions. Particularly concerned, given the impact on the resources of the state, are the tax and customs administrations. Other main priorities for the second year of the programme will be fiscal consolidation (basically a priority for the 3-year programme), the improvement of the business environment, the implementation of the energy sector action plan - in consultation with the World Bank - and the strengthening of the financial sector.

In June 2002, the *World Bank* adopted its new Country Assistance Strategy for Albania, which focuses on reducing poverty by supporting the country's National Strategy for Socio-Economic Development. To this end, the Bank is supporting the

[24] COM (2003) 139 final of 26 March 2003. Commission Staff Working paper on Albania (SEC (2003) 339) available at: http://europa.eu.int/comm/external_relations/see/sap/rep2/com03_339.htm

government to improve governance and strengthen institutions, promote sustainable private sector growth and foster human development. Four projects (three sectoral credits and one Poverty Reduction Support Credit) for a global amount of USD 61 million have been approved under the framework of the new CAS. Implementation of a further 17 projects approved prior to the current CAS totalling approximately USD 220 million is also continuing.

The strategy of the *European Bank for Reconstruction and Development* for Albania is to focus its action on private sector development and support to SMEs, participation in strategic privatisations, more particularly in banking and telecommunications sectors, and infrastructure financing and development, especially in the energy and transport sectors. By the end of 2002, the EBRD had provided assistance loans to Albania for a value of over EUR 150 million. In 2003, it invested some EUR 4.7 million in the insurance company INSIG.

**Concluding remarks**

Over the past years, Albania has experienced considerable GDP growth, low inflation and exchange rate stability. The fiscal position has continuously improved, but it remains a source of concern, given the low level of revenues compared to GDP. On the external side, both trade and current account deficits remain quite large, whereas the external debt position is kept under control. Progress in the implementation of structural reforms has slowed down in the recent past. The privatisation of the remaining large state-owned enterprises, including the Savings Bank, has encountered delays, while some limited progress was registered in the management of public expenditures and revenues. During the second year (June 2003-June 2004) of the triennial PRGF-supported IMF programme, particular focus is being given to strengthening governance and the integrity and competence of public institutions.

To consolidate and enhance growth prospects, the Albanian authorities should pursue in the coming years fiscal consolidation, based on improved tax administration and a better prioritisation of expenditure. They should also continue with their efforts to improve the business environment, namely through a strengthening of the legal framework and the strict implementation of their anti-corruption plan. At the same time, the process of restructuring/privatisation of the remaining state-owned bank should be accelerated, with a view to reducing its dominant position and stimulating the competition in the Albanian banking sector. Finally, the reform of the energy sector, more particularly electricity, should be actively pursued.

## BOSNIA AND HERZEGOVINA

- **After the positive performance of 2002 (GDP growth of 5.5%), the economic situation points to a slowdown of real economic growth, estimated at 3.5% for 2003, weakened by a negative external environment which has slowed down BiH's exports.**

- **The external sector continues to raise concerns. Both the trade and the current account deficits remain large, reflecting the weak productive and export capacity of the country. Some positive signs come from Foreign Direct Investment, which almost doubled in 2002, thanks to efforts to improve the investment climate; this positive trend seems to have continued in 2003.**

- **The process of structural reforms has continued, with most progress observed in management of public finances and in the financial sector. The privatisation process, especially of large state-owned companies, needs a serious revitalisation to allow the private sector to play its role in spurring domestically-generated growth.**

- **In November 2003 the Commission finalised a Feasibility Study concerning the opening of negotiations on a Stabilisation and Association Agreement. It identifies a number of measures in which BiH needs to make significant progress within the next year, if the Commission is to recommend to the Council the opening of negotiations.**

**Table 10. Bosnia and Herzegovina - Main Economic Trends. 1998 - 2003**

| | | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 p |
|---|---|---|---|---|---|---|---|
| Real GDP growth | *Percent* | 15.6 | 9.6 | 5.6 | 4.5 | 5.5 | 3.5 |
| Inflation rate | *Percent (average)* | -0.3 | 3.4 | 5.1 | 3.1 | 0.3 | 0.4 |
| | *Federation of BiH* | 5.0 | -1.0 | 1.9 | 1.9 | -0.2 | 0.5 |
| | *Republika Srpska* | -14.0 | 14.0 | 14.0 | 7.0 | 1.9 | 0.7 |
| Unemployment rate | *Percent of labour force* | 37.4 | 38.9 | 39.7 | 40.1 | 41.0 | 41.0 |
| General govt. balance (1) | *Percent of GDP* | -19.9 | -22.4 | -16.3 | -10.4 | -7.1 | -3.4 |
| General govt. balance (2) | *Percent of GDP* | -7.8 | -9.1 | -7 | -3.3 | -2.2 | 0.3 |
| Trade balance | *Percent of GDP* | -48.4 | -42.8 | -32.1 | -32.8 | -36.8 | -36.6 |
| Current account balance (1) | *Percent of GDP* | -20.3 | -21.4 | -22.4 | -23.3 | -23.8 | -21.3 |
| Current account balance (2) | *Percent of GDP* | -8.2 | -8.1 | -12.5 | -15.5 | -18.5 | -17.5 |
| External debt | *Percent of GDP* | 71.6 | 68.2 | 59.2 | 46.4 | 38.9 | 35.4 |
| | *Billion €* | 3.3 | 3.3 | 2.4 | 1.9 | 2.0 | 2.4 |
| Debt–export ratio | *Percent* | 352 | 319 | 276 | 155 | 146 | 121 |
| Foreign direct investment (3) | *Percent of GDP* | 2.9 | 2.1 | 3.2 | 2.6 | 4.4 | 4.9 |
| | *Million €* | 100 | 90 | 163 | 145 | 244 | 282 |

p Projections. *Sources*: National authorities, IMF, EC estimates. (1) Before grants. (2) After grants. (3) Net.

Bosnia and Herzegovina (BiH) is a small country consisting of two Entities (the Federation of BiH – FBiH, and Republika Srpska - RS) and a central State, with a population in 2002 of around 4 million. It is also a relatively small economy within the region, as it accounts for 12% of the Western Balkans' GDP and 17% of its population (2002 data). With a GDP per capita of around EUR 1,400 in 2002, it is the poorest economy (after Kosovo), and it falls within the World Bank definition of 'lower middle-income economy'; in 2003 GDP was still at around 60% of the pre-war level. Concerning the structure of GDP, 2002 figures show that agriculture accounts for 12% of GDP, industry for 21%, services for 62% and construction 5%. BiH is a very open economy, with the ratio of exports and imports of goods and services to GDP at 85% in 2002. However, this results from high imports rather than from substantial BiH exports. The EU is the main trading partner accounting for around 40% of BiH's external trade.

**Macroeconomic developments**

After the high real GDP growth rates observed during the reconstruction period (on average above 30% between 1996 and 1999), annual growth has slowed to around 5% on average and 5.5% in 2002. The main factor behind this performance has been the weak capacity of BiH to adequately mobilise domestic sources of growth, particularly private sector activity. The negative external environment (low growth in Europe) slowed down growth prospects for 2003 (at 3.5% of real GDP). The average official unemployment rate in 2002 was around 41% in FBiH and 40% in the RS; however, given the large number of people in the grey economy, unofficial estimates point to an actual rate of around 20%. The country-wide inflation rate was around 0.3% in 2002 and is expected to have remained at similar levels in 2003.

***Fiscal situation.*** Due to a better-than-expected revenue performance, the consolidated budget deficit amounted to 7.1% of GDP in 2002 (2.2% after grants), lower than the programme target of 11.5% (5.5% after grants). At the Entities level, revenue performance was stimulated by chain effects of a household credit boom, which appears to have financed purchases of imported goods, hence bringing higher revenues from sales and trade taxes. Savings on the expenditure side have also occurred, namely from (dollar-denominated) debt service payments due to euro (hence KM[25]) appreciation vis-à-vis the US dollar, but also from lower military demobilisation disbursements. As for 2003, in line with the IMF programme, the authorities have continued to limit expenditure commitments and targeted a consolidated budget deficit of 6.4% of GDP (2.2% after grants). For similar reasons as for 2002, this target seems to have been over-achieved (September data), and the deficit is now estimated at 3.4% of GDP (with a slight surplus after grants).

Although progressively declining, foreign financing of the budget, mostly in the form of grants or concessional loans, was at 9% of GDP in 2002 (including estimates for extra-budgetary funds), still one of the highest within the Western Balkans. The share of public spending in GDP is also diminishing, although it remains very large at around 50% of GDP in 2002. Of this share, 39% is spent on wages (including military pay), and public expenditure is associated with large inefficiencies especially in education, health and veteran benefits. Moreover, while *external* public debt remains contained (see below), the size of *domestic* public debt (which includes arrears, war damages, and frozen currency deposits) still needs to be fully identified. It may reach a level of 45% of GDP, hence bringing total public debt above 80% of GDP.

[25] Convertible Mark, the national currency pegged to the euro (at the rate of 1.96 KM per EUR).

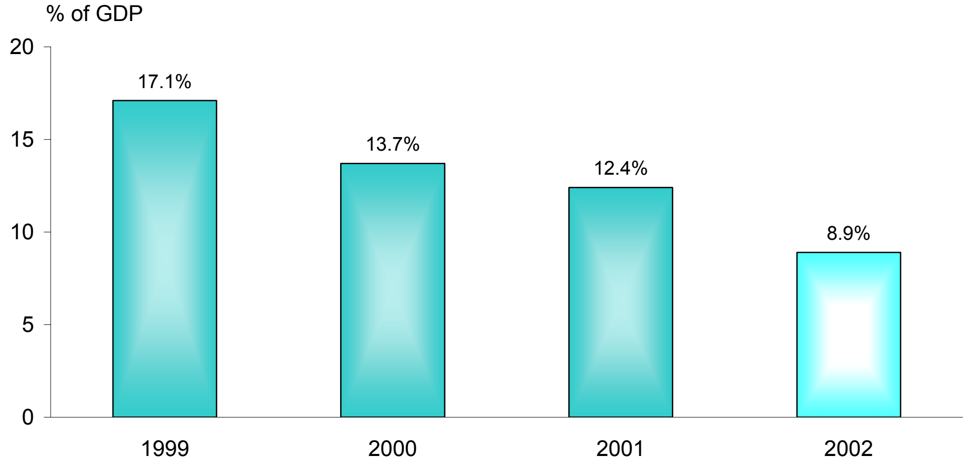
***Monetary policy.*** As foreseen by the Dayton Agreement, a currency board arrangement was established in mid-1997. As a result, active monetary policy is practically non-existent. However, the observed surge of credit to the household sector in 2002 (growth exceeding 100% over the year), triggered intervention by the Central Bank of BiH, in agreement with the IMF; the reserve requirements were changed, which equated to some monetary tightening. Overall, the currency board has kept inflation under control; at the same time, increased economic integration between the two Entities has been conducive to greater convergence in their inflation rates. In 2002 average inflation (CPI-based) was roughly zero in FBiH, and 2% in the RS, bringing the country-wide average at around 0.3%. Similar figures are estimated to have been recorded for 2003. In line with the current IMF programme, the currency board will remain in place, and the BiH authorities nominated in May 2003 the members of the new Governing Board of the Central Bank, which started its new mandate in August 2003.

***External situation.*** The merchandise trade deficit continues to remain large, at 37% of GDP in 2002. During the reconstruction years such deficits were justified by the large amount of imports linked to reconstruction aid. However, since then these imbalances may denote a more structural problem, such as an insufficient export and productive capacity of the country. Moreover, over time persistent deficits could endanger currency stability with potential effects on inflation and the sustainability of debt servicing. Despite data revisions that showed higher estimates for private transfers, the current account deficit deteriorated from 15.5% in 2001 to 18.5% of GDP in 2002 (including official transfers). The combined effect of the credit boom on imports, improved border controls, and the rapid impact on imports of the recent Free Trade Agreements signed with neighbouring countries partly explain this deterioration. For 2003, owing to the tightening of monetary policy mentioned above, the current account deficit is estimated to be slightly reduced to just below 18% of GDP. So far, Central Bank data until the second quarter of 2003 still show a slight worsening of the current account situation (+7% deficit increase relative to the same period of 2002).

Whereas in the past BiH was unable to attract large flows of FDI, this has changed recently thanks to efforts to improve the investment climate. In particular, by increasing transparency and reducing administrative barriers (notably through the ‘Bulldozer Committee’ initiated by the OHR) FDI in BiH almost doubled in 2002, at around EUR 244 million. This positive trend is expected to continue for 2003, together with the country’s reduced reliance on foreign assistance (see Chart 10). At end-2002, gross foreign reserves of the Central Bank of BiH reached over KM 2.4 billion, equivalent to around 4.7 months of imports of goods and services, and for 2003 the import coverage should have remained at similar levels.

External public debt, at around EUR 2 billion, reached 39% of GDP at the end of 2002 (revised downwards from the projected 52%) and is expected to decline further in 2003. Debt service in percent of exports of goods and services, which started to pick up in 2002 (8.5%), mostly due to repayments to the IMF and the World Bank, it is expected to stay at this level in 2003 before going down in the coming years.

**Chart 10. Bosnia and Herzegovina - Foreign Aid. 1999 - 2002**




Source: CBBiH

## Structural reforms

BiH continues to pursue structural reforms, also with a strong involvement and support of the international community. Most progress in the past 18 months was observed in the management of public finances (including planned reform of customs and tax administration) and in the financial sector. Privatisation of large state-owned companies has been stalling, and needs to gain new momentum. Issues related to the domestic single economic space persist, such as on the mutual recognition of products, implementation of a consistent public procurement regime throughout the country, or the creation of a single business registration system. In the context of the finalisation of its PRSP and the Feasibility Study, the government adopted in July an "Action Plan for the Implementation of Priority Reforms" until March 2004. It contains a list of 131 measures, and it should give new impetus to the reform process in the coming months.

***Public administration reform – Management of public expenditures and revenues.*** Reforms in this area continue at a sustained pace. Some efforts have been made to fight corruption. Several laws include provisions on conflict of interest, and an anti-corruption Action Plan has been drafted and should soon be adopted. However more needs to be done in this area. The Treasury system that was introduced in early 2002 in both Entities and the State is being implemented smoothly, with further extension foreseen at sub-Entity level. All budget users are now included in the system and a Single Treasury Account is being used, instead of the previous sixty. The system has therefore brought enhanced transparency, better control over commitments and expenditures, and substantial savings. On the revenue side, inter-entity harmonisation of indirect taxes continues, and a major reform of the tax and customs administrations is underway. In particular, the Indirect Tax Policy Commission established by the OHR in February 2003, drafted legislation foreseeing a single Indirect Tax Authority (ITA). During 2003 this was adopted by government and parliament. The ITA will collect indirect taxes at the State-level by establishing a unified customs administration, prepare for the introduction of State-level VAT, and through its Governing Board involve also the State in fiscal policy formulation.

***Enterprise reform – Enterprise restructuring and privatisation.*** Although the legislative framework has been in place for five years, privatisation has made slow progress. Most occurred in small-scale enterprises. As of September 2003, 76% of small-scale companies had been sold in the Federation, and 49% in the RS. For large-scale enterprises, privatisation has been even slower, with only 24% of large enterprises sold in the Federation at end 2002 and 42% in the RS. Most problems have occurred in the large-scale *strategic* enterprises (in sectors such as mining, refineries, tobacco plants, car parts). Notwithstanding support from the international community, at end 2002 only 18 out of 56 strategic companies had been sold in the Federation, and 4 out of 80 in the RS. Lack of political will, social concerns, and problems of corporate governance and corruption are all factors discouraging potential (foreign) investors. As a result, it is estimated that 45% of GDP is in private hands (2002 figure from the EBRD 2003 Transition Report), against an average of 55% for the region. In the first nine months of 2003 no further progress was made in this area, while according to the latest Status of Implementation of the authorities' Action Plan some action has been taken on adopting an operational plan for strategic enterprises.

More generally on the business environment, the 'Bulldozer Committee', which was launched by the High Representative in November 2002 in order to dismantle administrative barriers to business operation and creation, successfully pushed through the adoption of 50 economic reforms in May 2003. The Entity governments recently adopted fully harmonised bankruptcy legislation, which is now under parliamentary consideration.

***Financial sector reform.*** After a slow start, the reform process in this area is proceeding well. Privatisation of state-owned banks is now complete in the RS, and the six remaining public banks in FBiH have all undergone liquidation procedures. Consolidation of the banking sector has further reduced the number of banks, now 37 (27 in FBiH, 10 in the RS), and with a large foreign presence, notably Austrian, Croatian and Slovenian banks. Banking supervision was strengthened by enforcing the current prudential regulations: new capital requirements apply as of 1 January 2003 (at KM 15 million, up from KM 10 million) and have been met by all banks. In the context of the IMF programme, and in line with international practices, the authorities have amended regulations on banks' foreign currency exposures to include assets and liabilities indexed to foreign currencies, previously excluded.

In spite of this commendable progress, long-term lending to the private sector remains so far fairly low, also due to the short-term nature of deposits. Moreover, although on a declining trend, real interest rates are high compared to EU levels and the spread between deposit and lending rates is still large (around four times the EU average and twice that of candidate countries). High bank commissions reflect a strong risk perception, but they are also a sign that efficiency of the banking sector could be improved.

***Trade liberalisation.*** Trade liberalisation progresses well. A BiH unified customs tariff applies since 1999, and the tariff structure consists of four categories (from 0% to 15%) with the maximum rate only applying to 10% of the tariff lines. Most quantitative restrictions have been eliminated. In May 1999 BiH applied for WTO membership and this is now expected in the first half of 2004. In the context of the

Stability Pact for SEE, BiH signed FTAs with all the Western Balkan countries, as well as with Bulgaria and Romania. So far, only three of these are fully applied (with Croatia, the former Yugoslav Republic of Macedonia and SCG). A FTA has also been concluded with Slovenia. The full implementation of these agreements however remains also constrained by a limited administrative capacity. Moreover, given BiH's weak productive base, the short-term impact of these agreements has been a marked increase of imports, even though in the long-run trade liberalisation should be advantageous for exports as well. BiH also benefits from the autonomous trade measures (ATMs) of the EC introduced in September 2000 (covering industrial and most agricultural products) but it failed yet to take full advantage of them, notably due to non-compliance with EU safety, veterinary and phyto-sanitary legislation.

## International relations

***Stabilisation and Association Process.*** After the Commission judged in September 2002 that sufficient progress was achieved on the Road Map agenda (covering political, economic, and democratic aspects), it launched in Spring 2003 a Feasibility Study. The Study, which assesses whether to open negotiations for a Stabilisation and Association Agreement (SAA), was finalised in November 2003[26]. It identifies a number of measures with which BiH needs to make significant progress within the next year, if the Commission is to recommend to the Council opening negotiations for a SAA. In the economic sphere, these range from customs and taxation reform, to budget practice, development of BiH's single economic space, and a consistent trade policy.

***EC assistance.*** The EC supported the country's reforms under the OBNOVA programme and, since 2001, with CARDS assistance. The 2003 CARDS annual programme adopted by the Commission in March 2003 foresees commitments of EUR 63 million. The assistance principally focuses on refugees return, customs and taxation reform, justice and home affairs and environmental management.

The EC has also supported the process of economic reforms in BiH through Community macro-financial assistance. After the implementation of the first package (EUR 60 million) between May 1999 and December 2001, the Council decided in November 2002 to provide BiH with a second package (EUR 60 million). It comprises a loan element of up to EUR 20 million (with a maturity of 15 years) and a grant element of up to EUR 40 million (Council Decision 2002/883/EC). Like the first package, the implementation is linked to progress in economic and structural reform; the first grant tranche of EUR 15 million was disbursed in February 2003 and the second grant tranche of EUR 10 million in December.

As of end of October 2003, the *European Investment Bank* had supported projects in BiH for a total of EUR 185 million, in the area of transport (roads and rail rehabilitation), electricity and construction.

***Relations with IFIs.*** Following the completion in May 2001 of the *IMF* stand-by arrangement (SBA) agreed in May 1998, and after some delays notably due to

[26] COM (2003) 692 final of 18 November 2003 available on: http://europa.eu.int/comm/external_relations/see/bosnie_herze/index.htm

discussions over war veteran benefits and pensions, a new 15-month SBA of about SDR 67.6 million (around EUR 100 million) was approved by the IMF Board in August 2002. The first tranche of SDR 19.6 million (around EUR 27 million) was disbursed soon after. The programme focuses on policies to achieve post-reconstruction growth through a continued commitment to the currency board arrangement and further significant fiscal consolidation. In addition, the programme foresees structural reforms in the areas of tax policy, privatisation, trade policy and improvements to the business environment. The second and third tranches were both disbursed in June 2003, totalling SDR 24 million (around EUR 33 million).

After an initial post-war strategy based upon reconstruction, the *World Bank*'s emphasis has shifted towards helping BiH achieve sustainable growth, notably through a *Business Enabling Environment Adjustment Credit*, approved in May 2002 to support the Government's programme aimed at improving the investment climate.

In 2002, the *European Bank for Reconstruction and Development* had signed five projects in BiH, reaching a cumulative investment of around EUR 230 million in sectors such as banking, telecommunications, power and energy, transport, and agribusiness. In June 2003, the EBRD issued its strategy for BiH, which will focus on strengthening the private sector (through bank consolidation and improving access to finance for micro enterprises and SMEs), infrastructure projects (namely on regional linkages), as well as on local projects with municipalities.

**Concluding remarks**

In 2003 Bosnia and Herzegovina continued its process of macro-economic stabilisation; in particular, it achieved significant fiscal consolidation (thanks to reduced expenditure commitments and to some debt service savings) while maintaining price stability through continued adherence to the currency board. Supported by the IFIs and EC assistance, efforts with structural reforms persisted, with most progress observed in management of public finances and in the financial sector. However, against the background of declining foreign aid, the country is not yet firmly on a path of self-sustaining growth. The productive capacity remains weak, including in the exports sector, which affects negatively the trade balance. Despite some encouraging results, FDI is not sufficient to compensate for large current account imbalances. To promote private sector development, the authorities need to improve the business environment, notably by tackling weak corporate governance and high enterprise debt, creating a single business registration system recognised throughout BiH, and reducing labour rigidities. The privatisation process should also be revitalised by clearly identifying attractive companies and swiftly putting into bankruptcy procedures the others. On the exports front, BiH should rapidly introduce the certification procedures that would allow it to comply with EU standards, and take full advantage of the duty-free access to the EU market.

# CROATIA

- **The macroeconomic situation continues to be favourable. GDP growth averaged at around 5% in 2002 and 2003 and inflation is expected to continue declining, to below 2% in 2003. However, the stimulus of credit growth for domestic demand is weakening.**

- **Compared to the improvements in 2000 and 2001 the current account deficit has widened again in 2002 and also in 2003 driven by a continuously increasing trade deficit. External debt grew in 2002 and 2003.**

- **Several important laws for the economic domain have been adopted in 2003 and the partial privatisation of the oil company INA was completed. The key follow-up will be to establish the capacity for appropriate implementation and enforcement of the legislation.**

- **The SAA signed in October 2001 is awaiting ratification by Member States. An Interim Agreement is in force since March 2002. In February 2003, Croatia applied for EU membership and the Commission is currently in the process of drafting its opinion on the application.**

### Table 11. Croatia - Main Economic Trends. 1998 - 2003

| | | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 p |
|---|---|---|---|---|---|---|---|
| Real GDP growth | *Percent* | 2.5 | -0.9 | 2.9 | 3.8 | 5.2 | 5.0 |
| Inflation rate | *Percent (average)* | 5.9 | 4.1 | 6.2 | 4.9 | 2.2 | 1.7 |
| | *Percent (end-of-period)* | 5.4 | 4.4 | 7.4 | 2.6 | 2.3 | 1.5 (1) |
| Unemployment rate | *Percent of labour force* | 11.4 | 13.6 | 16.1 | 15.8 | 14.8 | 14.1 (2) |
| General govt. balance | *Percent of GDP* | -1.0 | -8.2 | -6.5 | -6.8 | -4.8 | -4.5 |
| Trade balance | *Percent of GDP* | -18.8 | -16.6 | -17.4 | -21.0 | -23.5 | -27.2 |
| Current account balance | *Percent of GDP* | -6.7 | -7.0 | -2.5 | -3.7 | -7.2 | -5.4 |
| External debt | *Percent of GDP* | 44.8 | 50.1 | 60.0 | 57.9 | 68.2 | 74.3 |
| | *Billion EUR* | 8.2 | 9.9 | 11.9 | 12.8 | 14.7 | 17.7 |
| Debt–export ratio | *Percent* | 211 | 227 | 242 | 238 | 306 | 338 |
| Debt-export ratio (3) | *Percent* | 112 | 12 | 128 | 117 | 146 | 143 |
| Foreign direct investment (4) | *Percent of GDP* | 3.9 | 7.1 | 5.9 | 7.2 | 3.9 | 4.9 |
| | *Million EUR* | 744 | 1332 | 1176 | 1571 | 941 | 1225 |

p Projections. (1) as of October 2003 y-o-y; (2) 1st half of 2003; (3) using both merchandise and service export. (4) Net
*Sources*: National authorities, IMF, EC estimates.

Croatia is a small economy with a population of 4.4 million (according to the 2001 Census) and a GDP at current prices of some EUR 23,760 million in 2002. The country's population is about 1.2% of that of the European Union, while its economy is about 0.26% in GDP terms. Croatia's economy is large by regional standards accounting for roughly half of the GDP of the Western Balkans. The GDP per capita is in the order of EUR 5,400 (measured by the average exchange rate 2002). Croatia is also a very open economy: in 2002, the total trade-to-GDP ratio (goods and services) was at some 103% of GDP, up by some 15 percentage-points relative to 1998, of which external merchandise trade volume accounts for roughly two thirds (exports 22%, imports 46% of GDP). The main trading partners are traditionally in the EU, which accounts for more than half of both exports and imports, with Italy, Germany and Austria being the most prominent partners.

Since independence in 1992, Croatia has experienced a process of de-industrialisation albeit less severe than in other transition countries and only gradually after 1996: the importance of industry including construction declined to some 30% of total gross value added in 2001. The services sector, notably tourism, has grown from about 50% at the time of independence to correspond to roughly 60%. The share of agriculture in GDP declined slowly in the second half of the 1990 but still stands above 9% reflecting the absorption of self-employment of persons who lost their job in the manufacturing sector.

**Macroeconomic developments**

In 2002, despite sluggish external demand the Croatian GDP grew by 5.2% in real terms, which was the highest growth rate since the recession in 1999. In line with investment and consumption growth, value added in construction (+13.9%) and retail and wholesale trade (+12.7%) recorded the strongest gains. The growth of manufacturing decelerated from 4.8% in 2001 to 4% in 2002.

In the first two quarters of 2003, gross fixed capital formation remained strong; it grew by 16.2% and 18.3% respectively compared to the same period of last year. Private consumption growth somewhat cooled down to 4.9% and 4.7% respectively reflecting high indebtedness of households as well as slower credit expansion. Debt-financed public investment, especially in highway construction, measured up to the activity level of the previous year with the exception for the first quarter, when weather conditions were less favourable. The tourist season was however good (overall earnings are expected to have increased by 15% in 2003) and GDP is likely to have grown at a similar level as in 2002 (some 5%).

Croatia maintained price stability using the exchange rate as nominal anchor. The average retail price inflation fell from 4.9% in 2001 to 2.2% in 2002 ensuing from falling agricultural prices and subdued growth of non-agricultural prices and despite prominent inflation in services. Producer prices fell by 0.4% in 2002 but showed an accelerating trend towards the end of the year. Recent inflation indicators underpin a continuation of the positive trend: retail price inflation in November 2003 (yoy) was 1.9%. Producer prices rose by a modest 0.9% (yoy).

Unemployment remains high but there are first signals of a gradual easing of the situation. Economic growth, some systematic changes including stricter eligibility rules and consolidation of data resulted in a continued fall of the official unemployment rate. In October 2003, the official rate stood at 18.6%, 3.1 percentage points lower than in September 2002.[27]

***Fiscal situation.*** The 2002 budget execution was implemented slightly below plan. As a consequence of the unexpected high economic growth and ensuing favourable

[27] The unemployment rate according to ILO methodology declined to 14.1% in the first half of 2003 (annual average rate in 2002: 14.8%).

revenue collection, the fiscal deficit of the general government in 2002 corresponded to only 4.8% of GDP compared to the forecast of 6.2%. The deficit was financed by privatisation revenues (1.8%), foreign borrowing (2.8%) and domestic borrowing from the non-banking sector through bonds and T-bills. Following data reconciliation[28] between the Ministry of Finance and the Central Bank, the public debt stock was at 51.6% of GDP in 2002, which is substantially lower than previously estimated (57.5%).

Under the original general government budget for 2003, revenues were expected to modestly decline to 44.3% of GDP relative to 45.2% the year before. The expenditure level in terms of GDP was expected to further decline to 49.3% of GDP, which is a two percentage reduction over the past three years, resulting in a deficit of 5% of GDP. Current expenditure including the wage bill (10.3% of GDP) was expected to continue to decline in 2003 to now 42.5% of GDP (compared to 43.2% in 2002) whereas capital expenditure increased for the fourth year in a row to 6.4% of GDP. Budget amendments in September left the overall revenue and expenditure unchanged. However, better than foreseen revenue collection during 2003 drove the revenue ratio up and the budget deficit target was changed to 4.6%. This allowed to hold the debt stock stable at 51.5% of GDP. Further adjustment efforts were unlikely in an election year but may result from some under-executing of expenditure.

***Monetary policy.*** The overall fiscal consolidation provided room for the easing of monetary policy in 2002 resulting in falling average interest rates for enterprises and households throughout the year. However, against the background of strong credit growth, the Croatian Central Bank (HNB) introduced in mid-January 2003 a number of strict administrative measures, which are likely to be phased out by the beginning of the year. With a view to containing external borrowing, the HNB increased in August 2003 the foreign exchange component of reserve requirement for banks allocated in kuna (HRK) from 25% to 35% and again in November in two steps to eventually 42% by December, which will remain effective in 2004. These measures contributed to slowing down nominal credit growth from 31.3% in 2002 to an expected 14.3% by the end of 2003 but are likely to have produced some circumvention effects (e.g. leasing).

In 2002, the nominal exchange rate of the kuna vis-à-vis the euro followed the customary seasonal pattern with appreciation towards the Summer during the main tourist season (3.3% from January to June) before weakening again. At the end of the period the exchange rate had depreciated by 1% relative to December 2001. Over the first 11 months of 2003, the seasonal pattern of the exchange rate has been less pronounced than in the past and the HNB has kept the exchange rate below 7.7 HRK/EUR in 2003[29]. The exchange rate as of end November depreciated some 2.9% relative to end of 2002, which is still slightly higher than at the end of 1999. As a result of the US dollar depreciation versus the euro, the gross international reserves of the Central Bank expressed in US dollar grew steeply in the course of 2002 (+25%) and further in 2003 to peak at some USD 7 billion in September (+20% compared to December 2002, equivalent to more than 5 months of imports) notwithstanding a modest dip of reserves between May and September.

[28] Elimination of double counting of direct debt and guarantee items
[29] Since the kuna is effectively anchored to the euro, the exchange rate vis-à-vis the USD essentially follows the development of the euro (resulting in a 14.5% appreciation by December 2002 (yoy).

Exchange rate stability remains at the centre of monetary policy and is crucial given the high degree of euroisation. As of 30 September 2003, foreign currency deposits including those denominated in, or indexed to, foreign currencies corresponded to 87.4% of total deposits, but the share is on a modestly declining trend. Similarly, most bank loans are denominated in, or indexed to, foreign exchange (74.7%) but many recipients do receive kuna-denominated income and/or do not have access to hedging instruments. Unwilling to allow for more exchange rate volatility, the HNB seems committed to use its supervisory powers to ensure proper risk pricing.

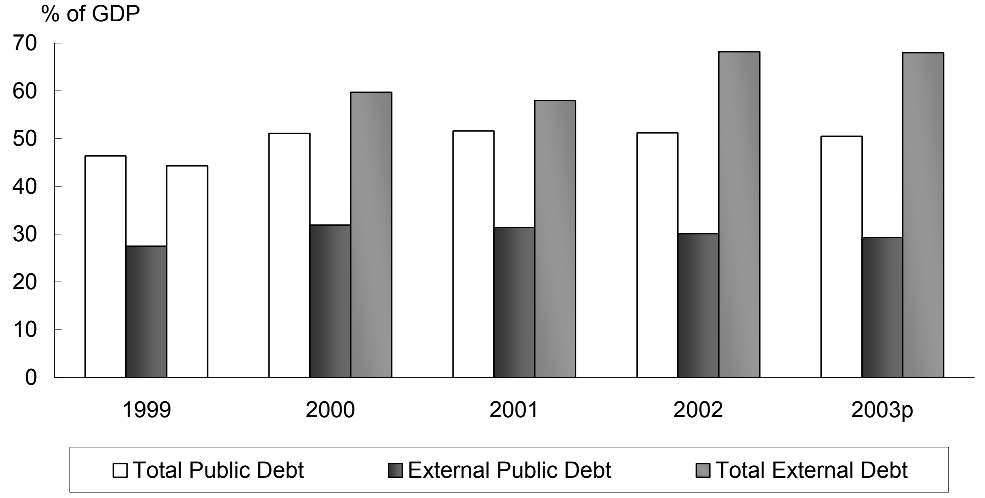
***External situation.*** Croatia in recent years has run merchandise trade deficits, which were however partially offset by surpluses on the services balance. For the entire year 2002, the growth of merchandise exports was again outpaced by import growth (5% compared to 16%) resulting in a significant trade deficit in the order of 23% of GDP in 2002. The relative strength of the kuna, the subdued demand from the EU, in particular as regards the most important export markets (Italy and Germany), and the modest industrial performance hindered a more pronounced upturn of exports. For the first time Bosnia and Herzegovina was the second most important export destination ahead of Germany and behind Italy. More generally, there are first indications that trade with the region and also with CEFTA countries seems to pick up.

Despite favourable tourism income (+14%) and more optimistic forecasts, the current account deficit in 2002 almost doubled (7.2% of GDP compared to 3.7% in 2001) highlighting a deterioration of the saving-investment balance of the non-government sector linked to the highway construction by public enterprises and also private consumption. The reliability of balance of payment data remains a concern: the net errors and omission item equals about 5% of GDP, up from some 3% in 2001. For 2003, the size of contraction of the current account deficit will rely on the tourism season since the negative trends in trade continue. Even though exports have grown by 25% in the first nine months of 2003, the strong import growth results in a widening of the trade deficit by 38% compared to 2002[30]. Both the nominal and real effective exchange rate appreciated in the order of 3.4-3.5% (December 2002, year on year). The external competitiveness of Croatia has however not deteriorated since the appreciation has been equally pronounced in the main competitors and trading partners. The same applies to unit labour costs.

By the end of 2002, the external debt stock expressed in US dollar increased by 36% relative to 2001, but only by 10 percentage points to 68.2% as a share of GDP since some 70% of the debt stock is denominated in euro. The public debt represents roughly 41% of the total external debt stock. External debt service corresponded to 27.5% of exports in 2002. The debt stock grew further by 24% in the first seven months of 2003 (roughly a third of this increase can be attributed to the depreciation of the US dollar against the euro) but should remain in the order of 70% of GDP by the end of 2003. The current account deficit together with the rising external debt (see chart 11) triggered the above mentioned administrative measures to contain credit growth.

[30] It should be noted that the weakening of USD has an effect on the USD value of trade in view of the fact that most of Croatian exports (some 67%) and imports (some 74%) are denominated in euro.

**Chart 11. Croatia - Debt developments. 1999 - 2003P**




Source: IMF, national sources

P Projections

## Structural reforms

In 2002 and 2003 structural reforms continued to be implemented in Croatia. However, the pace was generally moderate reflecting the fragility of a multi-party coalition in a pre-election context. More recently, a number of important decisions have been taken such as the adoption of important laws for the economic domain and the privatisation of the oil company INA. They call for a careful and swift implementation and follow-up to reap their full benefit.

***Public administration reform – Management of public expenditures and revenues.*** In the area of public finance, the New Organic Budget Law was adopted by Parliament on 29 May 2003 taking into account most of the comments of international experts. This includes rules on the organisation of internal and external audit functions. The authorities shifted basic payments functions to the Central Bank. The original intention of shifting important tasks of debt management to a newly established body inside the Central Bank and to make HNB the genuine fiscal agent of the government did not materialise.

The Government is working towards a stricter and more consistent policy on conditions for State guarantees and has limited the issuance of financial guarantees for 2003. It issued a decree on the criteria for guarantee issuance aiming at zero net issuance and the Ministry of Finance is developing a register of government guarantees to enable better monitoring. According to this register, the cumulative stock of issued financial guarantees increased by end September 2003 but remained unchanged at 10.5% as a share of GDP relative to the end of 2002. There are obvious and continued weaknesses in the production of timely, comprehensive and reliable data on fiscal developments including guarantees.

On 28 May 2003, the first Government Kuna Bonds were issued (HRK 1 billion equivalent to EUR 133 million) carrying 6.125% interest rate with a 5-year maturity. The main clients were institutional investors like pension funds, although bonds will also be available to individual investors on the Zagreb Stock Exchange. The Kuna

Bonds are in line with the Government commitment to shift from foreign to domestic borrowing to develop the local capital market but current trends do not yet support this shift in 2003.

***Enterprise reform – Enterprise restructuring and privatisation.*** According to Government data, the state-owned companies registered HRK 3.4 billion (EUR 460 million) profits in 2002 compared to losses of HRK 1 billion (EUR 135 million) in 2000. For a number of companies, the positive results are however a consequence of subdued competition in the relevant markets. The Government also approved their 2003 business and investment plans worth HRK 19 billion (EUR 2.5 billion) of which the business plan of Croatian Railways is the most important. The shipbuilding sector remains a continued source of concern asking repeatedly for budget resources.

As regards large scale privatisation, the purchase of a 25% plus one share stake in the petrol company INA was finally approved in July 2003 with the Hungarian MOL being the successful bidder (even though the payment only materialised in early November). The sale of a 7% stake in the Croatian Telecom Company (HT) to employees has been postponed until after the elections. The authorities intend to partly privatise the power generation and distribution entities of the electricity company HEP, but probably not before 2005.

The government adopted the Privatisation plan of the Croatian Privatisation Fund (HFP) to divest all minority state's shareholdings (967 companies) and to offer stakes in companies with majority state ownership (170) through public tenders. Despite a politically inspired resignation of the HFP board in the beginning of 2003, the progress of privatisation projects that were under preparation (focussing on privatising tourism and agricultural enterprises) has apparently continued. On the other hand, the recent adoption by the government of a proposal to dissolve the HFP and to establish a new entity completing the privatisation, has slowed down the preparation of new projects. The portfolio of the HFP comprises some 1,080 companies as of November 2003 of which the state ownership is above 50% in 156 companies.

More generally, a number of new laws were adopted in the past months aiming at modernising the commercial law framework including the company law, competition law, bankruptcy law and labour law. The key will be to establish the appropriate implementation capacity in the legal system which is characterised by a number of problems (slow procedures, substantial backlog of cases, varying legal opinion and interpretation within the courts system, low administrative, professional and technical capacity).

**Financial sector reform.** The consolidation of the banking sector continues. The number of savings banks has more than halved since the end of 2001 from 21 to 10 institutions, which was triggered by stepped up prudential capital requirements. The top ten commercial banks hold a dominating position of around 87% (as of end September) both of total assets and deposits. The overall number of banks is likely to decrease in the near future taking into account the on-going plans of the six foreign-owned banking groups in Croatia, controlling more than 90% of banking assets, to consolidate the past acquisitions of smaller banks. The authorities plan to privatise the remaining two state banks, i.e. the Postal bank (HPB) and Croatia banka. Furthermore, the Government aims to reach an agreement with the Catholic Church which is being offered a 25% stake in Croatia Osiguranje as compensation for nationalised Church property.

Foreign ownership has been instrumental to modernise and widen the range of products and loan maturities. According to performance indicators, the profitability and soundness of financial institutions has not deteriorated. In September 2003, commercial banks agreed to establish a central register of debtors. It remains to be seen whether the recent growth of lending activity in particular to private households will have an impact on the credit quality. Some part of the credit risks associated with banks' retail portfolios have apparently been transferred to insurance companies. This will represent an important challenge for the supervisory agencies.

The development of capital markets remains limited with a number of companies taken over by foreign investors, which further reduced the number of listed companies. However, the authorities established rules for obligatory listing of companies even though shares might not be traded. Given the investment needs of pension funds, the authorities also promised to increase domestic borrowing under the current IMF programme. A new foreign exchange law was adopted in June 2003 further liberalising the use of foreign currencies.

***Trade liberalisation.*** Croatia has been a member of the WTO since November 2000. It is now reducing its external tariffs according to the schedule agreed within the WTO agreement. The weighted average tariff rate for industrial products on MFN basis (most-favoured nation) stood at 3.5% at the beginning of 2003. In the context of the Memorandum of Understanding on trade under the Stability Pact, Croatia completed negotiations on Free Trade Agreements (FTAs) with all neighbouring countries at the end of 2002. Other FTAs signed concern Turkey and Lithuania thus increasing the number of countries covered by FTAs to 31. As of 1 March 2003, Croatia's membership in CEFTA became effective.

The economic effect of the increased openness has been limited as regards Croatia's export performance. This can be traced back to a number of factors. First of all, not all FTAs signed are in force yet. Secondly, the export structure is largely unchanged and thus reflects the continued domination of former and current public enterprises (in particular shipbuilding with large import components) as well as the lack of significant FDI in the manufacturing sector. Furthermore Croatian companies are often not able to apply the EC standards and Croatia is not yet included in the Pan-European System of Diagonal Cumulation of Rules of Origin.

## International relations

***Stabilisation and Association Process.*** Croatia has been participating in the Stabilisation and Association process (SAp) since its very beginning and has benefited from its overall co-operation framework, including preferential trade concessions and financial assistance. It was the second country to sign a Stabilisation and Association Agreement (SAA, in October 2001) with the EU, which has been ratified by 10 Member States as of December 2003[31]. Pending the complete ratification of the SAA, an Interim Agreement on trade and trade-related matters is in force since 1 March

[31] COM (2001) 371 final, available on:
http://europa.eu.int/comm/external_relations/see/docs/index.htm#sap

2002[32]. This agreement provides for the establishment of a free trade area with the EU over a transitional period of six years. Implementation is asymmetrical since Croatia already benefits from the EU's autonomous trade preferences. On 26 March 2003, the European Commission adopted the Stabilisation and Association Report 2003 including a Commission Staff Working Paper on Croatia[33].

Croatia submitted on 20 February 2003 its application for EU membership. On 14 April, the Council invited the European Commission to draft an opinion on the application. The Commission opinion is expected to be finalised in Spring 2004.

***EC assistance.*** EC assistance for Croatia is provided under CARDS and the provision of assistance is guided by the strategic framework of the Country Strategy Paper 2002-2006[34]. On 6 June 2003, the European Commission adopted its Annual Programme for Croatia under the 2003 Community budget, totalling EUR 62 million. The priority areas are economic and social development, democratic stabilisation, justice and home affairs, administrative capacity building, and environment and natural resources.

Since the extension of the external lending mandate to Croatia in November 2000, the *European Investment Bank (EIB)* has signed eleven projects as of December 2003 totalling EUR 446 million. Apart from global loans which channel SME finance through local banks, the EIB has continued with its traditional focus on infrastructure projects, providing an additional EUR 230 million in financing of transport projects listed by the Infrastructure Steering Group (ISG).

***Relations with IFIs.*** The *IMF* Board approved on 3 February 2003 a 14-month stand-by arrangement (SBA) which will formally expire on 4 April 2004. The first two reviews were completed in August and November 2003. The SBA amounts to SDR 105.88 million (about USD 147 million) but is of a precautionary character as the previous SBA (which expired on 18 May 2002), indicating that the authorities do not intend to draw on the funds. At the outset, the main aim of the SBA was to stabilise the public debt ratio through fiscal prudence whereas the review broadened the focus and underlined the need to contain the external current account deficit and external debt. The subsequent IMF programmes have proved useful to support the government policies of macroeconomic stabilisation and should be continued.

The *World Bank* continues to play an important role in Croatia. Since 1993, the Bank committed a total amount of USD 1,226 million for 23 projects (of which 12 are still active). A Structural Adjustment Loan (SAL) of USD 202 million was fully disbursed by October 2003 (a first tranche of USD 102 million was disbursed in February 2002). In addition to financial assistance, the World Bank provided for several analytical and policy studies through its agencies. The Bank presented in Autumn a broad scope Country Economic Memorandum (CEM) identifying key challenges in Croatia's transition process. The findings of the CEM are meant to underpin the design of a new Country Assistance Strategy supported by a three-year Programmatic Adjustment Loan (PAL).

[32] Council Decision 2001/868/EC of 29 October 2001, OJ L330 of 14.12.2001

[33] COM (2003) 139 final of 26 March 2003 including Commission Staff Working paper on Croatia (SEC (2003) 341); available on: http://europa.eu.int/comm/external_relations/see/sap/rep2/com03_341.htm

[34] see http://europa.eu.int/comm/external_relations/see/croatia/csp/index.htm

Croatia is member of the *European Bank for Reconstruction and Development (EBRD)* since March 1993. By December 2002, the EBRD had made a cumulative commitment of about EUR 1,161 million , contributing to a total project value of almost EUR 3.5 billion excluding regional investments. About 70% of EBRD's total portfolio in Croatia relates to private sector projects.

**Concluding remarks**

Croatia has achieved a rather stable macroeconomic framework in the past years with sound growth, low inflation and an improved fiscal stance. Structural reforms progressed but at a moderate speed. The deterioration of the external situation and the rapid increase of the external debt need close monitoring. Therefore, the policy of fiscal consolidation should be continued and structural reforms need to be accelerated also with a view to the challenges related to EU rapprochement. More is needed to enhance the role of the private sector in the economy and to make Croatian products more competitive. Several important laws for the economic domain have been adopted in 2003 and the partial privatisation of the oil company INA was completed. The key follow-up will be to establish the capacity for appropriate implementation and enforcement of the legislation. The new momentum should be used to continue with privatisation projects that help to utilise the economic potential of Croatia like in tourism. As in the past, the IFIs should continue to play an active role in Croatia’s adjustment and reform process.

# FORMER YUGOSLAV REPUBLIC OF MACEDONIA

- **After a modest performance in 2002, the economy of the former Yugoslav Republic of Macedonia showed some positive signs in the course of 2003. GDP growth is estimated to reach around 3%, fiscal deficit to fall to 1.5% of GDP, while inflation remains under control.**

- **The external accounts recorded an improvement in 2003, but the trade deficit as share of GDP is expected to remain large, with private and official transfers contributing to limit the current account deficit.**

- **The structural reform process slowed down and reached almost a standstill in the course of 2002, regaining momentum towards the end of the year, after the formation of the new Government. The signature of a new agreement with the IMF in Spring 2003 gave fresh impetus to the reform process.**

- **The ratification process of the Stabilisation and Association Agreement (SAA) is almost completed. The authorities launched an action plan for the implementation of the recommendations provided by the European Commission in the annual Stabilisation and Association report.**

**Table 12. former Yugoslav Republic of Macedonia - Main Economic Trends. 1998 - 2003**

| | | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 [p] |
|---|---|---|---|---|---|---|---|
| Real GDP growth | *Percent* | 3.4 | 4.3 | 4.6 | -4.5 | 0.9 | 3.0 |
| Inflation rate | *Percent (average)* | 0.8 | -1.1 | 5.8 | 5.3 | 2.4 | 1.2 |
| | *Percent (end-of-period)* | -1.0 | 2.3 | 6.1 | 3.7 | 1.0 | 2.4 |
| Unemployment rate | *Percent of labour force* | 34.5 | 32.4 | 32.2 | 30.5 | 31.9 | 36.7 |
| General government balance | *Percent of GDP* | -1.7 | 0.0 | 1.8 | -7.2 | -5.7 | -1.5 |
| Trade balance | *Percent of GDP* | -14.4 | -12.5 | -19.3 | -15.2 | -20.5 | -17.2 |
| Current account balance (1) | *Percent of GDP* | -8.6 | -2.9 | -5.8 | -8.2 | -11.3 | -8.3 |
| Current account balance (2) | *Percent of GDP* | -7.5 | -0.8 | -2.1 | -6.8 | -8.6 | -6.2 |
| External debt | *Percent of GDP* | 38.5 | 39.2 | 40.1 | 38 | 38.8 | 33 |
| | *Billion EUR* | 1.2 | 1.4 | 1.6 | 1.5 | 1.5 | 1.3 |
| Debt–export ratio | *Percent* | 107 | 121 | 109 | 113 | 130 | 114 |
| Foreign direct investment (3) | *Percent of GDP* | 3.3 | 0.9 | 4.9 | 13.0 | 2.0 | 1.0 |
| | *Million EUR* | 105 | 30 | 191 | 498 | 82 | 41 |

[p] Projections. *Sources*: National authorities, IMF, EC estimates. (1) Before grants (2) After grants. (3) Net.

The former Yugoslav Republic of Macedonia is one of the smallest economies of the Western Balkans and has a population of around 2 million. In 2002, the nominal GDP of the country reached EUR 3.9 billion, which represents around 7% of the regional GDP and corresponds to a per capita GDP of around EUR 2,000. The service sector accounts for around 60% of GDP, and industry and constructions for almost 30%. The share of the agricultural sector in total GDP is around 10%, against an EU average of 2%. The former Yugoslav Republic of Macedonia is very open to trade; the sum of exports and imports of goods and services is equal to around 95% of GDP (2002). The main trading partner of the former Yugoslav Republic of Macedonia is the EU, with a share of 47% in total trade (51% of total exports and around 45% of total imports) in 2002.

**Macroeconomic developments**

In 2002, the performance of the economy was quite modest. GDP posted a slight increase by 0.9%. Several factors such as the persistence of the negative effects of the 2001 crisis, the weak external environment, the political uncertainty surrounding the general elections in September and the lack of an IMF agreement had a negative impact on the economic and business climate. Industrial production declined by around 5% in 2002. This contraction was however compensated by positive growth in agriculture (+2.3%) and the service sector (+4%). Total employment fell by 6% compared to 2001, whereas official unemployment, according to ILO standards, increased to around 32% of the labour force, from 30.5% in the previous year. However, unemployment figures should be assessed with care, considering the large size of the grey economy.

Preliminary economic data for 2003 show some positive signs. GDP growth reached 2.7% in the first half of the year. Industrial production increased by 3.7% in the first eight months of 2003, compared to the same period of the previous year, thanks to a positive performance of the textile and the steel and iron sectors. Real GDP is expected to grow by 3% in 2003. However, this resumption in economic activity is not yet sufficient to recover the pre-crisis GDP level of 2000. Latest data based on the Labour Force Survey (ILO standards) point to an increase in the official unemployment rate to almost 37% in 2003, owing mainly to a higher participation rate in the labour force that is not matched by a corresponding job creation.

Inflation remained under control in 2002, with consumer prices increasing by less than 3% on average and the end-of-year inflation rate bottoming out at 1%. In the first half of 2003, in spite of the increase in VAT rates (see below) and the peak in oil prices, consumer prices increased on average by only 0.3% on an annual basis, owing to lower food costs. Average inflation is forecast at 1.2% in 2003.

***Fiscal situation.*** In 2002, fiscal performance slightly improved, due to reduced security-related expenditures and higher than expected revenues. The general government deficit (excluding foreign-financed projects in the budget) decreased to 5.6% (from 6.3% in 2001), but went well beyond the initial plan of 3%. Some pre-electoral spending decisions - such as the increase by 12% on average in public sector wages and the decision to reimburse depositors who lost their savings in the 1997 TAT pyramid scheme - had a negative impact on public finances. General government revenues increased from 34% in 2001 to 35.3% of GDP in 2002, boosted by the favourable VAT collection and the temporary tax on financial transactions, which however had distortionary effects and ceased to exist at the end of the year. Total expenditures as a share of GDP remained broadly stable at around 41%, well beyond their pre-crisis level of 35% of GDP.

In 2003, the general government deficit is expected to have reached 1.5% of GDP, which represents a fiscal adjustment by 4 percentage points of GDP with respect to the previous year. This relatively large correction may be explained by the underexecution of planned capital expenditure, and the reduction or elimination of some significant non-recurrent expenditures in 2002, such as security-related expenditures and the one-off repayment to depositors involved in the TAT pyramid scheme. The 2003 budget also contained a mix of expenditure cuts and tax increases.

In particular, the authorities raised the VAT rate applied to electricity and other staples (excluding food, water and printed materials) from the preferential level of 5% to the standard level, which was at the same time reduced from 19% to 18%. According to the IMF stabilisation programme, the planned fiscal deficits should allow for a rapid reduction of the gross government debt, which is expected to fall from 50% in 2002, to 45% in 2003 and then to 42% in 2004, moving closer towards a long-term target level of 40% of GDP.

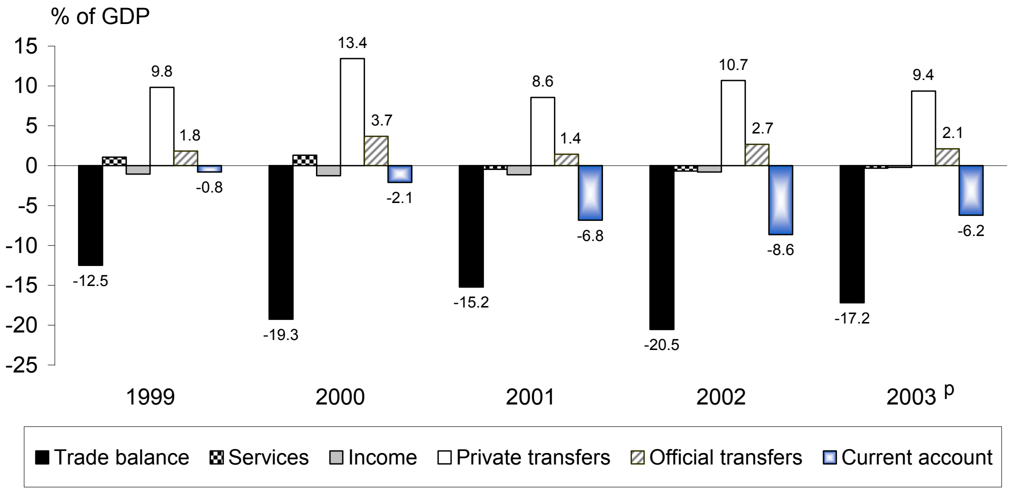
***Monetary policy.*** A tight monetary policy and the preservation of the exchange rate anchor contributed to maintaining inflation under control. The Macedonian denar (MKD) has been de-facto pegged to the Deutsche mark and then to the euro – at around MKD 61 per euro - since full current account convertibility was introduced in 1998.

After the new government reached an agreement with the IMF on a 14-month Stand-by Arrangement in February 2003, the central bank has been more resolute in easing monetary policy. The central bank lowered the discount rate from 10.7%, the level since June 2001, to 8% in February 2003 and to 6% in April. In the course of 2003, the average interest rate on Central Bank bills declined from 14.7% in January to around 6.5% in October. However, commercial banks did not fully pass the decline in interest rates through to their customers. In September, average lending rates were still high at 15.3% against an average deposit rate of 7.4%.

***External situation.*** In 2002, exports continued to decline (-4%) while imports reversed the negative trend of 2001 and rose substantially (+12%) compared to the previous year. This resulted in a considerable widening of the trade deficit, which reached around 20% of GDP. Exports reached their lowest level over the past eight years. A strong resumption in private and official transfers, from 10% of GDP in 2001 to 13.4% in 2002, partly compensated for the widening of the trade deficit and contributed to limiting the current account deficit to 8.6% of GDP, which however increased by two percentage points compared to 2001 (see chart 12). In 2002, FDI amounted to about EUR 80 million or around 2% of GDP, dropping compared to the exceptional level of 2001, when FDI had reached almost EUR 500 million or more than 13% of GDP, owing to the privatisation of the national telecommunications operator. Gross official reserves decreased by EUR 20 million, reaching around EUR 705 million at the end of 2002. This is equivalent to 4 months of following year's imports of goods and services.

In 2003, the trade deficit is expected to have widened in dollar terms but improved in terms of GDP owing to exchange rate effects. Exports are expected to recover, as a result of new contracts in the textile industry, the re-opening of the large formerly loss-making enterprise Jugohrom and the resumption of oil exports by OKTA. In the first three quarters of 2003, exports increased by 20%, thanks to a good performance of the textile and steel and iron sectors, while imports rose by 17%, mainly because of an increase in imports of crude oil, goods for processing and raw materials. The end-year target trade deficit was set at more than EUR 700 million, corresponding to 17.2% of GDP. In 2003, the current account deficit (including grants) is expected to have fallen to 6.2% of GDP (see chart 12). According to the IMF, both FDI and net short-term capital inflows are expected to amount to a level equivalent to around 1% of GDP each. These flows are not sufficient to compensate for the gap in the current account balance, resulting in a balance of payments deficit. This is expected to have been financed by the release of substantial donor support (about EUR 106 million or around 3% of 2003 GDP), including EC macro-financial assistance, which allowed to maintain foreign exchange reserve at a level equivalent to four months of imports.

**Chart 12. former Yugoslav Republic of Macedonia**
**Current account balance. 1999 - 2003$^{p}$**




Source: National Bank and IMF

p Projections

The external debt remained relatively moderate, amounting to EUR 1.5 billion or around 39% of GDP at the end of 2002. The bulk of this debt, around 96%, consists of medium and long-term debt. The former Yugoslav Republic of Macedonia has been meeting its debt servicing obligations on a regular basis, which are estimated at about 16.5% of exports of goods and services in 2002. According to the IMF, the external debt as ratio to GDP declined by five to six percentage points in the course of 2003, in part due to the weakening of the US dollar against the euro. Government and the non-financial private sector do not have direct access to international financial markets, which may only take place indirectly, through the banking system.

## Structural reforms

The structural reform process slowed down and reached almost a standstill in the course of 2001-2002. It progressively regained pace towards the end of 2002, once the political uncertainty generated by the Autumn election had dissolved and the new government, which was formed at the end of October, had launched its programme. In particular, the signature of a new agreement with the IMF in Spring 2003 (see below) triggered the release of substantial foreign financial assistance, which had been frozen since the previous year, and gave fresh impetus to the reform process in the course of 2003.

***Public administration reform – Management of public expenditures and revenues.*** The downsizing and modernisation of the public administration is one of the priorities in the reform agenda. With the support of the World Bank and other bilateral donors, the authorities divested several non-core functions of the public sector. They began the functional analysis in all ministries - except for the Ministry of Culture and the Ministry of Economy - in order to identify strategic objectives and activities. Some progress was made also in the development of the General Secretariat, which should support the government in setting strategic priorities, co-ordinating and monitoring their implementation. More important, in early 2003 and ahead of the Budget preparation, the Government prepared a document establishing strategic guidelines and set clear expenditure ceilings for the various Ministries, which were enforced by the Ministry of Finance. Following the agreement with the IMF, the Government committed to reinforce the control of the wage bill in the public sector, freezing also public sector employment on a net basis, except for hires related to the peace Framework Agreement. However, the decompression of the civil service salary structure, which should grant adequate incentives to public sector employees, initially foreseen in 2003, has been postponed to 2004.

Public expenditure control in the former Yugoslav Republic of Macedonia has made substantial progress. The reform of the Treasury, initiated in 1999, is still ongoing and a Treasury single account, identifying all budget users, has been introduced and is now operational. This single account includes all central government revenues and expenditures and its scope should be extended in order to encompass also extra-budgetary funds, without however providing a control mechanism for the latter. In the Spring of 2003, the Government amended the law on Budgets and the Law on Public Procurement in order to ensure proper supervision and control by the Treasury over line ministries' expenditure commitments and payments arrears. In June 2003, the authorities prepared a draft Strategy for the Development of Government Securities Market. The first issue of short-term Government securities, using the central bank as agent, is expected for the beginning of 2004.

Fiscal decentralisation – one of the commitments of the Ohrid Framework Agreement - is high on the reform agenda of the Government. In the country, fiscal policy remains highly centralised, whereas municipalities have few fiscal responsibilities, spending only around 1.8% of GDP and collecting revenues for less than 1% of GDP. In January 2002, the Law on Local Self-Government, which defines a broad set of municipal responsibilities, became effective. However, the process of fiscal decentralisation depends also on the implementation of two important laws on the definition of new boundaries of the municipalities and on Local Government Financing, which were approved by the Government in December 2003. The latter law, in particular, provides a general framework for financing municipalities and identifies the fiscal resources that local governments should manage and retain for expenditure at local level.

***Enterprise reform – Enterprise restructuring and privatisation.*** The privatisation process of small and medium size enterprises (SMEs) is almost concluded. As of end of September 2003, 1,683 enterprises had been privatised, while 81 state companies of those included in the privatisation programme that began in 1993 were left for sale. The Government is now focusing on measures and activities to support the development and enhance competitiveness of SMEs. In January 2003, it adopted a programme on Small Enterprises Development Support and Entrepreneurship Encouragement and, in September, the Parliament approved a law setting up the Agency for Promotion of Entrepreneurship. The authorities also endorsed the principles of the European Charter for Small Enterprises, and set up a strategy for their implementation. On the contrary, the process of large-scale restructuring and privatisation is proceeding at a slow pace. In 2000, the government had launched an

Action Plan, which identified 40 large loss-making enterprises to be restructured, privatised or liquidated. The implementation of the programme was virtually suspended during the second half of 2002, with the main exception of the liquidation and sale of the assets of Jugohrom - a large metallurgical company - to the French company SCMM in September 2002. The process resumed in the first half of 2003 and was expected to be completed by the end of the year.

***Financial sector reform.*** The financial sector in the former Yugoslav Republic of Macedonia is dominated by the banking sector, while the role of non-bank financial institutions is very limited. The banking sector is highly concentrated, the three largest banks having a combined market share of 65% in terms of total assets. It is largely privatised, with 84% of total capital of the sector in private hands, and characterised by a substantial degree of foreign participation – 40% of total banking capital is in foreign hands. Confidence in the banking sector has been steadily increasing, thanks to the monetary stability. However, banks are not yet either willing or properly equipped in terms of human resources to expand their lending activity against an increasing deposit base. In 2003, six banks were under enhanced supervision by the National Bank, but the repercussions on financial stability of the whole system were rather small, since all these banks were not particularly large. As of mid-2003, the capital adequacy ratio of the banking system was high, 28%, owing to the high liquidity of banks, while non-performing loans represented 16% of total portfolio assets. Banking supervision in the country should further improve thanks to the implementation of a new regulation on consolidated accounting and banking supervision, which is expected to be approved by the central bank by the end of 2003. The financial sector of the country was recently assessed by a joint World Bank/IMF mission. The IMF Financial Sector Stability Assessment (November 2003) notes that, while the financial sector's role in intermediation is still limited, a core group of banks with sound and prudent practices is emerging. Remaining vulnerabilities include poor governance in a few smaller banks and weaknesses in banks' balance sheets.

***Trade liberalisation.*** An Interim Agreement with the EU on trade and trade-related matters entered into force in June 2001, after the signature of the broader SAA in April 2001 (see also below). The Interim Agreement foresees a gradual and asymmetric liberalisation of trade with the EU[35]. In 2002, the former Yugoslav Republic of Macedonia made some significant steps towards the liberalisation of its trade regime, signing Free Trade Agreements with Bosnia and Herzegovina, Albania and Romania and thus completing the network of bilateral regional agreements envisaged by the Stability Pact for South East Europe. Moreover, in Autumn 2002, the country concluded the negotiations for entry in the WTO, becoming officially on 4 April 2003 the 146th member of the organisation.

## International relations

***Stabilisation and Association Process.*** The European Union (together with its partners in the OSCE as well as with NATO and the United States) has consistently

[35] With the exception of some agricultural and fishery products, the EU eliminated, upon entry into force of the agreement in June 2001, custom duties, quantitative measures and charges and measures having equivalent effect on imports from the former Yugoslav Republic of Macedonia. The latter instead eliminated quantitative restrictions on imports from the EU when the agreement entered into force and, over a period of ten years starting from that date, it will fully liberalise imports from the EU.

supported the process of normalisation of the country based on the Ohrid Framework Agreement (August 2001), which settled the internal civil strife that had started. The implementation of the Framework Agreement will also enhance progress in the SAp. The process of ratification of the Stabilisation and Association Agreement, which was signed in April 2001[36], is almost completed. In Spring 2003, the authorities prepared and adopted an action plan for the implementation of the recommendations of the EC Report 2003 on the SAp[37].

***EC assistance.*** Under the current CARDS programme, the former Yugoslav Republic of Macedonia benefited from EUR 36.5 million in 2002 and EUR 38.5 million in 2003, after around EUR 56 million of EC assistance in 2001. The 2003 CARDS programme includes projects in the area of democracy and the rule of law, economic and social development, justice and home affairs, and environment.

The Commission has completed the disbursement of the macro-financial assistance decided by the Council in November 1999 (EUR 80 million), which was increased by EUR 18 million in December 2001, bringing the total assistance to up to EUR 98 million. The third tranche amounting to EUR 20 million was released in May/June 2003, following the approval of the new stand-by arrangement with the IMF. The fourth and final tranche of balance of payments support – up to EUR 26 million – was released at the end of 2003, upon satisfactory fulfilment of the economic policy conditions attached to it.

Since 1998, the *European Investment Bank* had supported projects in the former Yugoslav Republic of Macedonia for a total of EUR 163 million. They were concentrated in the area of transport – in particular road construction – and small and medium enterprise financing. In 2003, a project in support of the energy sector was approved (EUR 13 million).

***Relations with IFIs.*** Relations with the *IMF* have not been always smooth over the past years: a programme which was launched in 2000 went off track partly because of the 2001 security crisis. In December 2001, the former Yugoslav Republic of Macedonia authorities had requested a Staff Monitored Programme (SMP), in order to establish a track record for an eventual new IMF programme. Nevertheless, the 6-month SMP expired at the end of June 2002, while the previous government failed to reach an agreement with the IMF on new SBA. On April 2003, the IMF Executive Board approved an agreement on a 14-month SBA of SDR 20 million (around EUR 25 million). The programme was on track in the course of 2003 and the first review of the SBA was successfully completed in October 2003.

As regards the relations with the *World Bank* Group, during the second half of 2002, the disbursement of World Bank assistance was frozen because of the lack of an adequate macroeconomic framework. After the new IMF SBA was approved in Spring 2003, the World Bank disbursed USD 17 million (around EUR 15 million) under the PSMAC (Public Sector Management Adjustment Credit) arrangement and USD 20 million (EUR 18 million) for the second tranche of the FESAL 2 (Financial

[36] Council Decision 2001/330/EC of 9 April 2001, OJ L124 of 04.05.2001.
[37] COM (2003) 139 final of 26 March 2003. Commission Staff Working paper on the former Yugoslav Republic of Macedonia (SEC (2003) 342) available at:
http://europa.eu.int/comm/external_relations/see/sap/rep2/com03_342.htm

and Enterprise Sector Adjustment Loan) arrangement. The third and final tranche of the FESAL 2 (USD 20 million) is still outstanding. In September 2003, the Board of the World Bank approved a new Country Assistance Strategy. It envisages a – performance based - lending envelope of US$90 million (base case) over three years, which could reach up to US$165 million in a strong reform scenario. The former Yugoslav Republic of Macedonia no longer qualifies for concessional IDA assistance.

As of end of 2002, the *European Bank for Reconstruction and Development* had signed 16 projects in the former Yugoslav Republic of Macedonia, reaching a cumulative investment of around EUR 260 million in sectors such as telecommunications, transport, power, municipal infrastructure, banking and general industry. In 2003, the EBRD, with other international shareholders, opened a Micro-Finance Bank, providing typically loan up to EUR 100,000, based on a model which has been successful in other transition countries (e.g. Albania and Bosnia and Herzegovina).

**Concluding remarks**

In 2003, the former Yugoslav Republic of Macedonia achieved good results in terms of monetary stability and fiscal consolidation. In particular, the general government deficit is expected to have reached the lowest level among the countries of the region. However, economic growth is still unsatisfactory, official unemployment is growing, the trade and current account deficit still large, while foreign firms are reluctant to invest in the country. The structural reform process slowed down and reached almost a standstill in the course of 2002, regaining momentum towards the end of the year, after the formation of the new Government. The signature of a new agreement with the IMF in Spring 2003 gave momentum to structural reforms and permitted the release of substantial foreign financial assistance, including EUR 46 million of EC balance of payment support.

Over the short-medium term, the authorities should improve the risk-profile of the country, maintaining political stability, increasing the fight against corruption, introducing more flexibility in the labour market, and ensuring the enforcement of creditors' rights. Public administration reform and public expenditure management remain key challenges, encompassing the implementation of fiscal decentralisation, the decompression of civil service salary structure, greater control of expenditure in extra-budgetary funds, the introduction of audits throughout the whole administration, and the development of a market for government securities. The process of large-scale restructuring and privatisation should be completed. Finally, competitiveness and efficiency of the banking sector must improve in order to allow an easier access to finance to SMEs.

## SERBIA AND MONTENEGRO

- **The economic situation over the past year is characterised by a decline in industrial and agricultural production with services and construction remaining the main sources of an estimated 3% real growth of GDP in 2003. Inflation continues to decline, reaching 8% by end 2003.**

- **Despite large exceptional inflows of FDI in 2003, the external sector remains vulnerable given uncertain medium term prospects for private capital inflows. Financing requirements, resulting inter alia from rising debt service obligations and important investment needs, continue to be high.**

- **Following a quick start with remarkable achievements in 2001/2002, structural reforms advanced at a slower pace in 2003. The restructuring of large socially- and state-owned companies and the process of bank privatisation have been delayed.**

- **Institutional reforms and the creation of a functioning single trade policy and single market in Serbia and Montenegro are essential requirements to further progress in the SAp. Following the adoption by the State Union Parliament of the Internal Market/Trade Action Plan, the Commission started its work on a feasibility study, assessing the readiness of Serbia and Montenegro to negotiate and implement a Stabilisation and Association Agreement.**

**Table 13. Serbia and Montenegro - Main Economic Trends. 1998 - 2003**

| | | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 $^{p}$ |
|---|---|---|---|---|---|---|---|
| Real GDP growth | *Percent* | 6.7 | -18.0 | 5.0 | 5.5 | 4.0 | 3.0 |
| Inflation rate | *Percent (average)* | na | 42.0 | 73.0 | 91.0 | 20.0 | 11.7 |
| | *Percent (end-of-period)* | na | 50.0 | 113.0 | 39.0 | 14.2 | 8.0 |
| Unemployment rate | *Percent of labour force* | na | 27.0 | 27.0 | 28.0 | 29.0 | 30.0 |
| General govt. balance (1) | *Percent of GDP* | na | na | -0.9 | -1.4 | -4.5 | -4.5 |
| General govt. balance (2) | *Percent of GDP* | na | na | -0.2 | -0.7 | -3.4 | -2.1 |
| Trade balance | *Percent of GDP* | -13.1 | -15.9 | -20.8 | -24.5 | -25.0 | -25.1 |
| Current account balance (1) | *Percent of GDP* | -4.8 | -7.5 | -7.1 | -9.5 | -12.9 | -11.0 |
| Current account balance (2) | *Percent of GDP* | -4.8 | -7.5 | -3.9 | -8.8 | -8.8 | -8.1 |
| External debt | *Percent of GDP* | 76 | 106 | 132 | 103 | 73 | 61 |
| | *Billion EUR* | 9.0 | 10.6 | 12.2 | 13.5 | 11.3 | 11.9 |
| Debt–export ratio | *Percent* | 267 | 500 | 448 | 436 | 365 | 322 |
| Foreign direct investment (3) | *Percent of GDP* | 0.8 | 1.1 | 0.3 | 1.4 | 3.6 | 5.8 |
| | *Million EUR* | 101 | 105 | 27 | 184 | 597 | 1063 |

$^{p}$ Projections. *Sources*: National authorities, IMF, EC estimates. (1) Before grants. (2) After grants. (3) Net.

Serbia and Montenegro (SCG) is a small economy with a population of 8.13 million (2002 data, without Kosovo) or around 2.5% of the EU and 33% of the Western Balkan population. Its estimated 2002 GDP at current prices was around 1,000 billion Dinar or EUR 16.67 billion, representing 29% of the Western Balkans GDP. Per capita GDP in 2002 was in the order of EUR 2,050, somewhat lower than the regional average of EUR 2,400. Serbia and Montenegro's economy is less open than the regional average. This may partly be explained by the legacy of regional conflicts and international sanctions imposed on the country in the nineties. These had negative effects on its external trade relations that were not reversed until after 2000, when sanctions and embargos were lifted and trade preferences were granted by the EU. In fact, the external component of growth has somewhat diminished over the past few years, due to the economic slow-down and lack of demand in the country's main trading partners, but also as a result of a difficult process of enterprise restructuring and the still low export potential. Indeed, growth appears to be mainly driven by domestic private and government consumption backed by substantial inflows of external financial support.

The EU Member States account for almost 50% of both exports and imports of Serbia and Montenegro in 2002; the main trading partners are Italy, Germany, Greece and France.

As a result of regional dis-integration, conflicts, sanctions and economic mis-management under the Milosevic regime, recorded GDP in Serbia and Montenegro fell by about 50% during the nineties. This decline was associated with substantial changes in the structure of output. The share of industry and mining in total output fell from 47.5% in 1989 to 35% in 2000, while the share of agriculture increased from 15% to 22% during the same period. The economy has also become more service-oriented, in particular in the areas of wholesale and retail trade, repairs and transport and telecommunication. From 2000 to 2003, the economy has grown by a cumulative 18.6% in real terms. A continued slowdown in industrial output since 2001 as well as a slight reduction in agriculture, suggest a further re-orientation of the economy towards services and construction.

**Macroeconomic developments**

In 2002, real GDP grew by an estimated 4% (after around 5% in 2000 and 2001), mainly driven by the services sector while agriculture remained flat and industrial production grew by a subdued 1.8% in real terms. The poor performance of agriculture continued during the first half of 2003 due to unfavourable weather conditions (Spring drought) which led the annual output of main products such as wheat, sugar beet and barley reach historically low levels. Moreover, gross industrial production declined by 3.0% in the first nine months of 2003 compared to same period in 2002, although this indicator might substantially underestimate value added growth in an economy that is undergoing restructuring, including the closure of loss-making activities. Moreover, it should be noted that official statistics do not cover output of a developing private sector. Real growth in 2003 is now estimated to have reached around 3%, compared to the original IMF programme target of 3.5-4.5%. Growth has been mainly driven by a continued strong performance of services and construction. Official unemployment in mid-2003 was recorded at around 32.4% in Serbia and 21% in Montenegro. While enterprise restructuring is likely to raise unemployment due to large redundancies, official figures do obviously not capture employment in the informal sector, which is estimated to account for 25-50% of the formal economy in Serbia and Montenegro.

Annual retail inflation in Serbia (end of period) in 2002 came down from 39% (end 2001) to below 15%. It was further reduced to around 9% by September 2003, despite an increase of electricity prices in July (by 15% on average) in line with the IMF programme, and higher food prices as a result of the Spring drought. The price trend in 2003 would suggest an end-of-year inflation below the targeted range of 9-11%. Montenegro recorded an end-of-year inflation rate of around 9.4% in 2002, lower than in Serbia, but still very high for a euroised economy. In 2003, annual inflation was further reduced and is now projected to have reached around 8% by end-year. The relatively high inflation is partly a result of the introduction of VAT in April and an increase in electricity prices. The lack of competition in some sectors, such as trade, may also play a role.

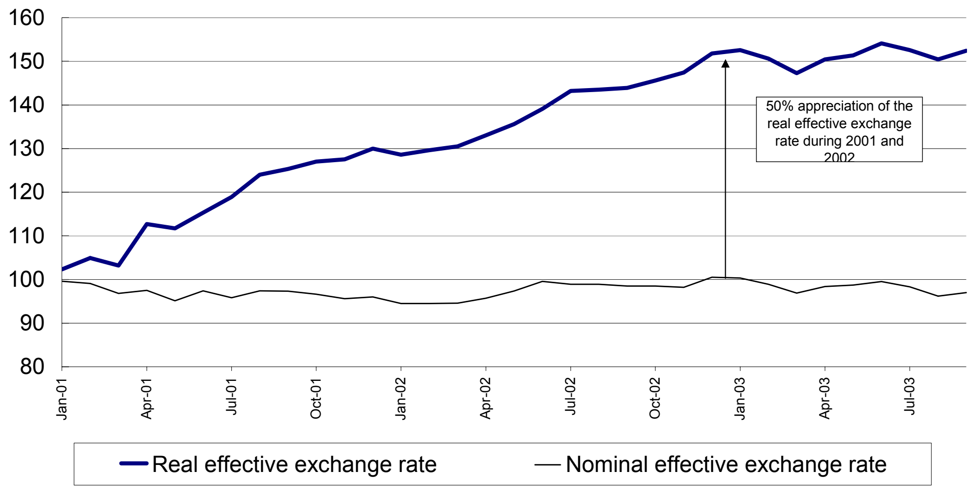
***Fiscal situation.*** The consolidated fiscal deficit in 2002 was somewhat lower than programmed (4.5% of GDP instead of 5.3%), mainly due to an over-performance of revenues, in particular sales taxes, as a result of a strong domestic demand and a broadening tax base. Improved tax performance more than compensated for a higher than programmed spending for wages and household transfers. The consolidated fiscal deficit for 2003 was programmed to be maintained at 4.5% of the GDP of Serbia and Montenegro (4.1% for Serbia and 0.4% for Montenegro), while the overall level of spending is planned to be reduced by 2 percentage points to make room for a lower tax burden, in particular in Serbia. In Serbia, budget execution in the first nine months of 2003 has reportedly been roughly in line with the budget plan with expenditures being somewhat lower than expected. Some transitional problems in revenue collection and cash management in the beginning of the year, which were related to the introduction of a new payment system, did not have a lasting negative effect on revenue collection. As a result, the consolidated Serbian deficit in 2003 was revised to some 3.5% instead of the programmed 4.1% of GDP. Due to a large net inflow of privatisation receipts of around 4% of GDP from January to October, the budget is over-financed, allowing for a net transfer to the Central Bank of around 2% of GDP, which implies an equivalent reduction of net public debt.

In Montenegro, in mid-2003, both revenues and expenditures have been increased by EUR 20 million (or 1.5% of its GDP) compared to the budget plans. An overall shortfall in revenues by some 11% in the first quarter of 2003 was compensated for during the second quarter, when revenues picked up substantially due to the introduction of VAT in April and higher revenues from excises. An increase in the number of registered employees as a result of a government's initiative to combat the grey economy had a positive impact on revenues from income taxes. The overall fiscal stance is difficult to predict due to uncertainties with respect to the financing of the expected deficit of 4% of Montenegrin GDP. In particular, it appears that foreign financing, programmed at some 3.3% of GDP, is much lower than expected which might be compensated for by higher domestic financing from commercial banks with the risk of crowding out private investment.

***Monetary policy.*** Since early 2001 and throughout 2002, the National Bank of Serbia (NBS) has pursued a rather restrictive monetary policy, which was geared to preserving the nominal exchange rate, leading to a real effective exchange rate appreciation of some 50% during this period, however, relative to an undervalued base in early 2001. In early 2003, the NBS temporarily further tightened monetary policy through an increase in reserve requirements on deposits to absorb an increase in commercial banks' liquidity that resulted from a shift of government deposits to banks in the context of the payment reform. The tight stance of monetary policy continued during the state of emergency in early spring to stabilise financial markets and inflation expectations. Since May 2003, monetary policy was somewhat relaxed through subsequent reductions of the compulsory reserve rate in line with the ongoing shift of government deposits from commercial banks to the NBS.

From January to June 2003, the exchange rate of the Dinar depreciated by some 5-6% in nominal terms vis-à-vis the euro and remained broadly unchanged in real effective terms in the first half of 2003. This was in line with the stated policy objective for 2003 to maintain a flexible exchange rate policy, primarily geared at anchoring price expectations while taking into account the impact on international competitiveness.

**Chart 13. Real and nominal effective exchange rate developments of the Dinar - Jan. 2001 - Sep. 2003**




Source: National Bank of Serbia

***External situation.*** The current account deficit in 2002 was slightly higher than expected (13% instead of 12% of GDP, before grants), due to strong import demand, but was more than offset by stronger-than-expected inflows of capital, including FDI and official loans from IFIs. As a result, official foreign reserves of the National Bank of Serbia (NBS) doubled during 2002 to EUR 2,175 million (3.4 months of imports), against an initial target of EUR 1,526 million.

For 2003, the current account deficit was expected to be reduced to 11%, mainly as a result of lower import demand (due to tighter credit conditions and fiscal stance) and continued export recovery. In the first eight months, both imports and exports increased substantially compared to the same period a year ago, by 28.8% and 22.6% in USD terms, respectively. As a result, the annualised trade deficit reached some EUR 3,792 million or around 20% of projected GDP. Net current transfers, mostly in the form of remittances, increased by 37% in the same period and financed a substantial share of the trade deficit. In the same period, the current account deficit reached some 10.6% of GDP (on an annual basis), in line with projections.

In the first quarter of 2003, the capital and financial account came under some pressure due to a number of factors, such as the re-purchase of Serbian Telecom shares from Telecom Italia, delays in obtaining external assistance and in March a decline in confidence following the assassination of the Serbian Prime Minister.

These developments contributed to a temporary reduction of official reserves by some EUR 185 million. The withdrawal of reserves was facilitated by a surge in banking liquidity in the context of the payment system reform. Following the temporary loss in reserves in the first quarter, official reserves increased continuously to a total of EUR 2,950 million by end-September (or by EUR 1,091 million). They are projected to have reached EUR 3,010 million (or 4.5 months of imports) by end-2003. The more favourable than expected external developments were largely a result of exceptionally large net inflows of FDI, that are now projected to reach EUR 1,060 million (compared to a projected level of EUR 550 million), and were driven by a few large successful privatisation deals.

Overall, the external sustainability remains a major challenge for the economy of Serbia and Montenegro. Despite substantial debt relief that is being provided by Paris Club creditors, the external debt (which stood at EUR 11.2 billion at end-2002 or 76% of GDP) will stay relatively high over the medium term. Therefore, Serbia and Montenegro will remain one of the most highly indebted countries in the region with a debt-to-export ratio of around 365% in 2002. Important financing requirements will mainly result from debt service obligations, which are projected to rise considerably, from around EUR 195 million in 2002 (5.7% of exports of goods and services) to EUR 412 million (10.7%) in 2003 and EUR 650 million (14.8%) in 2004. This ratio is likely to deteriorate further over the rest of the decade, as a result of the expiration of grace periods of restructured debt. Moreover, financing needs will result from real sector restructuring which implies huge investment needs and imports, and from a further strengthening of foreign exchange reserves. At the same time, prospects for private capital inflows remain rather uncertain, and the level of net FDI inflows will largely be determined by the pace of privatisation, as greenfield and equity investments are expected to remain low. Thus, the country is likely to require substantial inflows of official financing over the medium term.

**Structural reforms**

Public sector reform and privatisation of small and medium size enterprises continued at a commendable pace, while large enterprise and bank restructuring seemed to have lost some momentum in the course of the year.

***Public administration reform – Management of public expenditures and revenues.*** To enhance expenditure control in Serbia, an intermediate Treasury system with cash and debt management functions and a central accounting division were set up in late 2002 in the Ministry of Finance, and the establishment of a Single Treasury Account in the NBS for budget execution is moving forward and progressing well. Most ministries and other direct spending units have been progressively transferred to the Treasury during 2003. However, the management and control of extra-budgetary funds and budgets of local governmnet, accounting for 25% and 15% of consolidated government spending in Serbia, respectively, need to be further enhanced. Also, more progress is still needed in budget formulation and internal audit.

Following the adoption by the Serbian Parliament of a new Law on Tax Procedures and Administration in November 2002, the re-organisation and modernisation of the Public Revenue Agency (PRA) progressed in the first half of 2003. A new computerised system has been established and large taxpayer units have become operational in Belgrade and three other towns in Serbia. The transfer of tax collecting functions for payroll and income taxes as well as social security contributions from the old payments bureau (ZOP) to the PRA took place with effect of 1st January 2003. In order to back enhanced revenue collection, new tax identification numbers for all taxpayers have been created and constitute a precondition for the opening of bank accounts. The major next step of fiscal reforms is the introduction of VAT foreseen for mid-2004; to this effect, a draft VAT law was already adopted by the Serbian government in September 2003.

In Montenegro, following the introduction of a Treasury in the Ministry of Finance, the authorities have embarked on further reforms to contain public spending. In March 2003, the government adopted an employment and wage policy action plan. It foresees a reduction of redundant public employees, in particular by 3,000 in the education sector, as well as a larger differentiation of salaries to increase incentives for qualified staff to remain in or enter the public administration. A new Pension Law, which shifts the indexation of pensions from wage changes to a weighted average of price and wage changes and raises the minimum retirement age by 5 years in a phased manner, was adopted by the government in July 2003. The introduction of VAT in Montenegro in April 2003 marked a major reform step despite some temporary difficulties in revenue collection. Concerns have been expressed as to the adequacy of controls at the Serbia-Montenegro border, which need to be addressed to safeguard a free flow of goods within the territory of the country. This will become increasingly critical with the introduction of (a different rate of) VAT in Serbia, implying two different VAT systems operating in the two republics.

***Enterprise reform – Enterprise restructuring and privatisation.*** In Serbia, a number of laws, which aim to improve the legal and regulatory framework for private sector development, have been prepared or adopted in 2002 and 2003 by the government, but have not yet come into force due to the protracted parliamentary crisis culminating in early elections. These bills include amendments to the Serbian Privatisation Law, a new Bankruptcy Law, as well as laws on enterprises, competition, executive procedures, company registration, and procurement. These laws are partly based on recommendations of the Foreign Investors Council that was established in July 2002. New legislation came into force, including a new Accounting Law (February 2003), as well as a number of laws that broaden the scope for secured lending and thus support financing and investments (August 2003).

The Serbian authorities have taken a number of actions to strengthen the institutional capacity of the Privatisation Agency (PA). Since mid-2002, privatisation through tenders (mainly for large firms) and auctions (mainly for SMEs) in Serbia has progressed. As for tender privatisation, by end-October 2003 70 companies had been offered for sale, out of which 27 companies were sold for a total EUR 800 million in cash and EUR 600 million investment commitments. 800 small and medium-sized companies had been offered through auctions, out of which 735 were sold for a total of EUR 270 million and investment commitments of EUR 59 million.

The process of restructuring of some 50 large insolvent companies that were identified in 2002 by the PA has progressed slowly. For some of these companies, restructuring plans have been adopted, but it seems that creditors have not been willing to offer a restructuring of outstanding liabilities of these companies. In an attempt to accelerate the process, the Serbian authorities recently decided to launch conditional tenders on a case by case basis, which implies a restructuring of debt at the time of privatisation rather than before. It remains to be seen whether the new strategy will be more successful.

In Montenegro, the preparation of the privatisation of 16 large state-owned enterprises progressed with World Bank support. For all the companies, financial advisors have been chosen to prepare either restructuring plans or privatisation documentation. Following the first two tenders for two of these companies in early 2003, another eight tenders had been launched until October 2003.

***Financial sector reform.*** In Serbia, continued progress was made over the past year in financial sector supervision and restructuring. The National Bank of Serbia adopted a Supervisory Development Plan (SDP) in February 2003 that was developed and finalised with international assistance. The plan foresees to establish a new Supervisory Council to increase management oversight of banking supervision, and the harmonisation of supervisory rules with EU directives.

Following the acquisition of shares by the Serbian government in some 12 banks, which account for more than 50% of banking assets, through debt-equity swaps in August 2002, the authorities are currently developing a privatisation strategy for these banks and its implementation is envisaged to start in March 2004. The strategy will be implemented through the Bank Rehabilitation Agency (BRA) and foresees concrete steps for the efficient transfer of the state shares to private ownership. For the time until effective privatisation will take place, the NBS and the BRA have begun to put in place monitoring and control mechanisms to preserve the value of the banks. So far, the BRA has engaged an international financial advisor for the privatisation of three of its majority owned banks. A change in the top management of the BRA has obviously slowed down the process of bank restructuring. The BRA plans to issue the privatisation tenders for the three banks in the first half of 2004.

In Montenegro, the institutional framework for banking supervision has been strengthened over the past year with the introduction of new regulations on licensing, minimum capital, asset classification and provisioning and large exposures. Moreover, the authorities have eliminated loopholes that existed for offshore bank operations. The Montenegrin parliament also adopted an anti-money-laundering law in September 2003. The main progress was the successful privatisation of Montenegro Banka, which was sold to a subsidiary of a Belgian bank in May 2003. The privatisation of a second large bank, Podgorica Banka, is in preparation.

***Trade liberalisation.*** Since 2001, Serbia and Montenegro has actively pursued policies of trade liberalisation in line with the Stability Pact MoU on Trade Liberalisation and Facilitation that the country signed in June 2001. Free trade agreements (FTAs) with BiH (2002), Hungary (2002) and with the former Yugoslav Republic of Macedonia (1996) are in force. FTAs with Albania, Bulgaria and Moldova were signed in 2003. Conclusions of negotiations on FTAs with Croatia and Romania are expected soon. Delays due to internal disagreement over the state's single trade policy slowed down the finalisation of negotiations of several FTAs.

An Internal Market/Trade Action Plan which sets out a precise timetable for the creation of a single trade policy and a single market was adopted by the republican Parliaments in July and eventually by the State Union Parliament in August 2003. The Action Plan is a major step forward with respect to the harmonisation of trade, customs and excise regimes between the two republics. For some 93% of products, common tariffs are being applied immediately. However, key agricultural products were exempted from the plan, and their tariffs will be harmonised over the next several years. Moreover, a joint customs office with sufficient executive powers is not yet operational, and internal market obstacles are not yet sufficiently tackled.

Serbia and Montenegro has requested membership of the WTO in early 2002 and accession talks are ongoing.

Serbia and Montenegro has been benefiting from EU trade autonomous concessions since 2000. These concessions imply that all industrial products (with the exception of textiles and clothing) and most agricultural and fishery products can access EU markets duty and quota free. However, to date, Serbia and Montenegro has not been able to take full advantage of these autonomous trade preferences. Initial talks between the EC and Serbia and Montenegro on a trade agreement on textiles and clothing started at the end of 2003. Once in force, this agreement would remove current EC quotas on textile and clothing products and would provide for gradual market access for EU products in Serbia and Montenegro.

**International relations**

***Stabilisation and Association Process.*** A new "Enhanced Permanent Dialogue" between the European Commission and the authorities of the country was established to serve as the main platform to continue to provide policy advice for sector reforms, to deepen the work undertaken in the Consultative Task Force from 2001-2002. First meetings took place in July and October 2003. Following the adoption of the Internal Market/Trade Action Plan, the Commission started work on a feasibility study, the next step in the Stabilisation and Association process. This study would be the basis for the Commission whether or not to submit draft negotiating directives for negotiations on a Stabilisation and Association Agreement to the Council of Ministers.

***EC assistance.*** Under the *CARDS* programme the Community has provided some EUR 885 million in 2000 – 2003 to support institution building and sector reforms. Major programmes have been implemented in area such as public finance management, health sector reform, energy sector rehabilitation, infrastructure and transport, enterprise development, as well as civil society and media. Over the same period, over EUR 130 million in EC humanitarian assistance has contributed to addressing the primary needs of refugees, internally displaced persons and vulnerable local population. Moreover, the EC has been providing *macro-financial assistance* to support economic reform and stabilisation in the context of IMF adjustment programmes. A first aid package totalling EUR 345 million, including a EUR 120 million grant component, was implemented in 2001/2002. A second package of EUR 130 million, which contains a grant of EUR 75 million, was decided in November 2002; a first tranche of EUR 40 million and a second tranche of EUR 65 million have been disbursed so far. In November 2003, the Council decided to increase the amount of the second package by EUR 70 million up to EUR 200 million to help comforting additional balance of payments needs that were identified by the IMF.

After two years of operation in Serbia and in Montenegro, the *European Investment Bank* approved eight loan facilities for a total amount of EUR 498 million. The EIB contributed to the urgent rehabilitation of basic infrastructure in the transport (roads, rail, ports and airports) and energy sector, the urban renewal of the City of Belgrade, as well as the development of SMEs through a Global Loan Facility successfully managed by the National Bank of Serbia. In 2003, the EIB signed with the Serbian authorities its first operation in support of the Health Sector (EUR 50 million) in the Western Balkan countries.

***Relations with IFIs.*** The IMF is supporting economic reform and stabilisation in the country through a three-year Extended Arrangement approved in May 2002. The first and second reviews were successfully completed in January and July 2003, respectively. In October 2003, the Fund reached preliminary agreement with the outgoing government on most aspects of the economic and fiscal framework for 2004. However, in light of early elections in Serbia in late December 2003, the completion of the third review is expected to be delayed, with discussions on policies for 2004 expected to resume once a new Serbian government is in place. Total funds that have been provided under this programme so far amount to some USD 420 million.

*World Bank* lending to Serbia and Montenegro is based on the Transitional Support Strategy adopted in May 2001 and updated in August 2002, which contains a three-year exceptional and temporary IDA envelope of USD 540 million. In 2002, the World Bank disbursed two structural adjustment credits (SACs) of USD 70 million and USD 85 million, respectively, to support reform measures in Serbia in the area of public expenditure management, health and education as well as in support of privatisation, enterprise development and sound financial systems. In 2003, two SACs for Serbia to support social programmes (USD70 million) and to back privatisation and financial sector development (USD 80 million), as well as a first structural adjustment credit for Montenegro to support the implementation of the reform agenda in public finance, energy and labour market (USD 15 million) were approved. For the year 2004, the Bank envisages lending in the order of some USD 150 million.

As of end of 2002, the *European Bank for Reconstruction and Development* had signed 15 projects, reaching a cumulative investment of around EUR 370 million in sectors such as telecommunications, transport, power, and municipal infrastructure.

## Concluding remarks

Over the past years, Serbia and Montenegro has made good progress in economic and structural reforms, supported by successive IMF stabilisation programmes, World Bank lending, and substantial EU assistance, including macro-financial aid. These efforts have led to a substantial reduction of inflation, exchange rate stability and continued real growth, backed by a good performance of services and construction while industrial production has been declining. However, relatively high fiscal and external imbalances continue to put a strain on the economy and point to the need of further fiscal adjustments. Therefore, overall public spending as a share of GDP should be continuously reduced. Moreover, a clear prioritisation of public spending is essential to allow for the inevitable costs of structural reforms and rising interest payments. This should include a reduction of current expenditures, in particular subsidies to loss-making enterprises. Macro-economic stabilisation should continue to be backed by prudent monetary policies, complemented by careful exchange rate policies taking into account the possible impact of real exchange rate trends. Structural reforms need a new momentum as they have slowed down in 2003. The restructuring, privatisation and/or liquidation of large state and socially-owned enterprises need to be speeded up. Banking sector reforms clearly must be accelerated, in particular with a view to the privatisation of those banks in which the Serbian government has acquired shares through debt equity swaps. This process should gain substantial momentum in 2004 and be finalised by mid-2005. In order to encourage the continued inflow of foreign private capital, the economic, legal and regulatory framework for foreign investments needs to be further improved.

# KOSOVO (SERBIA AND MONTENEGRO)

- **Following a strong rebound of GDP after the conflict (21.2% in 2001), Kosovo's economic growth is expected to have fallen sharply to 3.9% in 2002 and close to 5% in 2003 resulting from a decline in foreign assistance and remittances as well as an unintended tightening of the fiscal stance.**

- **Exports remain subdued and essentially relate to the expenditure and consumption of expatriate staff. The deficit of the goods and services balance continued to exceed GDP in 2003. Given the low domestic savings, the economy is heavily dependent on foreign assistance to finance its large current account deficits.**

- **The process of structural reforms continued in 2002-2003 but at low speed. The privatisation process eventually started and a number of commercial laws were enacted. However, the current business environment is not conducive to free market entry and exit. UNMIK and the PISG need to agree on a strategic medium-term economic policy programme.**

- **Kosovo participates in the Stabilisation and Association Process through the Tracking mechanism which provides guidance and technical advice by the Commission on policy areas and met three times in 2003.**

**Table 14. Kosovo (Serbia and Montenegro) - Main Economic Trends. 2000 - 2003**

| | | 2000 | 2001 | 2002 | 2003 [p] |
|---|---|---|---|---|---|
| Real GDP growth | *Percent* | na | 21.2 | 3.9 | 4.7 |
| CPI Inflation | *Percent* | na | 11.7 | 3.6 | 0.0 |
| GNP/GDP ratio | *Percent* | 191.0 | 162.2 | 151.2 | 148.8 |
| Consumption | *Percent of GDP* | 298.8 | 214.7 | 199.4 | 185.2 |
| Investment | *Percent of GDP* | 66.9 | 57.6 | 48.3 | 40.5 |
| General government current balance (1) * | *Percent of GDP* | -7.8 | 8.5 | 10.7 | 12.1 |
| General government overall balance (1) * | *Percent of GDP* | -10.1 | 6.7 | 7.5 | 4.1 |
| General government overall balance (2) | *Percent of GDP* | 6.1 | 10.3 | 8.9 | 4.4 |
| Trade balance | *Percent of GDP* | -184.9 | -112.7 | -96.6 | -88.8 |
| Current account balance (1) | *Percent of GDP* | -174.6 | -110.2 | -96.5 | -76.9 |
| Current account balance (2) | *Percent of GDP* | -22.1 | -19.1 | -33.5 | -32.9 |
| Foreign direct investment | *Million EUR* | 0 | 5 | 10 | na |

[p] Projections. (1) Before grants * Including budgeted capital expenditure, but still excluding significant donor-funded investment outside the budget. (2) After grants. *Sources:* IMF, World Bank, Ministry of Finance and Economy. Data have been revised in autumn 2003.

Kosovo (Serbia and Montenegro), hereafter called Kosovo, is a small economy with a population of approximately 1.7-1.8 million and a GDP at current prices of some EUR 1,300 million in 2002. The GDP per head is estimated to be in the order of EUR 700; the Gross National Product (GNP) per head is significantly higher (above EUR 1,000) thanks to traditionally high remittances. Kosovo has a simple trade regime with low tariffs but exports are essentially limited to the local consumption of expatriates and international peace keeping forces. In 2002, imports mainly originated from the EU

(24% also including Switzerland), Serbia and Montenegro (24%) and the former Yugoslav Republic of Macedonia (15%).

**Box 3. Kosovo – Institutional framework**

Based on UN Security Council Resolution 1244 of 10 June 1999, the International Community has set up an international security presence (KFOR) and an interim civil administration - the United Nations Administrative Interim Mission in Kosovo (UNMIK). UNMIK is headed by the Special Representative of the UN-Secretary General (SRSG). Following the elections of 17 November 2001, the establishment of the Provisional Institutions of the Self-Government in Kosovo (PISG) in March 2002 has changed the political and institutional structures in Kosovo. Based on the UNMIK Regulation establishing "A constitutional framework for provisional self-government in Kosovo" of 15 May 2001, policy-making is now divided into two spheres: the functions transferred to the PISG and the functions reserved to the SRSG (so-called "reserved powers"), while leaving ultimate power under UNSCR 1244 with the SRSG.

This new division of responsibilities is reflected in the Kosovo General Budget. It consists of three parts: the PISG, the reserved powers under the SRSG and the municipalities. The Ministry of Finance and Economy (MFE) is responsible for the implementation of the budget. The donor-financed Public Investment Program (PIP) covers most of the capital investment spending but is essentially outside the budget.

## Macroeconomic developments

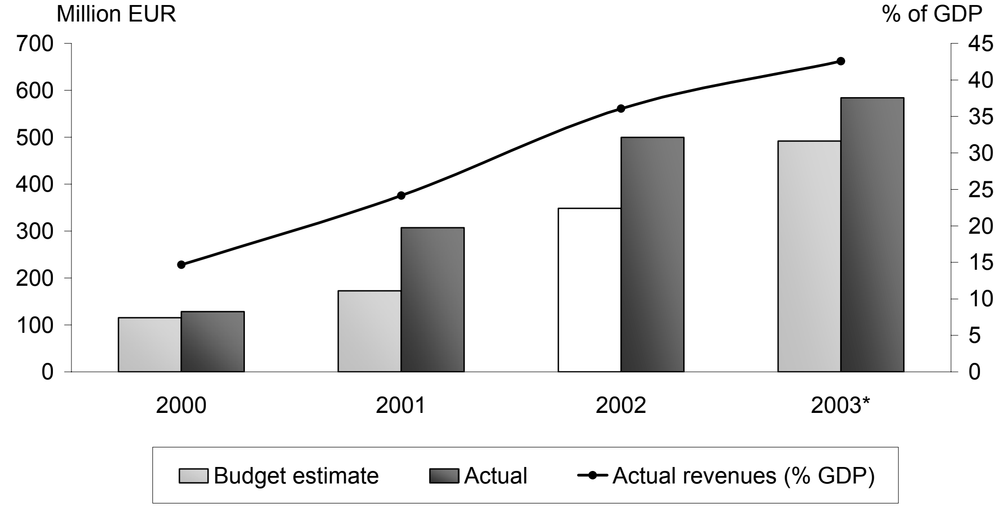
After the post-conflict and reconstruction driven boom, Kosovo has shown declining growth rates of 3.9% in 2002 and an estimated 4.7% in 2003. Private sector activities continued to be dominated by reconstruction and trade- and service-related businesses, which are more exposed to the current reduction of the international presence and external donor assistance. This is also likely to be the main factor for the rising unemployment since manufacturing and export activities remain subdued. CPI inflation declined to 3.6% in 2002 and further to zero in 2003 reflecting the combination of improving distribution channels and lower margins in the face of weak consumer demand.

***Fiscal situation.*** In 2002, total revenues again over-performed relative to estimates but border taxes still accounted for the bulk of revenues (about 74% of total). Total expenditures remained below budget appropriations resulting in a positive balance of some EUR 110 million to be carried forward into 2003. The use of the balance has not been decided, except for an allocation for emergency repair (EUR 17.3 million) for coalmines so as to secure energy supply. Furthermore, commitments of past budgets in the order of EUR 156 million have not been spent in 2002 and have been carried over into 2003.

The original budget for 2003 planned revenues to reach EUR 492 million and foresaw total expenditures of EUR 517 million (excluding donor designated grants) resulting in a budget deficit of EUR 25 million thus leaving the accumulated balance almost untouched. In line with the seasonal pattern of the past, the budget implementation as of mid-2003 is lagging behind on a pro-rata base as regards expenditures. As for previous years, revenue collection is again above plan notably through higher excise collections and is estimated to be 18% higher than planned in the budget (see chart

14). Even though the mid-year review of the PISG suggests differently, the IMF expects another sizeable surplus of EUR 156 million in the current balance taking into account the slow implementation of the capital budget.

**Chart 14. Kosovo - Domestic revenues. 2000 - 2003p**




Source: Ministry of Finance and Economy

* For 2003, "actual" shows revised

Given the high investment needs, UNMIK and the PISG need to elaborate a long-term framework integrating the budgets. This requires a consensus on the economic strategy including the priorities of the medium- and long-term public investment programme. Therefore spending policies in the short-term need to be carried out in a prudent way so as to avoid the possible waste of funds, to take into account the uncertainty of future tax revenues as well as donor contributions and not to destabilise the macroeconomic balance. This is even more important against the number of future challenges for the Kosovo budget including taking over tasks carried out by internationals and so far funded by the UN, one-off costs related to reforms, maintenance and capital investment.

***Monetary policy.*** Kosovo does not carry out an independent monetary or exchange rate policy. The economy is *de facto* euroised, since the free use of foreign currency beside the dinar was permitted in September 1999. Notwithstanding price stability, the interest rates of commercial banks for loans remained high (in the second quarter of 2003 essentially at the same level as in the fourth quarter of 2001) as well as the spread over deposit rates in the order of 12%. Some 82% of outstanding loans have been granted to private non-financial enterprises and only some 16% to households, which has however grown rapidly in 2003. The responsibility of the Banking and Payments Authority of Kosovo covers several other tasks usually attributed to a central bank including the supervision and regulation of the banking and insurance sector as well as the pension funds, the cash and vault management of the economy and the interbank clearing system.

***External situation.*** The current external position of Kosovo is bleak: the deficit of the trade balance corresponded almost to GDP and the deficit of goods and services was still at 125% of GDP in 2003. Most of the "exports" recorded in the trade balance (IMF data and methodology) relate to the expenditure and consumption of expatriate staff and not to exports of goods. Foreign assistance, albeit declining, and workers' remittances (equivalent to some 43% of GDP in 2002 and 2003) continued to be important contributors to partly compensate for the trade deficit highlighting the high dependence of the economy on external financing flows. The 2003 deficit of the current account balance after grants is estimated to have been approximately at the level of 2002 (33% of GDP) .

**Structural reforms**

On the **structural side**, some progress has been made: a number of commercial laws have been enacted in 2002 and 2003 and the modern three-pillar pension system introduced in 2002 is operational. However, the privatisation process which commenced in mid-2003, is currently blocked and the current business environment is not conducive to free market entry and exit.

***Public administration reform – Management of public expenditures and revenues.*** The authorities continued in 2002 and 2003 to develop the tax system and the administrative capacity to manage and collect funds. As regards the institutional setting, the Central Fiscal Authority was dissolved by the end of 2002; all functions including the Treasury were moved to the Ministry of Finance and Economy of the PISG. Within the EU Pillar, a "Fiscal Affairs Office" was set up to provide the SRSG and the Deputy SRSG with analysis and advice on fiscal and other issues. In May 2003, an organic budget law was promulgated laying down the rules and procedures as well as the division of labour and responsibilities in budget management between UNMIK and the PISG.

With an international consultant having been selected, the review of the wage scale and job classification has started. The objective is to decompress and equalise the wage scale across Ministries as well as to identify surplus employment. It is unlikely though to use first results for the 2004 budget. Given the already relatively large public sector wage bill, there is growing awareness in the PISG to streamline the efficiency  the civil service.

***Enterprise reform – Enterprise restructuring and privatisation.*** The *Kosovo Trust Agency (KTA),* established in June 2002, exerts control over socially owned and public enterprises via supervisory boards. The restructuring plans for the public enterprises were prepared in 2002 and 2003 and are being implemented. However, the process is still at a very early stage. Following an international tender, a decision for creating a domestic air carrier ("Kosovo air transport") was taken. When assuming the responsibility within UNMIK in mid-2002, the EU-Pillar commissioned audits of the public enterprises, which have recently been finalised, identified a number of shortcomings in terms of accountability and transparency. This will serve as a basis for the further restructuring. The process is likely to constitute a permanent need for budgetary funds, in particular in the case of KEK, the Kosovo Electricity Company, which at the same time needs to take measures to improve collection rates.

The KTA is also responsible for the privatisation process: the first tendering procedures for 23 socially owned enterprises (SOEs) have been completed and attracted significant interest. The assets are being transferred to a new company whereas leaving the liabilities with the existing company. Most sale receipts of some

EUR 26 million will be kept with a trust account so as to compensate for any claims. To this end a special chamber of the Kosovo Supreme Court has been established in 2003. However, the final signature of past deals is still outstanding. Furthermore, the privatisation process has been temporarily suspended in Autumn 2003 amid legal problems and it remains to be seen when and under which conditions it will be continued. More generally, the legal status of land use needs to be clarified also for those SOEs, which will not be privatised but liquidated. This would allow the economic use of land, which is probably the most valuable asset.

A number of laws further developing the commercial law framework were promulgated in 2003, including the laws on the transformation of the right of use of socially-owned immovable property, public finance and accountability, mortgages, the establishment of an immovable property registry, external trade activity and bankruptcy. The social assistance scheme was upgraded to come into force in December 2003 providing for a monthly support between EUR 35-75 for eligible families.

***Financial sector reform.*** The foundations for a sound financial sector have been laid. Within the BPK a strong and professional supervisory department has been built up in 2002 and 2003. Seven banks have been licensed operating 139 offices (September 2003) in the province and providing basic financial products. In addition, there are 15 micro financial institutions operating 41 offices, which provide small loans to the non-bankable sector. An inter-bank payments system has been established.

Overall, financial intermediation through the banking sector has improved. Outstanding loans as of September 2003 more than doubled relative to end 2002. However, loans still only correspond to some 38% of deposits and also hide an uneven situation. The biggest bank MEB (Micro-Enterprise bank, the first bank licensed in Kosovo) has so far only shown modest interest to expand lending (10% lending relative to deposits) while accounting for almost 60% of total deposits. The rapid credit expansion of the other banks has to be monitored closely even though there are no indications yet on possible problems with the portfolios. Due to the short-term nature of deposits, loans of a medium- and long-term maturity are currently not being offered but discussions are ongoing with a donor to provide appropriate refinancing. The BPK is advocating to expand the existing credit registry to include all banks in the coming months.

In the area of insurance, further progress has been achieved. As of September 2003, seven companies had been licensed. The range of products is widening to include property and personal liability insurance; an application for a life insurance is being processed. Additional business areas have been approved and the relevant regulations are being drafted (e.g. a draft regulation on life insurance already finalised). In Spring 2003, a complaint system was introduced. The major concerns relate to compliance with existing BPK rules (there are 30 rules in place) and to the lack of product knowledge with agents.

***Trade liberalisation.*** From the outset of UNMIK's mandate, all quantitative restrictions on trade were abolished and a low and simple tariff introduced in 1999 (a 10% customs rate, varying excise duties and a uniform 15% VAT rate). In 2003, UNMIK unilaterally associated itself to the Stability Pact regional trade liberalisation initiative (Stability Pact Memorandum of Understanding on Trade) and has declared its readiness to negotiate FTAs with interested signatories of the Memorandum of Understanding. A FTA with Albania is being applied since 1 October 2003. Outstanding problems in the application of the 1996 FTA of the Federal Republic of Yugoslavia (now Serbia and Montenegro) with the former Yugoslav Republic of Macedonia were solved, which made the reciprocal free trade functional. Even if the export potential remains limited in the short run, FTAs are important for the region and will help to attract much needed investment.

**International relations**

***Stabilisation and Association Process.*** Kosovo is included in the EU's Stabilisation and Association Process and benefits from the various instruments of this policy framework, i.e. trade preferences, EC assistance as well as reform monitoring and recommendations. To further deepen the EU's involvement in Kosovo and to boost EU-compatible structural reforms in the province, the Commission devised the Stabilisation and Association Process Tracking Mechanism for Kosovo (STM) in 2002 so as to provide technical assistance and political guidance on Kosovo's path to implement EU-compatible practices and regulations. Following a general seminar in November 2002, three meetings of the STM were organised in 2003.

***EC assistance.*** Between 1998 and 2002, the Community committed over EUR 1.2 billion assistance in favour of Kosovo and is the largest donor. Apart from the emergency humanitarian assistance, the financial assistance comprises reconstruction and development assistance under CARDS and managed by the European Agency for Reconstruction, exceptional financial assistance, of which the last tranche was disbursed in December 2002, and funding of the EU Pillar of UNMIK. The Annual Action Programme 2003 under CARDS was adopted in April and amounts to EUR 53 million. It continues to put the emphasis on institutional capacity building, public administration reform and economic development. The *European Investment Bank (EIB)* is currently not implementing financing projects in Kosovo. However, the Council of the EU confirmed in April 2003 that Kosovo is already covered by the existing external lending mandate of the EIB for the CEEC (Central and Eastern European Countries). Technical discussions between UNMIK and the EIB are currently taking place to agree on a workable arrangement.

***Relations with IFIs.*** Under the current status, Kosovo cannot become a member of the IMF and the World Bank. The *IMF* has been providing significant technical assistance since 1999. At the request of donors, IMF staff is assisting the authorities to design a macroeconomic policy programme, including selective quantitative and structural targets, that staff could monitor subsequently. This would not only underpin the credibility of the envisaged programme but also facilitate the availability of financial support from donors.

Following the conflict, the *World Bank* adopted a Transitional Support Strategy (TSS) totalling USD 60 million in grant assistance through a Trust Fund for Kosovo financed from the World Bank's net income. A second 18-month TSS was adopted in July 2002 making available USD 15 million, which will be fully committed by the end of 2003. The Bank continues its analytical work and plans to produce a comprehensive economic study in the coming 6-9 months on the sources of growth.

*The European Bank for Reconstruction and Development (EBRD)* is already active in Kosovo through an equity fund and is exploring possible engagements in infrastructure projects.

**Concluding remarks**

Kosovo's economic growth rates are falling reflecting a decline in foreign assistance and remittances as well as an unintended tightening of the fiscal stance. Exports remain subdued resulting in a large deficit of the goods and services balance. Progress has been made in structural reforms, whose implementation will require sufficient commitment from all involved. In order to embark on a path of sustainable economic development, Kosovo needs to carry out prudent fiscal policies and to stimulate domestic growth. Given the one-off opportunity of the sizeable accumulated cash balance, UNMIK and the PISG need to agree on a strategic medium-term economic policy programme prioritising the public investment needs. The current business environment is not conducive to free market entry and exit hence impeding the development of a competitive private sector in the economy and the inflow of foreign direct investment. Therefore UNMIK and the PISG need to continue the adoption of modern laws as well as to improve the implementation and enforcement of the legislation. Within the restrictions of their mandates, the EC and the IFIs have devoted considerable activities to Kosovo and will be important partners for shaping future policies.