CONVERGENCE AND COMPARISON – METHODOLOGICAL ASPECTS

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INTEGRATION MATURITY – EXPERIENCES AND PERSPECTIVES

1. Theoretical approaches

Every integration organization can set certain membership conditions or criteria for those who wish to join it. Most of these are obvious (they follow from geographical proximity or political orientation) or general enough not to be exclusive. The Treaty of Rome prescribed for membership of the European Community only that the country in question should be ‘European’ and ‘democratic’. This has caused uncertainty regarding its geographical boundaries (e.g. in the case of Turkey), but it was sufficiently general to offer as widely as possible the opportunity to join.

With the advance of integration it can be assumed that the preparedness of potential participants for integration, their ‘maturity’ with regard to integration, progressively increases in importance. This is indicated by the development of the European Communities, in which, as they progressed from a simple customs union and common market towards a single market and economic union, this question became more and more prominent.

In the EC/EU concrete accession criteria were first formulated in 1991 in relation to the transition to economic and monetary union. The so-called Maastricht convergence criteria set important requirements of monetary integration, when as condition of membership of EMU on the part of member countries, specific and well-defined indicators of monetary and fiscal stability were examined. (The single currency was envisaged as non-inflationary, like the DM.)

It was an important new development in economic union, or ‘positive integration’, that participation in it on the part of member countries or those interested was now by no means automatic: certain conditions must be fulfilled. Market liberalization was not without consequences, but these were mostly unilateral and asymmetric (the less developed, weaker partner could lose more) and the retroactive effects were not manifested in a direct manner. With economic union the situation is different. The reciprocal effects are heightened and become direct. The less developed partner’s economic difficulties (budget deficit or regional inequalities) have repercussions on the economy of the more developed, and can destabilize it (e.g. by triggering inflation) in more direct way. The decision to join in an economic union is one that fundamentally affects the institutional and political structure of the country in

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question. In this connection maturity or readiness for integration is an issue that has to be examined.

Taking into account the complexity of preparation and of the preparedness of countries for participating in regional integration, we feel that a distinction should be made between:

Accession maturity (meeting certain pre-set and concretely defined criteria as condition of entry into the organisation),

Membership maturity (concrete criteria for members inside organisation) and

Integration maturity.

For new candidates for admission, the EC/EU accession criteria were first determined in connection with ‘Eastern enlargements’. The so-called Copenhagen criteria were approved in June 1993, and form the basis for assessing the preparedness of applicant countries.

Stability of institutions, guaranteeing democracy (rule of law, human rights, respect for and protection of minorities);

A functioning market economy;

Capacity to cope with competitive pressure and market forces within the Union;

Ability to take on the obligations of membership, including adherence to the aims of political, economic and monetary union;

The Union’s capacity to absorb new members.

Thus accession criteria refer to some concrete integration organization (e.g. in our case we are looking at the question in relation to the EU), and they formulate narrowly only the conditions for becoming a member. Accession criteria mean conditions that have to be fulfilled at the time of joining, naturally depending on what stage integration has reached in the given organization. Greece and Portugal joined an EC still modelled on the common market, but new members now join a single market on entering, and want to (in fact, have to) match up to the requirements of economic and monetary union.

Membership maturity refers to the conditions and requirements set (usually formally and officially) for participation in integration. In EU, it means complete acceptance and adoption of “acquis communautaire”. Membership criteria, on a large extent, should be fulfilled from inside, and they may be sanctioned (Stability Pact or compliance with democratic principles set out in the 6. and 7. Articles of Amsterdam and Nice treaties).

Integration maturity is defined as the capacity or ability to maximally exploit the advantages offered by given integration forms, and at the same time to minimize the costs and disadvantages. Integration maturity can be measured by the balance of the costs and benefits of integration. A country is mature for integration if it is able to turn its membership into a positive-sum game, that is, integration is advantageous for it. Integration maturity can be
analyzed for the different basic forms of integration from the free trade area to economic union. Assessment of integration maturity concentrates not only on the conditions and requirements of participation in integration, but also on its outcome and the consequences of that integration.

The three are closely interdependent, since accession and membership criteria seek to express integration maturity, as they do in reality, but in a narrower sense. Accession criteria rather formulate the minimum requirements for admission to take place, while the question of maturity goes beyond this, and in general examines the conditions for successful and effective integration. Accession and membership criteria approach integration maturity, readiness for integration, in a detailed way, and mostly from certain aspects only, while in the case of integration maturity these interrelations have to be analyzed in their entirety and complexity.

In integration economics integration maturity was not formerly dealt with comprehensively and in detail. An exception to this is the literature analyzing the integration of developing countries, which from the outset drew attention to the problems, for example in free trade areas or common markets, arising from wide developmental and structural differences.

In analyzing integration maturity we can rely on various analyses carried out in macroeconomics, integration economics, political sciences, sociology and European studies. Accession criteria are concrete, but particularly for interpreting the Copenhagen criteria we had no proper guide. With regard to their maturity and readiness for membership the candidate countries were regularly surveyed by the EU Commission and other organs (European Parliament - Country Reports) of course chiefly from the point of view of fulfilment of the accession criteria. These do not provide a more serious theoretical and methodological foundation for integration maturity. Their system of criteria and methods of analysis are not yet clear, and provide only a loose framework for evaluation that takes place on political grounds.

In some cases the parameters relating to fulfilment of certain criteria have been precisely worked out (e.g. the Maastricht convergence criteria), while in other cases the parameters required for analysis and evaluation are sketchy, inconsistent, highly debatable, or simply related to negative fulfilments. This can often be attributed to the rough nature of methods of analysis; in other cases it reflects a certain deliberate intention, making it possible to treat the conditions flexibly, or to accelerate or even delay and hinder the integration process.

The accession and membership criteria and also integration maturity can be analyzed in three main dimensions:

- economic
- political (social)
- institutional contexts.

This applies to the Copenhagen and the Maastricht criteria, but we can structure the analysis of integration maturity also along these lines.
1. Economic criteria. In the economic context, accession, membership criteria and integration maturity cannot be separated; in fact, they overlap. But the fulfillment of accession criteria can be (and in practice, is) judged according to narrower parameters (Country Reports), while the “functioning market economy” is a broader and more complex notion and in fact it should be considered the main factor in integration maturity. The “mobility of factors of production” or “flexible factor markets” as conditions of the smooth operation of a monetary union (optimal currency area) are nothing else than an extended interpretation of the concept of a “functioning market economy”. Competitive capacities are important conditions of monetary union as well; even if in the Maastricht criteria de facto they are restricted to the requirement of exchange rate stability. Monetary union assumes a certain convergence of development levels and economic structures (able to cope with “asymmetric shocks”), but in many respects the question arises even at the lower stages of integration. Most of the parameters set in Maastricht refer to the stability and stabilization of participating economies, although they are formally limited to only the monetary and fiscal aspects of the process. They stress monetary and fiscal “convergence”, but avoidance of asymmetric shocks requires convergence in a broader structural sense. Stability of monetary union cannot be achieved without economic policy coordination, and budgetary transfers among the participating countries (extension of the theory of the “optimal currency area” by G.M.A. MacDaugall and P.R. Allen) could be necessary to cope with social and regional tensions. A normally-functioning economy cannot be imagined without social stability. Successful integration presupposes social integration and cohesion; social and political support for the integration process is of the utmost importance.

Taking into account the above considerations, in an integration economics approach, in relation to the different basic forms of integration the following basic criteria of economic integration maturity could be formulated:

- a market economy (“functioning”);
- competitiveness;
- macro-stability and stabilization;
- convergence (real or financial convergence);
- financing or financeability;

These criteria are partly general frameworks for the normal operation of given integration forms; partly they express the conditions of the success of the given integration. The economic criteria will be more broadly analyzed, inasmuch as the advantages of enlargement depend to a large extent on economic circumstances, and they are important from the point of view of the welfare of the whole society. As we can see, only the first three are concretely formulated as membership criteria, but even in their case, we take a broader analytical approach.

2. Political criteria. Although the Treaty of Rome concerning potential members refers to certain political conditions (democracy, and belonging to “Europe”), the first formal political criteria for membership were set for CEE candidates only in 1993 in Copenhagen (“stability of institutions, guaranteeing democracy; rule of law; human rights; respect for and protection of minorities”), and then in 1995 in Madrid. Consequently, candidates must meet the following requirements:
• a state of democracy (1957, Rome);
• “stability” of democracy and institutions (1993, Copenhagen);
• “functioning” democratic institutions (1995, Madrid);

Lately political criteria have been set (in fact, codified) for member countries: compliance with democratic principles (1997, Amsterdam; 2000, Nice).

In political dimensions, accession, membership criteria and integration maturity cannot be separated. In fact, as they relate to given institutions and a given stage of integration, they can be considered only as concrete criteria. Of course, the question of democracy can be analyzed in general theoretical terms, and general political conditions of integration can be interpreted as questions of integration maturity (democracy and efficiently functioning market economy). In this respect, there are possibilities for a more general analysis than just looking at criteria, which are taken into account upon entry to the given integration.

Some stress the importance of social integration and social cohesion, but we refrain from analysis of these aspects of maturity.

3. Institutional dimensions. Institutional criteria can be analyzed in a very broad sense, and they are applied right from the beginning as membership criteria. In fact, as they relate to concrete institutions, they cannot be anything other than membership criteria. As countries join a given integration form (a free trade area or common market) and the related institutions, there is no choice other than to comply with the generally agreed rules. As integration progresses, new institutional criteria can be set (EMU; independence of the central bank), and meeting them is important from the point of view of the successful operation and development of integration. We imply economic policies as institutional membership criteria, although the efficiency of economic policies raises the question of broader properties of integration capacities. As far as the Copenhagen criteria are concerned (the “ability to take on the obligations of membership, including adherence to the aims of political, economic and monetary union”), they can be divided into the following main obligations:

• acceptance and adoption of “acquis communautaire”;
• commitment to EMU;
• commitment to “political union”.

Continuous “maintenance” of integration maturity is unavoidable, in order to exploit the advantages of integration. This was recognized in relation to Eastern enlargement, and in fact in Copenhagen the EU noted the importance of its own ability to receive the new entrants (the “Union’s capacity to absorb new members”). These requirements were not specified in detail, but the main directions and fields of necessary “reforms” were broadly identified and accepted. In these terms, the necessity of the following measures should be particularly stressed:

• CAP reform;
• budgetary reform;
• completion of EMU;
• institutional reforms.
2. Economic integration maturity

A normally functioning market economy is a starting condition in relation to every form of integration. The whole theoretical and analytical system of integration economics is based on this assumption. Only with the proper functioning of market mechanisms can the advantages of internal free trade be exploited. As an official membership criterion the question (of a functioning market economy) arose only in connection with the admission of the CEE countries, but this did not mean that it was not relevant earlier. It is obvious that this question receives varying emphasis at the different stages of integration, and in the closer forms of integration (such as EMU) it cannot be avoided even in the case of the most highly developed countries. It is another question, that the requirement of a functioning market economy (flexible markets and prices for factors of production) was not formulated in the EMU as a membership criterion, but only analyzed in informal theoretical discussions.

In the case of eastward enlargement, with regard to the accession criteria a new situation arose, in that the question of integration maturity could not be handled automatically and without more serious analysis. At the beginning of the 1990s (Copenhagen – 1993) the CEE countries were still in a transitional situation, and in Copenhagen the accession criterion basically stressed nothing else than the transition from a centrally-planned to a market economy must be completed. In relation to Central and Eastern Europe, on the one hand the introduction of the condition of a “functioning market economy” was in practice an attempt to formulate a certain desirable minimum transformation for these countries, while on the other hand it referred to the requirement of participation in the single market.

We shall attempt in what follows to formulate and summarize in general, from the integration maturity point of view, the parameters of a “functioning” market economy, regardless of the requirements of any given basic form of integration.

- Comprehensive liberalization of prices (wages, interest rates, exchange rates, etc.). Transparency and flexibility of prices.
- Freedom of market actors; free entry to and exit from the market. There are no obstacles to mobility of factors of production.
- Competitive market structures (competition, which prevents prices from remaining for long substantially higher than costs; pressure for innovation and increased efficiency; elimination of monopolies; a great number of market actors; freedom of choice).
- Company performance dependent on profit (agents under severe constraint to cover their current expenditure out of the receipts from their sales, and make a profit on them).
- Elimination of state support and subsidies.
- Liberalization of foreign trade; abolition of state control and monopolies; non-discriminative policies.
- Convertibility of national currencies (mainly on current account).
- Creation of real money and capital markets (reform of the banking system; development of financial services compatible with developed money markets; stock exchange; other forms of non-banking institutions and activities).
- Money as a vehicle of coordination.
• Dominance of the private sector (privatization in countries undergoing transformation).
• Restructuring of companies (corporate finances, marketing, management).
• Market-conformity of state regulation (taxation, monetary policies, “positive” structural policies; “integration conformity” is something more).
• Transparency of regulation (simple and accountable legislation, lack of corruption).
• Efficient “eco-social market economy” (separation of social policies from efficient functioning of the market; recognition of the need for protection of the environment).

Naturally, the requirements receive varying degrees of emphasis in relation to the different basic forms of integration.

Analyses of transition (for example, carried out since 1994 by the European Bank for Reconstruction and Development (EBRD), together with the EU’s Annual Country Reports, conclude that the candidate countries of Eastern Europe, including Hungary, by the end of the 1990s satisfied the “functioning market economy” requirement. In Hungary privatization has more or less been completed, and the main market economy elements have been harmonized with the chief parameters characteristic of the developed countries. Apart from the Central European countries this also applies to the Baltic states, while among the candidates those most at a disadvantage were Bulgaria and Romania. On the whole, the disadvantages of the other countries in the region (the ex-members of the former Soviet Union and Yugoslavia) were more serious, although countries like Croatia could quickly catch up.

Any market integration which opens countries’ markets to each other, within the framework of any kind of free trade bloc or grouping, raises the question of development differences: more precisely, different levels of costs and competitiveness among the various sectors and companies. A free market is expected at micro-level to increase efficiency, partly through the exploitation of economies of scale, partly as a result of the beneficial effect of competition in reduction of costs and better satisfaction of consumers’ needs. In competition, producers that can deliver more modern products at lower cost come to the fore, while the less efficient, if they cannot adapt, are squeezed out of the market.

Similarly to the concrete parameters of the “functioning market economy”, those of “response to competitive pressure” were not defined in more detail by the EU, thereby leaving ample scope for interpretation. In our opinion the EU has defined competitiveness only indirectly and in a restricted sense as a criterion for accession. At the same time, competitiveness must be regarded as an important indicator of integration maturity (perhaps one of the most important), and therefore we must discuss it in this spirit. Unquestionably the candidate countries cannot exploit the advantages of integration unless they possess a company structure capable of holding its own in market competition. This may mean products, or it may mean standing up to competition in terms of costs, quality and innovation. Competitiveness was thus a fundamental interest, since otherwise the competition could have swept most of the new member countries’ companies out of the market.

Competitiveness is a complex indicator, can be defined in both micro- and macro-economic contexts. Countries compete not only with their techno-economic structures (technologies, products, innovations, company managements etc.), but also with their socio-economic and institutional systems.
Competitiveness basically determines the situation of a given country or region’s producers and, most important, its possibilities as regards exploitation of the advantages of integration. A lack of competitiveness can have serious negative consequences for the integration, and some solution has to be found: either integration, that is, participation in the integration organization or grouping, must be abandoned, or suitable mechanisms must be built in to compensate for disadvantages and losses.

As regards the circumstances of “response to the pressure of competition” as a criterion for accession, the EU did not define it clearly and unambiguously. At the same time, a few aspects are particularly emphasized by the EU, and these turned up whenever fulfilment of the accession criteria were examined.

- The Copenhagen competition criterion definitely implies that the country seeking admission is capable of adopting the EU’s rules on competition and its competition policy (acquis communautaires). This presupposes not just their application in law (which is formulated in the association agreements, and in the White Book), but also the ability of the given country in the long term to meet the standards of competitiveness. It is vital to create new institutions and regulatory systems that are in harmony with and conform to the institutional frameworks and competition regulation systems of the EU member countries.
- Competitiveness is closely and mutually dependent on stable macroeconomic policy conditions, especially budgetary and monetary policies. A proper harmony is absolutely essential from the point of view of creating competition-friendly economic policy and a stable economic environment.
- There is thus a need for consistent industrial, trade and subsidy policies that will ensure the development of healthy competition in the economy.
- From the point of view of competitiveness, the level of development of the factor markets has an important role, in relation to both capital and labour. The EU’s competitive disadvantage relative to the US is most noticeable in connection with this.
- In the EU literature and documents the manifestation and demonstration of competitiveness is linked strongly with exchange rate development.

There is no doubt that economic stability and stabilization are important factors in integration maturity. It is an important factor from the point of view of the normal functioning of the market, and consequently from the point of view of the ability to exploit the advantages of any market integration. Of course, macro-economic stability and integration are mutually dependent, therefore while it is one of the preconditions of successful integration, at the same time it is also an indicator of the success of that integration. There has been lengthy, chicken-and-egg discussion about the performance of the economies of the EC countries, particularly in the 1960s, when no one could decide which was more important: rapid economic growth promoting smooth and rapid trade integration, or dynamic intra-trade, which was then supposedly one of the main factors in that rapid economic growth.

It is, however, a more complicated question, how we can define and then measure the stability or stabilization process of an economy. This is particularly important, because for the candidates stabilization is one of the fundamental questions relating to their accession maturity.
One important question is how to measure stabilization, and particularly what sort of benchmarks should be used in order to evaluate the process of stabilization. In this respect there are several possibilities, and one can choose depending on what sort of priorities are set in terms of the process of that stabilization. In general, it is difficult to find any absolute standards or parameters upon which one can state that a country shows a state of “stability” or represents the optimal process of stabilization.

The benchmarks are rather relative:

- “Optimal” or favourable macro-performance.
- Achievement of “sustainable growth”
- EU-related performance pattern of economies:

Some feel that using these parameters one can calculate a certain “stability or stabilization index”.

Convergence, both in real and in monetary and fiscal terms (monetary union), is desirable, and in a certain sense, a necessary condition of efficient and successful integration. In general, however, there is only a loose relation between levels of development and maturity for integration. Equalized levels are not demanded, but in the case of large differences (industrial and developing countries) the benefits may be unequally distributed. The ideal case is more or less similar levels, and integration programs usually set equalization as a desirable (politically declared) objective (EC/EU documents).

When six countries signed the Treaty of Rome, their levels of development and economic structure were very similar, and differences were limited to some regions only (basically to southern Italy). Later, with successive enlargements, differences in levels of development increased, and this particularly applied to the entry of the Mediterranean countries. Their backwardness was fairly substantial (they were about 40-45% below the Community average), but with varying success they managed to accelerate their economic development, and in little more than two decade they were able to accelerate convergence with the developed part of the Union.

Eastern enlargement creates a totally different and new situation. The differences in levels of development are much greater (ranging from a 20-30% to about 60-70% on average), and the difference between the two extremes (Bulgaria on the one hand, and Denmark on the other) is of a magnitude of nearly 500%. At the same time, the levels of development of the most developed new candidates and the less developed members are very close, in fact, identical. This means that the new members represent a highly diverse group, not only in terms of economic and social development but also concerning their historical and cultural traditions.

Financing and financeability. The approximation to one another of economic development levels and economic structures involves serious development requirements. This demands financing. Similarly, the unequal distribution of trade advantages raises the question of compensation of weaker members and losers. Tensions and disturbances due to differences in growth are not in the interest of the more developed partners either, therefore in the various kinds of integration grouping solidarity and compensation were from the very outset on the agenda in some way. Since most integration organizations proclaimed the achievement of
equality as a political commitment, the question could not be ignored. The instruments of convergence can be of a commercial and financial nature.

Since there were no substantial structural and developmental differences among the six founding countries of the EEC, at the beginning there was no need to discuss financing problems. More precisely, to the extent that such differences existed, and they did, attempts were made to compensate for them. This was the aim of the introduction in the 1960s of the common agricultural policy, which sought to compensate France and Italy, with their predominantly agricultural structure, in comparison with heavily industrialized Germany. In practice this compensation began simultaneously with the creation of the customs union and the common market, and in view of the relative backwardness of agriculture in the above-mentioned countries, internal agricultural free trade (the common market) was supplemented by relatively large income transfers and strong protectionism externally.

It is another question, whether in the case of greater differences in development, financing criteria can be considered in connection with free trade agreements or with the customs union as well. Later, as a result of enlargement, this is precisely what happened, when with increasing differences in development the question of regional subsidies came to the fore. Such subsidies were earlier received mainly by southern Italy, but with further enlargements they had to be extended. The creation of the European Regional Development Fund from 1975 was partly due to the accession of Ireland and the UK, which brought more backward areas into the Community. With Mediterranean enlargement the problem became more marked. The single market, and later the economic and monetary union, has tended to increase the need for regional compensation.

With eastward enlargement, as a result of which the diversity of the future Union increased significantly, with regard to both economic development levels and structures the question of financing and financeability became one of the critical enlargement issues.

New members need resources for several reasons:

- For improving and safeguarding the competitiveness of their economy.
- Development of the infrastructure for integration.
- Building institutions, meeting requirements (environment), harmonization of laws and regulations.
- Compensation for losses.
- Financing the budgetary obligations toward the Union.

Thus financing serves the purposes of both convergence and economic stability. As regards external resources, the ability of CEE countries to catch up in terms of development is of course basically dependent on foreign private capital investment. We can assume that integration will be accompanied by improved allocation of resources.

Although “financing” is based overwhelmingly on private, market sources (private investments, financial markets), the role of state (national and EU) budgets is also important.

Although it is heavily constrained, Eastern enlargement is financeable. Efforts and reforms are needed, however, particularly in the area of budgets and on both sides. Long-delayed
structural reforms should be accelerated, and *budgetary discipline* is due more than ever on both sides. If this is achieved, it may be one of the most important dividends of the whole enlargement.

**Some weaknesses of integration maturity** (with particular emphasis on Hungary):

- **Structural weaknesses**: too high dependence on export, high reliance on new „sensible industries” (car or consumer electronics).
- **High dependence on external financing** (transnational companies, and credits from international capital markets, high indebtedness of state (66% of GDP), consumers and companies (about 70-80%).
- **High share of foreign banks in GDP**, and vulnerability to international financial crises.
- **Weaknesses of SME sector**, international trends suggest high transnationalisation. But only small part of SMEs are integrated into transnational networks and follow transnational strategies. They are weak in financing and competitiveness.
- **Only partial reforms in public services**. Not yet satisfactory in health, education, or public administration. Waist of resources and low level of services. These sectors are victims of political fights.
- **Oversized state distribution**, high public expenditures and taxes. Above 50% of GDP. Delay in reforms of state household and taxation system.
- **Separation of social and economic policies** far not consequent (gas prices).
- **Need for fundamental reform of the whole social systems**. It is wasteful, inefficient, disfunctional, missing to fulfil the social objectives to perform designed for them.
- **Weaknesses in stabilisation (H)**: it is an experience, which should be learned by the others.
- **Between 1995-2001**, Hungary was on the sustainable growth path (4%). The budgetary overspending, reaching 10% of GDP in 2006, had dramatic consequences to slowdown of growth, inflation and then unemployment. Stabilisation proved to be painful.

**EU integration maturity is also only partly fulfilled:**

- **EMU on track**, but financial sustainability not fully secured.
- **Institutional reforms** are completed by Nice Treaty only for recent enlargements (EU27).
- **Full reform of CAP and budget** in a Union of 27 countries remained for the future.

It is not by chance, that in recent years we experienced a certain *enlargement crisis*:

1. **A structural** one: EU countries were not prepared to „dislocation” and increased competition of CEEs.
2. **Financial**: Agenda 2000 was not fulfilled, tensions in financing of enlargement and 2007-2013 budget.
4. **Political**: Fears and disappointments about free movement of peoples.
Lessons to be learned:

- Experiences of 10 new members are useful for study for the new candidates.
- Priorities remain political, the strict fulfilment of accession criteria would not be applied for Southern Europe either, although, a minimum would be required (except for Turkey).
- TNCs (FDIs) play important role in making candidates mature for integration.
- Policies of preparation and reform are crucial.

References

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OECD STATISTICS: EVIDENCE-BASED POLICY EVALUATION

1. The mission of the OECD

OECD is an international organisation with 30 member countries. The core values of the organisation are democracy and market economy, values to which its members adhere. The purpose of the organisation is to analyse and compare policies and advice on policies – based on evidence. This activity takes place in a broad range of policy areas. The key point in each policy domain is to identify good outcomes – and less good ones. Based on analysis of these outcomes, the organisation seeks to identify successful policies and advice in accordance with this knowledge.

Well-known examples of OECD’s activities are the country economic reviews, comparing and advising on countries’ economic policy, and the PISA studies, comparing the outcomes of basic education systems of countries (http://pisa2003.acer.edu.au/index.php)

Results from the PISA study: Performance on the reading scale, 2006

Box 1

Source: OECD Factbook 2008

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2. The role of statistics in OECD

As explained above, OECD is not a statistical organisation similar to national statistical offices. Its purpose is not to produce statistics. However, statistics is a very important and well-known component of its work. This is because the policy advice is evidence based, and the evidence is, in most cases, based on statistics. Therefore, OECD collects a lot of statistical information on society, shedding light on almost all sectors: economy, labour, health, education, governance, etc.

These statistics are collected as a tool for policy analysis in order to compare countries. It is of course of fundamental importance to the organisation’s mission that these statistics are globally accepted as possessing a high degree of authority and quality. Fortunately this is also the case.

Although OECD is not a statistical organisation, the statistical activities are considerable, and these activities of the organisation belong to the global network of Official Statistics. Therefore, the organisation adheres to the UN Fundamental Principles of Official Statistics (http://unstats.un.org/unsd/methods/statorg/FP-English.htm) as well as to the Fundamental Principles governing International statistical activities: http://unstats.un.org/unsd/methods/statorg/Principles_stat_activities/principles_stat_activities.htm

The Official Statistics are there because all good decisions are based on facts. They aim to establish the basic figures on society – a common reference point for all decision makers – public or private. OECD statistics are a foundation for democracy and economy. In the era of information overflow and lots of dubious data, they form a lighthouse in the information jungle.

OECD statistics can be seen at different levels. The OECD Factbook (www.sourceoecd.org/factbook) offers a tour with broad overviews of data from all domains of society, giving a flavour of the richness of data and an entry point for further studies. The corporate statistical data warehouse OECD.Stat (http://stats.oecd.org/wbos/Index.aspx) gives all the details and provides the statistics gold mine, where users can search and combine data. More explanation about this is given in chapter.

3. Which data are needed to underpin the mission?

In order to use statistics as a basis for informed decision making, it is crucial that the statistics are really of high quality and, in particular, comparable between countries. This comparability is threatened by several problems:

- each country has its own way of defining concepts
- Each country is different: institutions, organisation of society and level of development can be so different that comparison is difficult or does not make sense, even when implementing same concepts and questions.

What can we do about it?
First of all, experts making the comparative analyses must understand the differences in reality in order to make good judgment.

In order to ensure uniform definitions and concepts, OECD is actively engaged in international standardisation work, together with countries and other international organisations. This involves agreeing on and implementing international standards for concepts and classifications. In many domains OECD is joining forces with others in developing Manuals, the most well-known example being the System of National Accounts, SNA.

Last but not least, OECD works to ensure that good metadata (i.e. descriptions of the data, concepts, quality etc.) always accompany the data, so that analysts and other users can understand for which purposes the data can be used. OECD is also engaging in developing international standards for such statistical metadata. The principles for OECD statistical metadata can be found at [http://www.oecd.org/dataoecd/26/33/33869551.pdf](http://www.oecd.org/dataoecd/26/33/33869551.pdf)

4. The OECD Quality Framework for statistics

The OECD has a high reputation for both the quality of its analytical work and for the statistics that underpin that work. In some areas, OECD statistics are internationally recognised as the “best” in terms of coverage, timeliness, and comparability. The network of national and international experts created, through the Committees and Working Parties, gives to the Organisation the possibility to launch research activities (and data collections) on new topics, play a leading role in producing new statistics and developing new definitions, classifications and standards.

Nevertheless, the improvement of quality is a continuous process. All OECD statisticians devote a large part of their time to improve quality, but, as experience of other national and international organisations has clearly demonstrated, the adoption of a formalised approach to quality for statistics embodied in the Quality Framework for OECD Statistical Activities can bring important benefits. First, it provides a systematic mechanism for ongoing identification and resolution of quality problems, optimising the interaction between experts in different fields (statisticians, ICT experts, final users, etc.). Second, it gives greatly increased transparency to the processes used by the OECD to assure quality. Finally, it reinforces the political role of the OECD in the context of an information society, increasing the credibility of the Organisation as one of the first class data providers.

Quality is defined as “fitness for use” in terms of user needs. This definition is broader than customary in the past when quality of statistics was often equated with accuracy. It is now generally recognised that there are other important dimensions to the quality concept. Even if data is accurate, they cannot be said to be of good quality if they are produced too late to be useful, or cannot be easily accessed, or appear to conflict with other data. Thus, quality is viewed as a multi-faceted concept. Which quality characteristics are considered to have the highest importance depend on user perspectives, needs and priorities, which vary across groups of users and uses?
Several statistical international and national organisations have identified the dimensions of quality. These have been adapted to the OECD context. Thus, the OECD views quality in terms of seven dimensions: relevance; accuracy; credibility; timeliness; accessibility; interpretability; and coherence. These are discussed below. Cost-efficiency is a related factor, which – though it is not strictly speaking a quality dimension – is still an important consideration in the possible application of one or more of the seven dimensions to OECD statistical outputs.

The OECD Quality dimensions and processes

The OECD Quality Framework contains standards and recommendations related to each of the standard statistical processes in order to satisfy the overall quality requirements.

5. Standardisation of data collection

OECD collects most of its statistical data from member countries, in particular from National Statistical Offices and National Banks. The collection has taken many forms:

- Electronic questionnaires to be filled interactively on a web site
- Excel sheets sent to respondents and returned after filling
- Word documents for metadata
- Web queries, i.e. macros developed and run by OECD to recuperate data from countries’ web data bases
- Sometimes OECD simply asks: “Send us what you’ve got”

None of these methods impose a sufficient degree of standardisation, and therefore they imply inefficiencies for countries delivering the data, as well as for the OECD. Some secondary effects of this are error proneness, loss of time and thus of timeliness of the statistics published, and of course waste of resources.

In order to minimise these problems, OECD is actively engaged in the World-wide standardisation of data collection and sharing SDMX (Statistical Data and Metadata
eXchange, see www.sdmx.org). These technical standards and the content guidelines coming along with them have been recognised as the preferred standard for data collection by UN Statistical Commission in 2008.

6. The OECD Statistical Information System

The OECD aims to provide high quality statistics for international comparisons and analysis, and to make these statistics available to decision makers, analysts and other interested users in an easily usable fashion. In order to be able to work efficiently and to secure optimal interchange of information with stakeholders, data providers as well as users, the OECD is committed to a comprehensive standardisation of methods, formats and contents. This standardisation involves all phases of statistical work.

OECD statistical activities are carried out in several Directorates by statisticians with different backgrounds and work experience. More than 100 statistical activities are carried out by the OECD, the vast majority of which are devoted to collecting, processing and releasing data. Statistics are used daily by a wide range of OECD analysts, whose primary needs are to access data and metadata in the most efficient way. Finally, both internal and external users increasingly need to navigate across databases to carry out multi-domain analyses and comparisons.

Although the decentralised model has many advantages, there are some disadvantages for which steps have been taken to overcome the risks which may result. The main problem areas are related to the efficiency of individual statistical processes and to the overall quality (in particular, coherence and methodological transparency) of OECD statistics from the user’s perspective. A “vision” for a modern OECD Statistical Information System was developed in the context of the Organisation’s strategy for statistics launched in 2001. In that vision, the OECD Statistical Information System was expected to contain tools for data and metadata collection, manipulation, storage, dissemination, discovery and retrieval, preserving the independence of data producers while making their data and metadata part of a coherent and seamless corporate system.

The overall architecture of the Statistical Information System consists of three layers:

- the production layer for the collection, validation, processing and management of statistical data and metadata;
- the storage layer where validated statistics and related metadata are stored;
- the dissemination layer for producing statistical publications and online/offline interactive statistical products.

The three layers in the architectural model (see Box 3) comprise six independent but inter-operating components of the new Statistical Information System:
Box 3

The architecture of the OECD statistical Information System, centered around the data warehouse OECD.Stat

OECD.Stat is the central repository (“warehouse”) where validated statistics and related metadata are stored. It has been designed to preserve the decentralised nature of OECD Directorates' statistical activities, while making their data and metadata part of a coherent corporate system.

OECD.Stat enables analysts and statisticians as well as other users to easily locate any data from a single online source, rather than having to navigate across multiple databases and data formats, each with its own query/manipulation systems. Access to metadata in OECD.Stat helps ensure appropriate selection and use of statistical data. OECD.Stat is progressively becoming the sole source of coherent statistical data and related metadata for the Organisation’s statistical publication and electronic dissemination processes.

Metadata can be attached at any level of an OECD.Stat dataset: dataset-level (e.g. Annual national accounts), dimension-level (e.g., “Variable means…”), dimension member-level (e.g., “GDP means…” and data-level for any lower level (e.g., series level, observation level, etc.).

StatWorks provides a common hosting environment for production databases, based on the OECD standard database platform, MS SQL Server. The objectives are to strengthen standardisation of design and to minimise the number of tools used in statistical activities across the Organisation, and as a result reduce support requirements.

StatWorks includes a toolkit for managing statistical data, including facilities for: database administration; data collection and validation; data manipulation; export of validated datasets to OECD.Stat.

MetaStore is the corporate metadata facility. MetaStore has been designed to improve the efficiency of metadata preparation, storage, access, management and dissemination for the Organisation’s statistical products. MetaStore provides dataset managers with a common set
of tools for managing metadata, and supports adherence to common metadata management principles across the OECD;
(see http://www.oecd.org/document/4/0,3343,en_2649_34257_41170308_1_1_1_1,00.html).
MetaStore and the metadata management principles address problems of fragmented metadata located in numerous databases and text files maintained by different Directorates with the aim of avoiding duplication of effort in metadata preparation, gaps in metadata availability, and inconsistent metadata across databases.

MetaStore provides a database manager with a storage area for statistical metadata; an interface for managing production metadata; facilities for enriching current metadata content through external links to standard classifications, glossary terms and definitions, etc.; export of validated metadata to OECD.Stat. Like OECD.Stat, MetaStore can accommodate any kind of metadata related to any level of detail of the corresponding statistical data.

The OECD.Stat Browser (see http://stats.oecd.org/wbos/Index.aspx) provides online access OECD statistical data and metadata. Greater visibility and availability of OECD statistics are key elements of the Organisation’s Statistics Strategy. The OECD presently provides external users with online access to its statistical resources via several channels: OLIS (the Online Information Service available to officials in national administrations and other international organisations), the OECD Web site, SourceOECD and CD-ROMs.

The browser is easy to use, but also incorporates, *inter alia*, advanced search features to help quickly locate data of interest, and the ability to display multiple families of data (e.g., environmental indicators together with statistics on economic growth) simultaneously.
7. OECD and non-member countries

Evidently, OECD statistics primarily deal with OECD member countries but there are substantial statistical activities involving non-member countries. Intensive cooperation is presently ongoing with the five countries negotiating for membership of the OECD (the accession countries):

- Chile, Estonia, Israel, Russia, Slovenia

OECD also undertakes an enhanced engagement with big and important economies that are not members of the organisation:

- Brazil, India, Indonesia, China, South Africa

The OECD Factbook is a window for showing some of the statistics allowing comparison with important non-member countries regarding economy, living conditions etc. Finally, many more countries participate in specific OECD programs, e.g. the PISA program where 67 countries will participate in 2009.
**Eszter Bagó – Eszter Németh** *

JOINING THE INTERNATIONAL STATISTICAL SYSTEMS – EXPERIENCE AND SUGGESTIONS

Even if statistical methods have a firm foundation, the comparative measurement of social and economic processes calls for a wide international consensus.

The building of statistics that are suitable for international comparison has been first time launched within UN framework. Since then the UN has been following an active role in making statistical terms and methods comprehensive. The classifications (International Standard Industrial Classification of All Economic Activities – ISIC, Standard International Trade Classification – SITC etc.) and methodologies (System of National Accounts – SNA etc.) necessary for consistent statistical surveys have been facilitating the advancement of the global statistical system. With the lead of the Statistical Commission and the Statistics Division and also the specialised agencies 192 countries are involved in the statistical activity.

For the OECD the key role is to help governments pursue sound economic policies by communicating effectively the true nature of the issues at stake, based on sound data and analysis. To do so, the organisation exploits the wide range of communication channels available today from both traditional and new media including one of the greatest comparative statistical databases all over the world.

At the same time IMF has created the Special Data Dissemination Standard (SDDS) aimed at improving the functioning of international financial markets through enhancing the availability of timely and comprehensive economic and financial statistics.

The European Union has achieved an overall harmonisation of statistical data coverage, methodology and dissemination, since timely, reliable and comparable information, statistics are needed in order to execute and evaluate common policies. The methodological principles of the European Statistical System (ESS) lean on the standardization efforts of the UN. At the same time, in accordance with the needs of the EU common policies, data building standards are in operation within the ESS, which are obligatory for the member countries. The article 285. of the Amsterdam Treaty, the 322/1997. Council Regulation and the *acquis communautaire* in statistics safeguard the harmonisation process. Statistical data are linked to administrative demands, too (excessive deficit procedure, membership fee level, subsidies).

Joining the ESS imposes a heavy burden on the members of the national statistical systems in the candidate or potential candidate countries. The legal harmonisation process means the adoption of approximately 300 laws in the field of statistics. The creation of the institutional framework is a requirement in acceding the ESS. The institutional framework should

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Eszter Németh, Head of Communication Department, Central Statistical Office, Hungary*
guarantee professional independence of statistical authorities from other policy, regulatory or administrative departments and bodies, as well as from private-sector operators, since this ensures the credibility of European statistics. Statistical authorities must produce and disseminate European statistics respecting scientific independence and in an objective, professional and transparent manner in which all users are treated equitably. The privacy of data providers (households, enterprises, administrations and other respondents), the confidentiality of the information they provide and its use only for statistical purposes must be absolutely guaranteed. In the ESS the role of the National Statistical Institutes (NSIs) should be strengthened as co-ordinators of the national statistical systems. In this process the NSIs need capacity building.

In joining the ESS not only statistical data coverage, methodology and dissemination are harmonised, the institutes of the national statistical system should adopt the European Statistics Code of Practice, and there is a need for quality commitment by NSIs. The European Statistics Code of Practice was adopted by the Statistical Programme Committee on 24 February 2005 and promulgated in the Commission Recommendation of 25 May 2005 on the independence, integrity and accountability of the national and community statistical authorities. The Code is based on 15 principles covering the institutional environment, statistical processes and outputs (among which non-excessive burden on respondents and cost effectiveness are also included). A set of indicators of good practice for each of the 15 principles provides a reference for reviewing the implementation of the Code. The quality commitment means that all ESS members commit themselves to work and co-operate according to the principles fixed in the ‘Quality declaration of the European Statistical System’. It ensures that product quality is regularly monitored, processes are in place to monitor the quality of the collection, processing and dissemination of statistics and quality guidelines are documented and staff are well trained.

The advantages of joining the ESS can be experienced by both national and foreign users and data providers as well. As a consequence of the harmonisation process in the field of statistics the users get good quality data, internationally comparable data at harmonised release dates. The data collections have coverage upon international consensus, change upon international consensus and ensure that the burden on respondents does not differ from that of competitors.

In order to integrate the candidate and potential candidate countries into the ESS, the EU has elaborated a co-operation programme with these countries. The purpose of multi-country statistical co-operation programmes is to improve the availability and quality of official statistics of the countries. The objectives of such programmes are:

- to reach and maintain compliance with the *acquis* in statistics,
- to integrate the NSIs into the ESS,
- to strengthen the role of official statistics,
- to strengthen the management capacity of the NSIs,
- to strengthen the role of NSIs as co-ordinators of the national statistical systems,
- to support the adoption of a quality framework,
- to make statistics a better tool for policy makers.

Each annual multi-country programme defines concrete objectives to be achieved through implementation of pilot projects in various statistical domains and through statistical
assistance activities such as study visits or participation in meetings. The various activities are funded through grants to the NSIs of the beneficiary countries (covering for example data collection) or through service contracts (e.g. transfer of knowledge through private experts). The CARDS Regional programme 2003, the Multi-beneficiary programmes of 2005 and 2006, the IPA 2007 and 2008 multi-beneficiary programmes have granted more than 27 million euros to the beneficiary countries. The ongoing activities cover six main fields.

**Macro-economic statistics**
Annual and quarterly national accounts are the most important elements of macro-economic statistics. They must be of high quality, timely, and harmonised with EU requirements to offer a solid basis for domestic decision making and comparison with the other countries. In addition, they must be exhaustive to give the full picture of the economic activities in the country. Balance of payments and financial accounts are also important elements of macro-economic statistics.

**Price statistics**
Reliable statistics on price developments are necessary for assessing the inflation in the countries but also for deflating the economic accounts expressed in current prices to get the real growth figures for example. Compilation of Purchasing Power Parities (PPPs) is required for international comparisons of GDP and other economic indicators originally expressed in national currencies. The result is used to allocate EU structural funds.

**External trade statistics**
External trade statistics and their compilation methods need to be harmonised with the EU requirements and their quality and coverage improved. The measures include the use of the Combined Nomenclature for the classification of goods, the extended use of the Single Administrative Document (SAD) and also the analysis and reconciliation of mirror statistics. Reliable external trade statistics are a key input for trade agreements and the discussion of other economic issues.

**Demographic and social statistics**
Reliable demographic and social statistics are necessary for guiding the policy making. Population estimates based on vital and migration statistics, and education statistics need to be improved and the classifications harmonised. Migration is a major priority of European policy makers. However, international migration statistics are among the less reliable statistics within the field of social statistics in the EU. The missing legislation (law related to statistics, but also on residence, on foreigners, on citizenship etc.) in the candidate and potential candidate countries must be established. Indicators and analysis based on reliable labour market statistics are of vital importance for the employment strategy.

**Agricultural statistics**
Agricultural statistics are of particular importance since agriculture is still a major economic activity in the candidate and potential candidate countries. They also provide major input for national accounts. Development of farm registers and agricultural economic accounts is important alongside statistics on agricultural production and prices.
**Business statistics**

Changing economic structures and emerging sector of small and medium sized enterprises underline the importance of business statistics based on reliable statistical business registers. In particular good structural and short term statistics are needed for guiding the economic policy making.

In the global world based on the widely used informatics all countries are in the interest of presenting to the world a reliable view of their economic and social processes. Joining the international statistical systems imposes a heavy burden on the national statistical communities, but in recent years international organisations have put a lot of emphasis on avoiding duplication and on helping the harmonisation activity through direct grants. Our common goal is to arrive at a common statistical language that embraces concepts, methods, structures and technical standards.
SASHO KJOSEV*

PLANNING FOR THE FUTURE – EXPERIENCES OF SOME OF THE SEE COUNTRIES (HUNGARY, CZECH REPUBLIC, SLOVENIA, BULGARIA), WITH SPECIAL REFERENCE TO THE REPUBLIC OF MACEDONIA

INTRODUCTION

On the 1st of May the EU welcomed 10 new member states: Poland, the Czech Republic, Slovakia, Hungary, Slovenia, Lithuania, Estonia, Latvia, Cyprus and Malta. On the 1st of January 2007 two more states joined the EU: Bulgaria and Romania. Diversity is the key word within this group. Both north and south of Europe are present and huge countries have the same rights and obligations like the small countries. The Communist experience itself is not a common denominator, because Malta and Cyprus did not belong to that bloc. Moreover, the history path of the formerly “sovereign” communist countries can not exactly be compared with that of former Soviet Republics, nor with that of the former republics within ex-Yugoslavia. Therefore, these 12 countries have lived through extremely different historical and political experience. For the ten ex-communist countries, the planning mechanisms (imperative and indicative) naturally suffered from deep discredit in the early 1990s. For a time, the terminology related to “planning for the future” was greatly linked to this discredit. Moreover, in a much deteriorated economic and social context, the priority was logically given to addressing short-term challenges.

But the fact that these states joined the EU together marks a shared future and a shared destiny. How do some of these 12 new EU member countries plan for their future? What type of institutional and methodological basis they have on undertaking activities of planning for the future, in order to be better prepared for tomorrow’s challenges more effectively? Without claiming to provide exhaustive answers to these questions, this paper offers presentation of the experiences in the field of planning for the future (institutional and methodological basis) in four SEE countries (Hungary, Czech Republic, Slovenia, Bulgaria) and tries to reach some basic recommendations on the institutional and methodological basis for the implementation of a system of macroeconomic indicative planning system in the Republic Of Macedonia, as a perspective EU candidate country and potential future EU member state.

In general, all of these countries follow the same routine when it comes to the institutional basis: a public player (a department under the aegis if the Prime Minister or a main ministry), and academic player (research institute within the Academy or one of the country’s major universities) and, where appropriate, a private player (regional or independent organizations). From the methodological point of view, more or less, they use input-output analysis, system of national accounts and social accounting matrices and macroeconomic models.

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EXPERIENCES OF SOME OF THE SEE COUNTRIES

1. HUNGARY

1.1. INSTITUTIONAL BASIS

a) ECOSTAT Governmental Institute for Strategic Research in Society and Economy\(^{42}\) – is one of the most prominent institutes for economic analysis in Hungary, specialized in econometric researches and prognostic information activities. The Institute aims to provide scientific researches of high professional quality. Besides the regular analytical, prognostic activities completed for governmental institutions, ECOSTAT cooperates with other research institutes in Hungary. As an organ of the Central Statistical Office it participates in the modernization of economic researches and the development of statistical and econometric methods. Its main activities cover the following:

1) Researches, analyses and prognoses
   • Comprehensive macro economic analyses. Systematic surveys of the national economy as a whole to reveal problems. Separate survey of certain problems requiring special methodology of analysis.
   • Efficiency studies analyzing the expected effects of certain economic policy measures or modification of rules on the national economy.
   • Comprehensive and detailed researches and analyses of the decisive indicators, tendencies and the expected development as regards the certain sub-sectors of economy.
   • Surveys on the development of Hungary’s areas and regions, comprehensive analysis of development levels, comparisons, economic prognoses referring to the certain regions.

2) Developing and operating of econometric models, making projections
   • Some economic policy decisions of the Government and strategic decisions of enterprises need special calculation methods or models enabling several variants and the detailed introduction of consequences deriving from certain decisions.
   • At the recent level of economic changes in Hungary the econometric modelling and scientific analyses of economic processes are of special importance. In the methodological scope of this ECOSTAT provides
     - long and short term analyses of macro economy,
     - projections related to certain spheres of economy,
     - economic analyses for the public service and the business sphere, and
     - the development of methodology connected to economic analyses.

b) GKI Economic Research Co.\(^{43}\) – is the market leader in the market of independent macroeconomic analyses and forecasts. It continues and refreshes the best traditions of its spiritual predecessor, the Hungarian Economic Research Institute – where among others the

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\(^{42}\) [www.ecostat.hu]
\(^{43}\) [www.gki.hu]
renowned Hungarian economist, Bela Balassa worked - it uses the most up-to-date domestic and foreign research achievements and the methods developed in the European Union.

The Hungarian Economic Research Institute was established in 1928 by István Varga and led by him until August 1949, when the institution was dissolved. The institute won European acclaim with its excellent theoretical and practical research staff and high quality studies. Bela Balassa, the world famous economist was one of the members of this workshop. In 1968 – as part of the reform of the central planning – the Economic Research Institute was re-established under the supervision of the Central Statistical Office. Its main task was to analyze the state and the short-term prospects of the economy, to help formulate a sound economic policy, the development of the national economy. After the regime change, in mid 1992 the government dissolved the Economic Research Institute. In October 1992 a number of former staff members of the institute with the help of banks, employer organizations and 154 renowned economists established the GKI Economic Research Company.

1.2. METHODOLOGICAL BASIS

a) Input-output tables

The compilation of input-output tables (IOTs) has a long-standing tradition in Hungary. The first Hungarian IOT was compiled for the year 1957, and since then it was prepared for every subsequent year. Approximately every five years the Hungarian Statistical Office compiles a so-called benchmark IOT based on completely renewed data base. The average size of these IOTs is about 90 times 90 (branches and products). Between two benchmark IOTs (or benchmark years) simplified smaller tables with about 20 groups of branches and products are prepared.

Hungary has been working on the introduction of ESA’95 rules concerning the supply and use tables (SUT) and input-output tables (IOT) framework for several years after 1990. As a result of own work and the PHARE projects (organized by EUROSTAT) for improving the compilation of SUT and symmetric IOT, the Hungarian SUT and IOTs have been compiled regularly since 1998. The first Hungarian *SUT at current prices* was compiled for the year of 1998 and the first *SUT at constant prices* was compiled for the year of 2000. From 2000 onwards the SUT are compiled at current and constant prices simultaneously. Hungary has published complete SUT at current prices and at constant, previous years’ prices for the years 1998– 2004. The symmetric input-output tables with the related import matrix are compiled each fifth tears – for years ending 0 and 5 (excepting the year of 1998) according to the Data Transmission Programme under ESA’95.

The theoretical concept and the definitions are the same for the SUT/IOT and the National accounts, but due to the different data sources, methodology and cross-checking possibilities, the data in the SUT can differ from the ones calculated in the frame of the regular National Accounts. Integration of SUT in the annual national accounts compilation is an important strategic element of the recent improvements aiming to build a fully integrated, more standard, transparent and more reliable estimates of National Account figures. To achieve this, the Hungarian Statistical Office decided to evaluate Norwegian SNA-NT methodology and software.
The Hungarian Central Statistical Office has the following work plan:

- compiling and balancing the system for 2005 (and 2004 as a base year for constant price calculation at prices of previous year) that serves as a reference point for the integrated accounts
- updating and balancing the SUT system for 2006 and 2007
- analyzing the results of three consecutive years
- decision making on the implementation of the new integrated compilation method as a regular method of calculation of NA in 2008
- decision making on the revision of the time series.44

b) Macroeconomic models

Since the start of the 1990s, economic modellers in transition economies have been faced with two main challenges. The first one, which has been a rather specific problem for these countries, is the task of building macro-econometric models of the transition using very few and unreliable data. The second one, which is a general consequence of the globalizing world, where interactions among national economies are becoming more and more important, is a modelling of the domestic economies interactively with the rest of the world. In the case of Hungary, the two best known structural econometric models are the Hungarian version of the NIGEM model developed by the London-based National Institute of Economic and Social Research (NIESR), and the Quarterly Projection Model (henceforth denoted by N.E.M.) of the National Bank of Hungary (MNB).

1. NIGEM (National Institute’s Global Econometric Model)

NIGEM is a nationwide, one-sector aggregate, economy model for Hungary used by the National Bank of Hungary for analyzing the effects of world shocks, for quarterly forecasting exercises and other policy simulations. It is developed in collaboration between the National Bank of Hungary and the National Institute of Economic and Social Research. Namely, this model is mainly a result of cooperation between the National Institute of Economic and Social Research (NIESR) and five Central-European Central Banks, including the National bank of Hungary (Czech National Bank, the National Bank of Poland, the Bank of Slovenia and the Bank of Estonia). The aim of this cooperation was twofold: (1) Building nationwide macro-econometric models for policy simulations and forecasting for five (in that time) accession countries: the Czech Republic, Estonia, Hungary, Poland and Slovenia. (2) Inserting these five national economy models into the NIESR’s NIGEM model, to be able to perform multi-country analyses and forecasting for the accession period.45

2. Quarterly Projection Model (N.E.M.) of the National Bank of Hungary

The origins of NEM (structural macro-econometric model of the National Bank of Hungary) date back to 1999, when the National Bank of Hungary (Magyar Nemzeti Bank) started to include Hungary in the NIGEM global model. This was primarily used for simulations and scenario analyses; however, projections for some world variables were also gained from NIGEM. The first version of the NEM model was developed in 2003. The decision to

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44 (Forgon and Ligeti, 2007, and Simpson, Homestad, Liv, 2007)
45 (Jakab and Kovacz, 2002)
develop a new macroeconomic model was motivated by the switch to the inflation targeting regime.

In order to achieve its inflation target, the MNB needs an assessment of the current state of the economy and a forecast for its future path. The MNB publishes its comprehensive macroeconomic projections in the Quarterly Report on Inflation. The forecasts are produced by using both the NEM model and other forecasting methods. The latter are comprised of expert forecasting systems using partial econometric equations, time-series techniques, indicator models and pure expert judgment, while the actual NEM model forecasts also encompass expert judgment in specifying the path of the exogenous variables and the possible add-factors that usually reflect foreseeable shocks to the economy. The model-based and expert forecasts are then harmonized, so that the final projection becomes a consensus of model-based and expert level information.

In addition to preparing the quarterly projection, NEM is used also for simulations and scenario analyses. On the one hand, these can take the form of updating the projections with changing some of the exogenous assumptions and, on the other hand, NEM is also used to carry out more complex policy and macroeconomic simulations.46

3. PM-KTI macroeconomic model
This model, developed jointly by the Economic Policy Department of the Ministry of Finance and the Institute of Economics of the Hungarian Academy of Sciences, can be used for short- and medium-term forecasts and simulations. The model describes the macro-level mechanisms of the Hungarian economy, relying on historical data and theoretical economic relationships. It can be used to forecast key economic processes in the short and medium term and to quantify the expected impact of economic policy measures and of changes in the external environment. The model contains approximately twenty behavioural equations which describe the decisions of economic actors, and a much larger number of accounting identities; thus it is similar to the medium-sized macroeconomic models used by other ministries of finance, international institutions and central banks.47

Moreover, what is really positively striking feature are the continuous efforts of the ECOSTAT Economic Modelling Department, dealing with development and applications of macroeconomic models. They have already developed several macro-econometric, simulation and calibrated models. Most important of them are the following:

- ECO-LINE model – a quarterly macro-econometric model of the Hungarian economy, designed for short and medium term forecasting and policy analysis. It is used regularly as a basis of the ECOSTAT short-term macroeconomic forecasts. It contains both econometric and balance equations and describes the whole national economy in the form of ESA95 system. The model is a simplified version of the Hungarian economy, mainly based on National Accounts concepts. ECOLINE is considered the first attempt to provide forecasting and policy analysis for the Hungarian economy within a macro-econometric modelling framework.
- ECO-TREND model – a calibrated macroeconomic model, by which the long-term development of the national economy is modelled and analysed. It was already used

46 (Benk, Jakab, Kovacz, Parkanyi, Reppa and Vadas, 2006)
47 (Biro, Elek and Vincze, 2007)
several times to make studies for different authorities and decision makers in Hungary.
• SOCIO LINE model – a model of long-term social and economic sustainability. This means that it also includes social indicators like inequality, environmental capital, rents, and also the democracy level is modelled.

2. CZECH REPUBLIC

2.1. INSTITUTIONAL BASIS

The Center for Social and Economic Strategies (CESES) is an interdisciplinary research and education unit engaged in the development of theory, methodology and practice of exploring possible futures, and the application of analyses and forecasts in decision making. For this purpose, CESES:
• identifies the key problems and development priorities of the Czech Republic;
• provides partial and comprehensive analyses, scenarios, visions and strategies of the social, economic, environmental and political development of the Czech Republic in a European and global context;
• promotes dialogue between experts, politicians, civil servants, civil sector activists, as well as individual citizens;
• provides cognitive and methodological provisions so as to help improve the strategic governance of the country.

It was established in October 2000 at the Charles University, Faculty of Social Sciences, as an interdisciplinary research think tank that interacts with many organizations and institutions in and outside the Czech Republic. The Center has established contacts with the Government of the Czech Republic, both Houses of Parliament of the Czech Republic, scientists, civic activists and the media. It has advisory role to the Council of the Czech Republic for Social and Economic Strategy, and is tasked with constructing scenarios on the economic, social and political development of the Czech Republic and on its international environment. The CESES’s main task is to systematically explore the possible futures of the Czech economy and society, to identify looming threats and developmental possibilities, and to outline visions, strategies and scenarios of its further development.

The centre is engaged in target-oriented, social-sciences research of high quality. Both the scope of its research work and the membership of its team have expanded progressively since its foundation in 2000. CESES currently conducts research work in the following areas: (a) Governance, Public Administration and the Public Sector, (b) Identifies the key problems and development priorities, (c) Education Policy, Research and Development Policy, (d) Human Resources and Social Capital, (e) Economic Competitiveness, (f) Security and Foreign Policy, (g) Demographic Trends, (h) Quality of Life and Sustainable Development, (i) European Integration, (j) Modernization Concepts, and (k) Social Cohesion, Cultural and National Identities.

www.ceses.cuni.cz
2.2. METHODOLOGICAL BASIS

a) Input-output tables

In the Czech Republic, the Czech Statistical Office (CZSO) is responsible for the national accounts in current and constant prices compilation. Until the year 2003, the constant prices data were calculated only for the quarterly GDP estimates. They were not based on the supply and use tables and were related to the fixed year base. Since 2004 the Czech Statistical Office has started with annual Supply and Use compilation in current and constant prices. From 2006 the Czech Statistical Office has introduced the Norwegian methodology and software SNA-NT for current and constant SUT compilation of the National Accounts. This has enabled compilation at more detailed SUT industry and product level. A more detailed SUT enabled improvements of the constant price estimation of VAT, product taxes and product subsidies by compiling more detailed valuation matrices in the Use table. It enabled also improvements of the constant price estimation of trade and transport services, by compiling more detailed trade and transport margin matrices in the Use table. The Czech Statistical Office provide the supply and use tables and symmetric input-output tables to a many users such as government institutions and ministries, Eurostat and also to universities, students etc.49

Currently, the Czech Statistical Office has a time series of supply and use tables for the period 1995-2006 and symmetric input-output tables for the years 2000 and 2005, and both of these tables are easily accessible at the following web-site: http://dw.czso.cz/pls/rocenka/rocenkaout.dod_uziti?mylang=cz.

b) Social Accounting Matrix (SAM)

Presently the Czech national accounts are almost fully compatible with the other countries of European Union, although in some details harmonization is still being carried on. Although methodologically there is no serious imperfection in Czech national accounts, there is a problem of data quality. While other countries of European Union, which have a long time experience with the compiling of national accounts, have relatively stable economic environment and long time series at their disposal, Czech Republic has been missing both of them. Before the main revision of Czech national accounts, Czech Statistical Office had no comparable time series of the national account aggregates. After the revision the Czech Statistical Office has time series of aggregates for the years from 1992 to 2006, which are methodologically harmonized with ESA 95 standard.

At the moment, the Czech Statistical Office has prepared social accounting matrices (SAM) for the years 2004, 2005 and 2006. All the three social accounting matrices are easily accessible at the following web-site: http://dw.czso.cz/pls/rocenka/rocenkaout.sam_matice?mylang=cz.

49 (Simpson, Homestad, Liv, 2007)
c) Macroeconomic Models

The preparation and usage of macroeconomic models for economic policy creation and analysis is quite dynamic. The main institution engaged in the process of macroeconomic model building is the Central Bank of the Czech Republic.

1. Quarterly Projection Model (QPM)

The goal of the CNB’s Quarterly Projection Model (QPM) is to provide a high-level description of the core dynamics of the macro economy. As a research tool, it provides a means of learning about the functioning of the economy and studying policy options. Within the context of the forecast, the model has two roles. First, it provides an organizational framework for the exercise, and a consistent story about how the short-term conjuncture will evolve into the medium term. A crucial part of this is a description of what needs to be done, conditional on all the other assumptions in the forecast, to respect the inflation target. This is the primary contribution of the model to a baseline scenario. Second, the model plays a more central role in dealing with uncertainty. Given the judgmental baseline forecast, the model can be used to study the implications of the major risks to the forecast. By exploiting the model’s power to simulate the implications of varying the key assumptions in the baseline forecast, the Czech Central Bank is able to expand greatly its ability to quantify the implications of the main risks. Moreover, the model, which is clear and simple in describing the economic situation in the country, captures the essential macroeconomic linkages, and especially the way monetary policy choices influence the economy and inflation. Thus, it provides a focus for debates on policy issues faced by the Czech economy and society.50

2. The new g3 structural model

The Czech National Bank has added a new model to its range of analytical tools: a "g3" dynamic structural model reflecting the basic characteristics of the Czech economy (since January 2007). The model captures the basic characteristics of the Czech economy as described by the levels and dynamics of variables such as prices, wages and GDP components in both nominal and real terms. Given the openness of the Czech economy, emphasis is placed on foreign trade and the exchange rate and its effects. The structural linkages within the model provide a relatively detailed view of the relationships between nominal variables and the real economy and of the supply side of the economy in an analytically consistent framework. The main difference from the previously applied QPM model is that the new model is more strongly anchored by microeconomic assumptions. In the g3 model, the economy is divided into a corporate sector, a household sector, a state sector and an external sector.

As an analytical instrument, the g3 model is used mainly to interpret present and to forecast future developments in the economy and analyse the risks of the forecast. The main forecasting inputs are an assessment of the current state of the economy (current structural shocks and the economic story they imply – the starting conditions), projected developments abroad and the outlook for administered prices and government consumption. Based on this input information and an expert view, the forecast is then compiled for the economy. The new

50 www.cnb.cz
model framework, like the previous one, allows alternative scenarios – capturing the main risks of the forecast - to be drawn up in addition to the baseline scenario.51

3. HERMIN CR
The model Hermin Czech Republic (HERMIN CR) is a medium-scale, multi sector econometric model built to handle small-open-economy issues. HERMIN macro models have been used successfully in the analysis of convergence of several peripheral countries of the EU (Ireland, Spain, Portugal and Greece) as well as in the investigation of impacts of the Community Support Framework (CSF) structural funds and the effects of the Single Market. HERMIN CR has been developed under the ACE PHARE with the title: “Macroeconomics and structural change in transition economies: common themes in CEE and EU-periphery countries”. The objective of the project was to apply the ‘methodology’ of HERMIN models in construction, estimation and testing of macroeconomic models of three transition countries: Czech Republic, Romania, and Slovenia. Today, the research mostly concentrates on issues of calibration and design of likely future scenarios for the socio-economic development of the Czech economy.52

3. SLOVENIA

3.1. INSTITUTIONAL BASIS

The Institute of Macroeconomic Analysis and Development (IMAD) of the Republic of Slovenia53 – is an independent government office. Its Director answers directly to the President of the Government. The key function of the Institute of Macroeconomic Analysis and Development is to prepare current analyses and forecasts of the macroeconomic trends on the basis of the statistical data from the Statistical Office of the Republic of Slovenia. IMAD's analyses and forecasts are expert documents intended for the Government of the Republic of Slovenia and ministries in formulating economic policy measures. IMAD was in charge of expert and technical co-ordination of several key strategic national documents such as the Strategy for the Economic Development of Slovenia, the Strategy of the Republic of Slovenia for Accession to the European Union (economic and social chapters), the Joint Assessment of Economic Policy Priorities, and Slovenia's Development Strategy. The Institute also participates in drafting the Budget Memorandum, the National Development Plan and the Stability Programme. The main publications for this purpose are the Spring and Autumn Forecasts of Economic Trends, which provide the macroeconomic basis for budget preparation, and the Development Report, a detailed annual overview of Slovenia’s development. The Institute performs the following tasks:

• monitoring and analysing current developments of the socio-economic and environmental dimensions of development, based on the national development orientation
• forecasting the main macroeconomic aggregates
• preparing expert opinions for the formulation of economic policy orientations and measures

51 www.cnb.cz
52 www.cnb.cz
53 www.gov.si/umar
• preparing short- and medium-term forecasts of macroeconomic aggregates (twice a year, by 15 April and 15 October)
• preparing analyses that serve as a basis for strategic decision-making and economic and development policy measures
• research work.

3.2. METHODOLOGICAL BASIS

Since the beginning of its independence from ex-Yugoslavia, Statistical Office of the Republic of Slovenia started creating an integrated analytical documentation (consisting of national accounts data, supply and use tables, the symmetric input-output tables and the social accounting matrices), which served as a basis for the preparation of current socio-economic analyses and forecasts of the macroeconomic trends (by the Institute for Macroeconomic Analysis and Development) of the future sustainable socio-economic development of the Republic of Slovenia. Moreover, the Institute for Macroeconomic Analyses and Development and the Institute for Economic Research are actively involved in the field of preparation and utilisation of different kinds of macroeconomic models (structural input-output models, CGE models, macro-econometric models, and so on) for macroeconomic analyses and forecasts.

a) Input-output tables

In Slovenia, supply and use tables are a part of the input-output system, which is an integral part of national accounts. They present a breakdown of goods and services account, production account and generation of income account in the system of national accounts. Supply and use tables are matrices describing the domestic production process and transactions in products of the domestic economy in great detail. They show the structure of production, costs of production and incomes generated in the process of production, flows of goods and services produced within the domestic economy and flows of goods and services with the rest of the world. Supply and use tables are the starting point of the system and a basis for the construction of a symmetric input-output table. The tables are used for analytical and statistical purposes.

As the other central and eastern European countries, Slovenia has a long tradition in compiling input-output tables. They were regularly compiled since 1960’s. From the year 1996, Slovenia has started compilation of SNA 93/ESA 95 supply and use tables. Up to the year 2001, Statistical Office of Slovenia compiled supply and use tables at the working version of 220 industries (following the 3-digit NACE classification) and 220 products for supply and 150 products for use of CPA classification, using Excel worksheets. The tables were balanced at the level of 60 industries and products groups. The set of compiled tables included supply and use tables, valuation matrices for taxes and margins and use of imports table. At this basis there were compiled symmetric product-by-product input-output tables, including tables for domestic output and for imports. During the Phare project period SORS
started using the SNA-NT methodology and software system which enables more convenient work with more detailed data compared to Excel compilation.\textsuperscript{54}

The latest prepared versions of the supply and use tables are for the years 2004 and 2005, and the symmetric input-output tables were prepared for the years 1996, 2000, 2001 and 2005. (see web-sites: \url{http://www.stat.si/eng/novica_prikazi.aspx?id=1528} and \url{http://www.stat.si/eng/pub_statinf1.asp?podrocje=3})

\textit{b) Social Accounting Matrix (SAM)}

Social accounting matrices are widely accepted and used in the process of socio-economic policy creation and implementation in the Republic of Slovenia. The first SAM for Slovenia was prepared for the year 1992 by Prof. Ivo Lavrac from the Faculty of Economics at the University of Ljubljana. It was based on the so called wider concept of production and GDP which includes all activities and commodities. The wider concept is methodologically dependent on the system and categories of the national accounts. This SAM was used as a basis for the creation of a computable general equilibrium model for the Slovenian economy, used for analyzing the possible effects of Slovenian integration to EU.\textsuperscript{55} There is significant number of papers presenting the earliest efforts and successes in compilation and preparation of the SAMs in Slovenia.\textsuperscript{56}

Since then, on yearly basis, the Institute for macroeconomic analysis and development prepares small, medium and large social accounting matrices, which are used for updating the computable general equilibrium models for the Slovenian economy. In addition, the Institute for economic research (\url{www.iер.si}) is also actively involved in the compilation and preparation of SAMs and macroeconomic models for the Slovenian economy.

\textit{c) Macroeconomic Models}

1. Computable General Equilibrium (CGE) Model
In 1996, a computable general equilibrium model was built to calculate possible effects of Slovenian integration to the EU.\textsuperscript{57} One of the advantages of this approach is the consistent database of the social accounting matrix for Slovenia for 1992, prepared for this model by prof. Ivo Lavrac from the Faculty of Economics at the University of Ljubljana. This model includes two production factors (labour and capital) and three types of institutions (enterprises, households and the Government). The model includes 3760 equations and the same number of variables. It is an applicative variation of the CGE model with a strong focus on expanded analytical application. This model was used to analyze the current situation of the Slovenian economy and prepare three types of simulations:

\textsuperscript{54} \textit{(Simpson, Hobbelstad Liv, 2007, 11-12)}
\textsuperscript{55} \textit{(Potocnik and Majcen, 1996, 177-206)}
\textsuperscript{56} \textit{(Lavrac, Ivo 1993; Zakotnik, Ivanka 1997; Lavrac, Ivo, Tavcar, Branka and Ivanka Zakotnik 1998; Zakotnik, Ivanka 1999)}
\textsuperscript{57} \textit{(Potocnik and Majcen, 1996, 177-206)}
• analysis of sectoral or structural effects of Slovenia approaching the EU
• analysis of global macroeconomic effects of approaching the EU together with the analysis of the structural problems, and
• analysis of the scenario of Slovenian economic development from the Strategy for economic development of Slovenia, together with the effects deriving from Slovenia approaching the European Union.

2. SLOPOL6 - quarterly macro-econometric model
SLOPOL6 is a quarterly macro-econometric model of the Slovenian economy, which is a revised and updated version of a series of models built by these authors since the late 1990s, with increasing degrees of sophistication and reliability. These models were used for various purposes of forecasting and especially evaluating alternative policies, where simulation and optimization experiments were conducted to arrive at politically relevant insights and policy recommendations. SLOPOL6 (SLOvenian economic POLicy model, version no. 6) is a medium-sized macro-econometric model of the Slovenian economy. In its current version, it consists of 57 equations of which 21 are behavioural equations and 36 are identities. The former were estimated by ordinary least squares (OLS), using quarterly data for the period 1995:1 until 2005:4. Data for Slovenia were provided by the Slovenian Statistical Office, by the Institute of Macroeconomic Analyses and Development (IMAD), and by the Bank of Slovenia. Euro Area data were taken from the EUROSTAT database, except for the short-term interest rate in the Euro Area, which was extracted from the database of the German Bundesbank.58

3. SloMod - Dynamic CGE model
In 2005, the Government of the Republic of Slovenia tackled extensive reforms for increasing the welfare in Slovenia. For a comprehensive analysis of complex consequences of the proposed tax reform a dynamic computable general equilibrium (CGE) model of the Slovene economy was prepared. The SloMod CGE model is based on the social accounts matrix (SAM) of the Slovenian economy for 2004. Even though detailed supply and use tables were not available together with all matrices of taxes, subsidies, margins and import, wishing to draw the base year as close to the present as possible the Institute for Economic Research prepared the estimate of SAM for 2004. The estimate based on the use of official supply and use tables for 2002 and data from national accounts for 2004. First, the estimate of the supply and use tables for 2004 had to be prepared so that later on SAM for 2004 could be produced. In its final form SloMod enables comparison of effects of alternative economic policy measures and scenarios for a large number of sectoral and national variables such as production, employment, investment, trade, prices and welfare. SloMod represents a precise framework on the basis of which results can only derive from explicitly used data and assumptions reflecting essential characteristics of the behaviour as proposed by the conventional economic theory. Results of the SloMod model provide useful information about the probable direction and size of responses to economic changes.59

4. SIOLG 2.0-overlapping-generations general equilibrium (OLG-GE) model
The model SIOLG 2.0 is a dynamic overlapping – generations general equilibrium model of the Slovenian economy, based on social accounting matrix (SAM) for 2000 data on

58 (Weyerstrass and Neck, 2007)
59 (Boris Majcen et al., 2006)
demographic structure of the population, expected future demographic developments, characteristics of Slovenian households, and decomposition of households within generations. The model has been developed with the very intention of analyzing the sustainability of the Slovenian public finances, though it can be used to analyze any part or any sector of the economy. Namely, the model SIOLG 2.0 makes possible analysis of intra-generational and inter-generational redistribution effects of potential effects of different strategies of public financing in order to achieve sustainable long-term economic growth and social development. It also enables monitoring and anticipation of effects of unfavourable demographic developments on the volume of social transfers to the population. Dynamic general equilibrium model SIOLG 2.0 comprises not only the standard model structure of a national economy, but also the demographic block and the pension block, within the framework of which the first and the second pillar of the Slovenian pension system are being modelled.60

4. BULGARIA

4.1. INSTITUTIONAL BASIS

The Agency for Economic Analysis and Forecasting61 – is a government Executive Agency (attached to the Ministry of Finance, as per the State Administration Act) and assists the Minister of Finance of the Republic of Bulgaria in the exercise of the powers by preparation of analyses, forecasts and strategic documents. The Vision of AEAF is to strengthen its position as a leading institution for analyzing and forecasting the economic development of Bulgaria and to support decision-making in the field of economic policy. The main tasks of the Agency are as follows:

- analyses the economic performance of Bulgaria and the current business environment and elaborates assessments on the country's economic development prospects;
- prepares short-, medium- and long-term forecasts for Bulgaria's economic development trends under different economic policy scenarios;
- prepares the macroeconomic budget framework for the current year and the following three years;
- prepares and/or coordinates the elaboration of the National Development Plan and the National Strategic Reference Framework;
- elaborates and updates annually the Convergence Programme of the Republic of Bulgaria in accordance with the Stability and Growth Pact;
- coordinates inter-departmental work on the preparation of the National Reform Programme of the Republic of Bulgaria as well as the monitoring and analysis of its implementation in line with the Relaunched Lisbon Strategy;
- participates in the elaboration of the Government's strategic documents and assesses their compliance with the National Development Plan and the National Strategic Reference Framework;

60 (Verbic, 2007; Verbic, 2007a; Verbic, Majcen and van Nieuwkoop, 2006)
61 www.aeaf.minfin.bg
• is responsible for the preparation of regular reports on the macroeconomic impact of the absorption of EU funds, the implementation of the National Strategic Reference Framework and the Operational Programmes;
• carries out analyses of the implementation of major infrastructure projects focusing on their economic impact;
• is put in charge of the assessment of the anticipated effects on macroeconomic level of any changes in the legislative and regulatory framework and economic policy.

4.2. METHODOLOGICAL BASIS

a) Input-output tables

The compilation of Input-Output tables in Bulgaria has more than 45 years of tradition. The first Input-Output table has been compiled in 1960 and till 1989 the general framework of the tables has been subordinated to the methodological principles of Material Product System (MPS), applied in the conditions of centrally planned economy.

The real implementation of the System of National Accounts methodology started in 1990-1991 and the first Supply and Use tables (SUT) for Bulgaria for 1991, 1992 and 1993 were published in 1996. During the transition period the general frame of the Supply and Use tables was improved in compliance with the revised methodology of SNA’93 and definitions, concepts and accounting rules of European System of Accounts 1995 (ESA’95). Presently the SUTs for Bulgaria are compiled annually at current and constant prices following the methodological principles of ESA’95. The compilation process is based on the newly established infrastructure and framework organized within the Norwegian SNA-NT application software implemented in practice in 2004 as a result of the two years bilateral cooperation with Statistics Norway. The year 2000 was the first reference year for a fully detailed and balanced SUT, using the SNA-NT methodology and software. Bulgarian National Statistical Institute has later completed SUT in current prices for the years 2001 and 2002.  

The latest publication of the National Statistical Institute of Bulgaria contains Supply and Use tables for 2003, elaborated and developed in a full compliance with International methodological standards of European System of Accounts, 1995 (ESA ’95) and System of National Accounts, 1993 (SNA ’93). The tables are an integrated part of Annual National Accounts, as they present in a final and balanced version, the economical categories into the structure of GDP, structured in details by: groups of products and services, types of production activities, types of categories of final demand. The national programme for statistical surveys for 2008, with regards to the supply and use tables, includes balancing the tables for 2004 and development of tables for 2005.  

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62 (Todorov and Kirilova, 2006, 2-3,18; Simpson, Hobelstad Liv, 2007, 9)  
63 www.msi.bg
b) Macroeconomic Models

1. The AEAF model: a medium term annual model of the Bulgarian economy
   The medium-term macroeconomic model was worked out by the agency's analysts, under EU PHARE Project BG 9909-02-01 “Support for the Implementation of the Medium Term Strategy and the Restructuring of the Ministry of Finance”.

   The model is an annual model, although some of the parameters are estimated on the basis of quarterly information. Its main feature is that it is based on an integrated set of financial and national accounts. It contains both, the determination of product demand and supply, labour demand and supply in the real sector of the economy and a rather detailed monetary sector. The latter describes the main financial relations between the central bank, private banks, government and the private and foreign sectors. In spite of the incomplete statistical information and the general difficulties in modelling financial flows, the inclusion of a monetary sector was considered extremely important from the outset. The main reasons are that monetary developments played a significant role in recent Bulgarian socio-economic developments.

2. Bulgarian National Bank Quarterly Projection Model
   This model was prepared within the twinning Project “Adjustment of the Bulgarian National Bank to operate as a full-fledged member of the European System of Central Banks and the Euro-system”. This model is similar to the European System of Central Banks multi-country model country blocks, and belongs to the group of traditional structural macroeconomic models.

   The development of a model over the period 1998-2007 poses formidable challenges, given the short and volatile time series, and hence the model is continuously tested and simulated in order to improve it. It should be viewed as work in progress and an area for future empirical research within the Bulgarian National Bank, rather than as a finished product. The purpose of the BNBQM is twofold: (1) to produce macroeconomic forecasts for the Bulgarian economy, and (2) to assess the effects of economic shocks on the Bulgarian economy in simulated scenario analyses.

RECOMMENDATIONS FOR THE REPUBLIC OF MACEDONIA

Why Republic of Macedonia needs macroeconomic indicative planning?

1990s were years of significant changes. In front of our eyes a world disappeared, a world that everybody thought to be stable, long-lasting and practically indestructible. The transformation of the socialist into market-based economies is basic task of the policy-makers, the international community and the economic profession. The economic reforms implemented in the ex-socialist economies are something new in the world economic history, having in mind its enormous complexity. The reason for this is quite simple: these reforms are not aimed at the reform and modification of the existing economic system, but at its complete transformation and replacement. Such ambitious goal asks for revolutionary changes in the institutional infrastructure and in the way one implements economic policy. These institutional, material and intellectual changes significantly affected the attitude
towards the role and the significance of the macroeconomic planning. There were tendencies to consider macroeconomic planning as the only reason for the destruction of all socialist socio-economic systems.

After gaining its independence, Republic of Macedonia left the system of economic planning of its economic development and started creating and implementing a functional market-based economy. But, in these efforts, Macedonia neglected the experiences of many of the market-based economies, which point out to the significant importance of the economic planning in managing the economic development processes in those countries. In other words, the market-based economies use economic planning as an instrument for preparation of development strategies and implementation of coherent and coordinated economic policies. Moreover, the transition countries experiences impose necessity to implement economic planning as one of the instruments for creation and implementation of economic policies that will enable and provide stable and continuous economic development in these countries.

The need for implementation of macroeconomic indicative planning is much more visible in Macedonia, as a transition country, where the Government should implement managerial activities in the public sector, public finances, etc. A basis for such indicative economic planning is the macroeconomic policy document of the Government, which provides instruments necessary for the realization of the predetermined medium and long-term development goals. The macroeconomic planning document of the Government should be a programme for the Government medium-term socio-economic and environmental policy, with clearly specified activities for the: public investments, public enterprises, local economic development, social assistance, public revenues and expenditures, etc. This system of indicative economic planning is compatible with those already existing in the market-based economies and enables realization of the Government medium and long-term goals of the socio-economic and environmental (sustainable) development.

Institutional aspects of the economic indicative planning in the Republic of Macedonia

The institutional aspects of the macroeconomic indicative planning are the most important issue when it comes to the organization of the future system of macroeconomic planning in the Republic of Macedonia. Here, one should have in mind the experiences of the institutional organization of economic planning systems and processes in the developed market economies. So far, there are no suggestions for the economic planning system institutional arrangements in Macedonia. In our opinion, the most significant part of the institutional arrangements of the future economic planning system in Macedonia should be the so called “economic triangle”, representing the close relations between the:

- State Statistical Office;
- Agency for macroeconomic models, analyses and studies (currently non-existent in the system); and
- Ministry of Finance (Department of macroeconomic and development policy).

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64 Kosev, 2001, 136-137
Their relations and interdependence is of key importance for efficient functioning of the future institutional organization and inter-relations in the system of macroeconomic indicative planning (picture 1).

**Picture 1**

**Institutional framework of the indicative macroeconomic planning system in the Republic of Macedonia**

The State Statistical Office collects, processes, analyses, stores, publishes and disseminates statistical data, studies’ results and analyses related to the numerous socio-economic aspects in the society. Its mission is to provide objective, timely and accurate information about the state and directions for development of the economic, social, demographic and environmental fields. It implements great number of research activities and surveys within the companies, households, public and private institutions in the Republic of Macedonia. All the statistical activities and surveys are realized using statistical methodologies harmonized and comparable with the international standards and classifications. The results from these research activities provide wealth of information about the Macedonian economy, for preparation of a scientifically and practically based efficient macroeconomic policy and planning.

The most significant role in the process of preparation, elaboration and harmonization of the macroeconomic development plans and programs rests with the Agency for macroeconomic models, analyses and studies (currently non-existent in the system). The Agency would have
two basic tasks: economic data collection and preparation of macroeconomic studies, analyses and forecasts. The Agency should be the basic institutional and organizational Government unit responsible for preparation and operational use of macroeconomic models for preparation or macroeconomic development policy and planning documents and programs. It basic tasks should also include:

- analysis of the sectoral and structural effects of the EU integration processes in the Republic of Macedonia;
- analyses of the global macroeconomic effects of the EU integration processes in the Republic of Macedonia; and
- econometric evaluation/estimation of the economic content of the political parties’ electoral programs in the Republic of Macedonia. This will increase the democratic responsibility of the political parties.

Department of macroeconomic and development policy (within the Ministry of Finance), cooperating with the Central Bank and other Ministries in the Government, would be an institution responsible for the preparation and realization of the macroeconomic and the development strategy and policy. Its basic tasks should be:

- preparation and elaboration of the macroeconomic policy and development strategy and policy documents, which would be operationalisation of the basic tasks and goals determined by the Government and the National Parliament;
- preparation of a medium and long-term development program (medium and long-term macroeconomic plan for the next 5-15 years);
- preparation of analyses on the conditions, development, the problems and the perspectives of the country on national and local level, for the main economic sectors and fields of economic activity;
- implementation of the economic policy measures; and
- drafting plans and programs for cooperation with the international development organizations and institutions, etc.

The Macroeconomic Department should use the macroeconomic models and macroeconomic analyses prepared by the Agency for macroeconomic models, analyses and studies in the process of preparation of the Government macroeconomic policy and development strategy and policy documents (also, immensely using the macroeconomic models prepared for the Macedonian economy by the OECD, IMF, the World Bank and other international institutions).

Methodological aspects of the economic indicative planning in the Republic of Macedonia

Indicative planning methodology has a significant importance on the coherency, complexity and consistency of the national planning system in the country. It enables the consistency during the process of obtaining information about the development conditions and problems, adjustment of the policy-makers’ tasks and goals, as well as the preparation and realization of the socio-economic development plans and programs.

65 (Kosev, 2004, 208-243)
In order to satisfy the abovementioned, it is necessary the effort of the scientists and experts in our country to be focused on preparation of a complex analytical framework, consisting of:

a) preparation of an input-output table;

b) preparation of a highly disaggregated Social Accounting Matrix – SAM

c) preparation of a macroeconomic CGE human sustainable development model.

**a) Preparation of an input-output table**

The input-output tables became vital parts of the national accounts in many countries worldwide. Today, they provide consistency of the data from different data sources for calculation of the basic macroeconomic aggregates – national income and the national product. The last input-output table for Republic of Macedonia was prepared in 1987 as a benchmark year. For this table, the system of material production was used (official statistical methodology of the ex-socialist countries). In 2000, the State Statistical Office of the Republic of Macedonia implemented a project on preparation and elaboration of supply and use tables for 1997 and 1998, but without any visible results. In 2008, a supply and use table for the year 2005 was prepared.

There is a strong need for the construction of an input-output table according to the SNA 1993 and ESA 1995 methodology. It will enable analyses and planning of the creation and distribution of the GDP and the national income, as well as the rest of the macroeconomic aggregates. This will significantly improve the analytic-accounting framework which will be used for the preparation and implementation of the Government macroeconomic and development policy. This input-output table for the Macedonian economy will:

- provide a conceptual and coherent framework to integrate the production data;
- provide a tool to test the coherence, consistency and quality of the various censuses and surveys for agriculture, industry and manufacturing censuses, service, trade, etc. surveys, SNA and other relevant information;
- provide a tool for the analysis of the production structure, its integration and links within and with the formation of factorial income (value added) and final demand;
- provide an analytic-accounting framework to study interactions regarding economic growth, employment and capital requirements and price formation, economic growth and factorial income distribution;
- serve as database for the partial updating of the sustainable human development model system.

**b) Preparation of a highly disaggregated Social Accounting Matrix – SAM**

There is no Social Accounting Matrix (SAM) for the Republic of Macedonia at the moment. But, for the period 1994-1996 there are data time series with a set of sectoral accounts (from the production to the capital account, for five domestic institutional sectors and rest of the world sector). Moreover, there is a high quality data time series for the national accounts for the period 1997-2005. Thus, it is a due time the State Statistical Office, together with the relevant ministries in the Government and experts from the scientific and educational institutions in Macedonia, as well as with institutions and experts from the developed market economies to start the preparation and construction of a highly disaggregated SAM for the
Republic of Macedonia, based on the positive experiences of the developed market and transition economies. The SAM for the Republic of Macedonia would mainly have two basic tasks:

- to enable presentation of information about the economic and social structure of the national economy; and
- to provide analytic-accounting framework as a basis for construction of macroeconomic models for analyzing the national economy and the effects from the implementation of the macroeconomic and development policy measures.

The SAM is a comprehensive, flexible, and disaggregated framework which elaborates and articulates the generation of income by activities of production and the distribution and redistribution of income between social and institutional groups. A principle objective of compiling a SAM is, therefore, to reflect various interdependencies in the socioeconomic system as a whole by recording, as comprehensively as is practicable, the actual and imputed transactions and transfers between various agents in the system. Having this in mind, a couple of urgent activities are of significant importance for our country:

- creation, harmonization and implementation of an integrated analytic-accounting framework as a basis of planning, programming and decision-making for the future socio-economic development of the Republic of Macedonia, based on the United Nations SNA and harmonized with the system and methodology for planning, analyses and decision-making in the developed market economies;
- affirmation of the role and the importance of the SNA and the SAM for the methodology for preparation, adjustment and implementation of the macroeconomic and development policy and planning documents in the national economy;
- construction of a SAM for the Republic of Macedonia, based on a comparative analysis of the SAM construction and implementation experiences in the developed market and transition economies.

c) Preparation of a macroeconomic CGE human sustainable development model

The unemployment (unemployment rate is over 30% since the independence, according to the Labour Force Surveys for the periods 1996-2007) is one of the most complex problems faced by the Republic of Macedonia in the transition period. This imposes some difficult decisions to be made by the country which has to increase the productive employment and decrease the number of unemployed in the country. One of the possible solutions is to pay special attention (in the theory, methodology and practice) to the concept of „human capital“, which presents the totality of knowledge, skills, innovation, creativity, personal abilities and other characteristics of the labour force.

Consequently, there is a need to construct a CGE sustainable human development model, based on alternative human development strategies, which construction, implementation and maintenance should become a permanent process. The model is necessary for the National Parliament, the Government and to other institutions in the Republic of Macedonia as a tool for a scientific and analytic support to the decision-making process, in order to integrate the sustainable human development issues within the overall socio-economic development.
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process. It will be based on the input-out tables and the SAM for the Republic of Macedonia. Such a model will have to provide answers to many questions in the field of economic policy:

- poverty reduction in the country;
- reduction of the income disparities among the regions;
- the impact of the economic growth on the poverty reduction;
- boosting the job creation and employment of men and women;
- securing continuous flow of the incomes, expenditures, investments and savings in the national economy.

The sustainable human development model should be a dynamically linked set of components, presented on picture 2, consisting of:

1. Economic (CGE) model
2. Demography (population) model
3. Education and health protection model
4. Household income distribution and consumption structure model

The economic (CGE) model presents the well known basic macro economic feedback mechanism, which depicts from production, powered by factors labour and capital along with technology and import, generating income which is used for consumption and the balance is saved. Then foreign saving plus domestic saving are mapped to investments and capital formation and back to production.

The demography (population) model can be disaggregated according to the sex, age structure and the urban/rural migrations. It will enable:

a) Map population to the household categories considered;
b) Refine the specification of labour supply to include labour force participation decisions by household category;
c) Allocate available labour supply to labour demand in various production activities depending on wage rates and other labour market characteristics;
d) Derive income and income distribution by household category;
e) Link an education and health protection model with the demographic model to compute the persons with primary (formal and non-formal); secondary and adult education; and thereby the literacy rate. This may further extend to labour by skill categories and refinements in specification of production functions.

The education and health protection model is a model that includes at least education and health. There are at least two important links from education: first, to quality of the skilled labour force and refinement in the production function; and second, to more informed choices and decisions about family size and child survival.

The household income distribution and consumption structure model provides wealth of information on the income distribution (calculation of the GINI coefficient), the level of satisfaction of the basic needs (the BASIC NEEDS concept), the poverty levels according to the household categories and the total population, etc.

Of course, the final result of the interdependencies and interrelations presented in each of the four sub-components of the CGE sustainable human development model will be the increase of the human development general level in the Republic of Macedonia.
The utility of this model is that it provides a system capable of supporting consistent and disciplined analysis over time of concerns related to the sustainable human development issues of income distribution, poverty alleviation, economic growth, population dynamics, education outcomes and productivity, and gender equity.

**Picture 2**

**CGE sustainable human development model**

Legend:
- CGE sustainable human development model
- Demography (population) model
- Education and health protection model
- Economic (CGE) model
- Household income distribution and consumption structure model

This model provides many other benefits to the Government of the Republic of Macedonia:

a) *Policy justification and effectiveness*: The model can serve as a solid background for the Ministries in the Government of the Republic of Macedonia to support their decision making, justify their policies, and make sure these policies are consistent;

b) *International relations*: Using a model based approach in national planning will strengthen and enhance the position of the Government of the Republic of Macedonia in dealing with international donors and agencies, and earn respect from other countries;

c) *Efficiency*: With a good, transparent model, it is possible to identify differences among opinions and test them, so that consensus can be reached. The model will provide a new, participatory tool to facilitate substantive, consistent, and disciplined dialogue among ministries, development partners, and interest groups;
d) Comprehensiveness: With an interactive computer model, it is possible to think through the vitally important connections among economic development, social development, and potentially environmental development in ways that become increasingly apparent, actionable, and effective.

The institutions in the Government of the Republic of Macedonia can use these integrated analytic-accounting framework (consisting of an input-output table, SAM and a CGE sustainable human development model) for:

- preparation of macroeconomic analyses for the economic, social and regional development;
- preparation of a macroeconomic policy document (as a type of a yearly macroeconomic plan for the national economy), which is a operationalisation of the tasks and goals set in the medium-term planning document;
- preparation of medium and long-term planning documents (for the next 5-15 years);
- preparation of studies and strategies for the national and regional/local economic development in the country;
- preparation of analyses for the situation and problems of the socio-economic development in the country;
- planning and implementation of the Government macroeconomic and development policy and strategy;
- implementation of cooperative activities with the international development organizations and institutions.

Concluding remarks

The state in the transition countries, also in the Republic of Macedonia, is responsible for the preparation and realization of efficient macroeconomic and development policies, thus creating conditions for stable functioning of the market and for dynamic economic development processes. Such macroeconomic and development policies are true basis for the implementation of the macroeconomic indicative planning in the Republic of Macedonia. Hence, the market economy in the Republic of Macedonia creates possibilities in which the macroeconomic planning and policy present consistent set of targets, parameters, measures and tools of the macroeconomic and development policy.

Consequently, we should free ourselves from our attitudes towards the economic planning from the so called „socialist planning syndrome“. Namely, it is necessary to accept in theory and in practice the modern concept of macroeconomic indicative planning. No matter whether we will accept the explicit or implicit institutional type of economic planning, it is really necessary to provide developed tools for managing the development processes (like those in the developed market economies). It implies utilisation of modern planning and forecasting techniques, as well as a developed information system as a basis for an efficient macroeconomic and development policy. It also implies that all Government institutions, in parallel with the specialised planning institutions, should use the economic planning as an instrument for a more efficient management of the economic development processes, as well as to provide a highly qualified personnel and modern equipment and information.
technologies that will meet the requirement of the economic indicative planning in the national economy. In other words, one needs a transformation/transition and reaffirmation of the economic indicative planning in its modern meaning and implementation.

All abovementioned shows that economic planning and market are complementary mechanisms in the new socio-economic system of the Republic of Macedonia. The successful combination of the „market's invisible hand“ and the „plan's visible hand“ will provide a more rational utilisation of the production factors and more dynamic economic development of the national economy. This will lead to a continuous improvement of the economic policy instruments, as well as the other types of planning and programming of the national economy development.

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CHALLENGES AND OPTIONS –
COUNTRY EXPERIENCE

LIVIU VOINEA *

THE ROMANIAN ECONOMY TWO YEARS AFTER EU ACCESSION:
MAIN CHALLENGES AND POLICY OPTIONS

1. The macroeconomic context

Romania has made marked progress in the past five to six years from a factor-driven economy (based on natural resources and cheap labour) to one driven by investment. High rates of growth in gross domestic product, an increasing share of fixed capital formation, and large inflows of foreign direct investment point seem to picture a catching-up economy.

However, development is uneven (large inter-regional gaps), real convergence is still a long way ahead, and vulnerabilities have appeared. Economic growth is fuelled by household consumption, based on a combination of rising wages (which are outstripping productivity gains) and a credit boom. The flat tax introduced in 2005 added fuel to the fire, stimulating consumption in an over-heating economy.

Table 1

<table>
<thead>
<tr>
<th></th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
<th>2008f</th>
</tr>
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<tbody>
<tr>
<td>Real GDP growth (%)</td>
<td>8.4</td>
<td>4.1</td>
<td>7.7</td>
<td>6.0</td>
<td>8.5</td>
</tr>
<tr>
<td>Inflation rate – December/December, (%)</td>
<td>9.3</td>
<td>8.7</td>
<td>4.9</td>
<td>6.7</td>
<td>7.0</td>
</tr>
<tr>
<td>Current Account Deficit (% of GDP)</td>
<td>-8.5</td>
<td>-8.7</td>
<td>-10.3</td>
<td>-14.1</td>
<td>-14.5</td>
</tr>
<tr>
<td>Trade Balance (% of GDP)</td>
<td>-8.9</td>
<td>-9.9</td>
<td>-12.5</td>
<td>-15.9</td>
<td>-16.5</td>
</tr>
<tr>
<td>Consolidated budget deficit (% of GDP)</td>
<td>-1.2</td>
<td>-1.7</td>
<td>-1.9</td>
<td>-2.6</td>
<td>-3.2</td>
</tr>
<tr>
<td>Public Debt (% of GDP)</td>
<td>22.4</td>
<td>18.9</td>
<td>20.3</td>
<td>21.7</td>
<td>23.1</td>
</tr>
</tbody>
</table>

Source: NSI and author
Note: f – authors’ forecast

* Liviu Voinea, Executive Director, Group of Applied Economics, Romania
This in turn has stimulated imports. The current account deficit has widened from 5 per cent of GDP in 2002 to 14.2 per cent in 2007. It would have been around 20 per cent had it not been for foreign remittances. The current account deficit is increasingly being financed by private debt, which has tripled over the past three years. More than 40 per cent of the recent inflows of foreign investment are in fact intra-company loans – which are more likely to be debt-creating. Most foreign investment in recent years has come in to retail, real estate and banking – sectors that stimulate consumption. The savings rate was only 13% of GDP in 2007 (decreasing from 15% of GDP in 2004), half of the EU average.

The macroeconomic policy mix is a mess. The National Bank tries to influence inflation by tightening the monetary policy (it has taken four consecutive decisions to increase the reference interest rate from 7% in September 2007 to 9.5% in March 2008), while the Government has a relaxed budgetary stance. There is a strong inconsistency between the liberal revenue policy and the increasingly leftist expenditure policy. State pensions have increased substantially (and are set to increase further in 2009), while contributions are set to decrease as some employees are transferred to a new mandatory private pensions scheme. Following the flat tax reform, the budget deficit more than doubled, and the high revenues expectations never materialized. For example, in 2007, the budget was based on revenues of 36.5% of GDP; instead, the revenues merely reached 32% of GDP. For 2008, revenues estimations of 39.3% of GDP look unrealistic; with rigid expenditures (in an electoral year) estimated at 42% of GDP, it is very likely that the 3% of GDP threshold for the public deficit will be exceeded. Frequent revisions of the budget – five times in 2006, three times in 2007, four times in the first ten months of 2008 – raise concerns that the destination source of government expenditure is often changed from investment to activities that fuel consumption; these revisions are possible because Romania has not yet implemented the multi-annual budget planning.
The first year of EU membership did not help to solve these problems. Romania was a net contributor to the EU’s budget in 2007 if pre-accession funds are excluded. Most worrying, Romania lost the sense of direction it had during the accession process. Local ownership of reforms is limited, and a clear post-accession strategy is still missing.

Persistent inflation – despite a sharp decline in 2006 and first half of 2007, it surged back to an annualized rate of 8% in February 2008 – has its roots in unresolved structural imbalances. The country, despite having one of the largest areas under cultivation of any EU member, is a large net importer of food; energy intensity is six times the EU average, and it has a growing dependence on oil and gas imports; and competition enforcement is weak, leading to high prices for most products and services. Moreover, the annualised growth rate of nominal net wage has been consistently above the inflation rate by a wide margin (e.g., by 20 percentage point in 2007), which is difficult to substantiate even with productivity gains factored in. Thus, inflation resurgence has constantly been an underlying threat to the Romanian economy. Inflation remains the most important problem to be solved before joining the euro area; so far, Romania fulfils three of five Maastricht criteria and has set 2014 as an indicative target date to join the euro-zone. The major contradiction here is to reconcile the inflationary effects of higher public expenditures with the need to consolidate disinflation.

As an open economy, Romania cannot escape the effects of the current international financial turmoil. The latter acted as a trigger for currency depreciation of 22.4% between July 2007 and January 2008. On the brighter side, this led the RON exchange rate to become more closely aligned with economic fundamentals. The depreciation may contribute to an adjustment in the balance of payments – an option not open to Bulgaria, for example – although sluggish aggregate demand in the eurozone will probably limit the extent of this adjustment. On the other hand, the rising cost of credit, together with the negative effect of currency depreciation on incomes, may constrain household consumption and slow down economic growth.

2. Dynamics of competitiveness

An important condition for a country’s competitiveness stands in its capacity to attract foreign direct investment – especially in a capital-scarce post-communist economy.

Romania has been increasingly attractive for foreign direct investments (FDI), as prospects for EU membership became stronger, and they were finally confirmed. While the stock of FDI between 1990-1996 was 1 bn euro, then the average annual flow of FDI was 1 bn euro between 1997-2002, the surge in FDI started in 2003. The large figure for 2006 is explained by the high value privatization of the Romanian Commercial Bank (about 30% of the annual FDI flow).

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67 Arguably, part of this has a statistical explanation, as reinvested profits were included in the calculation of FDI only starting from 2003
Foreign ownership accounts now for more than 90% of total assets of the banking system, for 100% of the mobile telecommunication services, and for more than 80% of the turnover in the manufacturing industry. Studies have found a positive correlation between foreign ownership and productivity growth in the manufacturing industry, but one must take into account the very low starting base (high reserves of X-efficiency reserves).

However, the FDI attracted so far failed yet to turn around decisively Romania’s competitiveness. The trade deficit (which is, after all, the ultimate reflection of competitiveness) has been widening every year since 2000. The export of high-tech products and services still represents a small fraction in Romania’s exports (4% in 2006, compared to 3% in 1995). Foreign private debt, most of it short-term, linked to FDI, more than tripled in only three years (2005-2007), reaching now more than half of total foreign debt.

A possible explanation is that the large foreign firms operating in Romania act as islands of profit, separated from the rest of the economy. They pay little profit tax (either due to case-by-case tax incentives, or due to transfer pricing), and pay small wages to the blue-collars. Competition problems are high in the Romanian economy, especially in the post-privatization cases, which is affecting the consumers, through higher prices. The privatization process has been quite controversial; anecdotic evidence shows that from an initial number of 3600 state owned enterprises, more than 8000 were privatized (as many enterprises were divided), and about 600 were left to be privatized. Moreover, from the 8000 privatizations, about half of them went to court, challenged by one of the sides. The most widely used method of privatization was direct negotiations, which led to market power inducements for the buyers. The most contested privatization was that of Petrom (the state oil and gas producer) in 2004;

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the price paid by OMV to buy the majority stake is equivalent with one year’s profits of Petrom (after privatization), while the Romanian state lost the access to resources. In many cases, privatization prices were smaller than the price of the land owned by privatized company. The practice of having one privatization commission for each privatization, with a separate evaluation procedure, made a mess of the privatization process. Many of privatizations can not even be named „privatizations”, as they were merely a transfer from one to another state ownership: OTE (telecommunications), Gaz de France (utilities), OMV, and many other foreign buyers are in fact state-owned. Nevertheless, one should be honest to acknowledge that some large privatizations proved to be successful, most notably Dacia-Renault (1998) and Sidex-Mittal Steel (2001). Even in these cases large state aids were granted, but the dynamics of the privatized companies were very positive, making them the leading Romanian exporters. The reason for this was that the foreign investors in those cases were large multinationals, which integrated the acquired companies in their global network of production and distribution.

Multinationals like Nokia and Ford recently started their new production facilities in Romania. Rumours are that other multinationals, especially in the car industry, are planning similar moves. Romania has become, in fact, a regional hub for car makers and car components producers. Romania has also had a tradition, which it managed to keep alive, in building ships and aircraft components. But many of these producers came, or are planning to come, for the low labour costs. This, in my opinion, is an advantage fading away (I provide evidence, in the next section, on how labour costs increased in the last three years). A recent strike at Dacia-Renault emphasized this issue. Romania will no longer be, in the medium term, an equivalent of China within the EU in terms of cheap labour. The nature of Romania’s competitive advantages is changing, as the economy as a whole is shifting from a factor-based economy to an investment-driven economy; EU membership may act as a safety net in this process (while outside EU borders labour might be cheaper, there are also other costs related to institutional and political risk and organized crime – such risks are avoided in Romania by the EU safety net). Eventually, Romania should move towards an innovation-driven economy; this is a lengthy process, as structural imbalances are still significant, but it is worth looking at the current state of the national innovation system.

Investing in education and research, this is a factor that could help Romania catching up with EU average. On the one hand, investment in education and research can lead to the creation of value added for local products and services, and hence it can contribute to lowering the trade deficit. On the other hand, access to education and knowledge can stimulate the saving and investment behaviour (as opposed to consumerism) and it can raise labour force mobility within Romania. Consequently, Romania increased its public spending on R&D from 0.2% of GDP early in this decade to 0.7% of GDP in 2007; a pact has been agreed upon by all political parties to increase the public budget on R&D to 1% of GDP (the Lisbon target) in 2008; also, the public budget on education should reach 6% of GDP in 2008.

However, spending public money is not all it takes to enhance R&D and innovation. How is the money spent is equally important. In my opinion, substantiated in a number of reports, Romania has a poor record on the efficiency and effectiveness of the public R&D.

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expenditures. First, the public spending fails to attract private spending; there is little, if any, spreading-out effect – as it should be. The private R&D expenditures have been stagnant at around 0.2% of GDP, despite a five times increase in public spending. This shows that the allocation of money does not stimulate private R&D. Second, more money are given for fundamental research than for applied research; industrial research constantly dropped as a share in public spending for R&D. This situation is not fit to stimulate cooperation between universities and industry. Third, the design of the national innovation system is inefficient. A number of problems can be identified in this regard: the uncertain role and poor efficiency of the national research institutes; the low university-industry link; the overlaps between various agencies and ministries with a role in administering the national innovation system; the lack of an independent national research council; the lack of a state (co)funded venture capital fund for innovative SMEs; the lack of ex-post evaluations for financed programmes and the lack of impact analysis.

Another aspect of long-term competitiveness of the Romanian economy pertains to the absorption and use of EU structural funds. There are structural operational programmes designed for competitiveness, infrastructure and transport, environment, human resources, regional development. EU will allocate about 19 bn euro to Romania, until 2013, for these objectives; while this may seem a large sum for the Romanian economy, it is in fact lower than the amounts committed to Hungary or the Czech Republic (countries with a much lower population than Romania). In this context, it is of paramount importance the EU budget review for the financial perspective 2014-2020; in particular, Romania would be very hard hit from a severe cut in agriculture subsidies, as one third of EU’s farmers live in Romania.

3. The labour market

Despite recent years of high GDP growth, the overall employment rate in Romania has been quasi-stationary (64.6% for males, 53% for females, 58% on average) as it remains modest relative to the Lisbon agenda target, the EU 27 average and the best performers in the new member states, such as Poland, Slovakia and Bulgaria. Reasons for this are the sluggish structural reforms in the public sector, the still high social contributions, the rigidity of the employment protection legislation, and – first and foremost- the large external migration flow.

Evidence suggests that some labour market categories have particularly low participation rates. These categories are primarily women, older workers outside agriculture and young people. Their employment rates are significantly below the Lisbon targets. Women’s employment rate is, for example, at 53% in 2006, is around 10 % points below that of males; the employment rate of older workers gravitates around 40%, well below its Lisbon target.

One has to be cautious in interpreting the employment rates of women and older workers. First, the two rates have been decreasing rapidly since the beginning of transition, before stabilizing at the current rates. Romania, unlike most of the EU countries, had a tradition of

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high women participation rates. The drop in the activity of women was largely involuntary, attributable to the decline in output and employment opportunities following the collapse of socialism, and the concomitant severe deterioration in living standards and increase in long-term unemployment. Therefore, a percentage of inactive women might return to work when labour market conditions start to improve. Labour market transition probabilities from out of the labour force into employment show a non-negligible female added worker effect, where women enter the labour market to compensate for the withdrawal of men. At the same time, the participation of women and older workers in the subsistence agricultural sector is even larger than in the case of men. The correlation between the decrease in agricultural employment on one hand, and the decrease in female and older worker participation, on the other hand can not be coincidental. This suggests that the employment figures in the two cases hide bigger imbalances than at a first glance.

A significant expansion in European employment was attributable to the relaxation of the labour legislation by promoting part-time and temporary employment during the nineties. In fact, most of the growth in employment in the EU visible since is in the two categories. In the case of Romania, the introduction of provisions allowing for part-time employment in the 2003 Labour Code appears to have yielded positive results. Currently, around 10% of employment is part time, one of the highest in Central and Eastern Europe, after Lithuania and Poland, although still well below the EU 27 average and the top European performers. Encouraging is primarily the fact that the share of part-time employment for the 15-25 years age group is significantly higher, at over 15% of the total employment for this category, particularly as this group has a low participation rate and a high unemployment.

A phenomenon which has become increasingly evident in recent years in Romania, as well as in most of the new EU member states, is the coexistence of labour and skills shortages in some sectors with excess supply in other areas of the economy71. While labour participation remains low by European levels and only slowly picking up, labour demand has expanded substantially in recent years. This has led to important shortages of labour and skills in segments of the labour market and has exacerbated imbalances by pushing wages above productivity gains, affecting competitiveness and augmenting inflationary pressures. While there is no systematic evidence on the magnitude of the labour shortages, sectoral studies and casual information seem to suggest that they affect both skilled and unskilled segments of the demand. Industries ranging from constructions and manufacturing to ICT, as well as services ranging from retail trade to public services, including health and education, seem to be affected and the imbalances appear to be growing. The situation is somewhat paradoxical, as Romania should not suffer from overall labour shortages, in spite of the large external migration flows. Inactivity rates are high, including among the young population, and there is a large under-employed pool of labour in the rural areas. With around 45% of the population living in the rural zones, and a significant unemployment, with rates often in double digits, in small urban mono-industrial localities where traditional industries collapsed raises the fundamental question why this important labour potential has not been appropriately exploited yet.

71 See the 5th GEA Report on Romania and the Lisbon Agenda
Evidence points towards several explanations for this context. First, it indicates a substantial mismatch between the skills of the labour released in the process of enterprise restructuring and the changes in the demand for labour. Put it simply, the large cohorts of workers who lost their jobs throughout the transition in the declining sectors have not been absorbed by the growing ones and have rather been pushed into unemployment, usually long term, into agriculture or out of the labour force. These outflows of labour, predominantly from traditional heavy industries, have been very large, as job destruction in Romania was among the most substantial in the former socialist bloc, relative to the size of its labour force.

A second explanation is associated with the relevance of education for the needs of the labour market. Labour force surveys point to an important flow of graduates, at all levels of education, going directly into unemployment and out of the labour force, including through discouragement. This suggests that there are important gaps that the current curricula fail to address in terms of endowing student with the appropriate mix of general and specific skills in order to make them attractive for employers. Further, as the number of tertiary education students coming from rural areas is almost insignificant, it suggest the existence of important obstacles to access to education which, inevitably, are reflected into labour market imbalances.

A third factor explaining the current widening imbalances is the low internal labour mobility, particularly between the rural areas, where the surplus of labour largely rests, and the growing urban regions, the engines of growth, where the demand for labour comes from. The complex transition Romania has gone through has seen large outflows of labour from the declining urban industries into agriculture and rural areas, while the migration from the latter to the former has been relatively modest. The situation is partly explained by the large external migration, as people appear to be better off by leaving the country and working in the old EU members, rather than moving to the cities. While there is migration from rural to urban, the inflows do not seem sufficient enough to keep up with the expansion of the demand. Cultural factors also seem to be at play as, traditionally, people do not move where the jobs are, a feature characteristic to much of Europe.

*Figure 3*

Vacancy rates, %, enterprises with more than 10 employees

Source: World Bank, Eurostat
External migration augments the existing and widening labour market shortages. The number of Romanian workers abroad is estimated at over 2 million. These workers have sent back to their families about 6% of GDP (over Euro 6 bn) in remittances in 2007. Romanian workers seem to be concentrated in countries experiencing both shortages of labour and tight labour market regulations, primarily in Spain and Italy. Cultural affinities clearly play a role in attracting the migrants, who seem to prefer Latin countries as destinations. The potential for migration after Romania’s accession to the EU remains non-negligible. A World Bank study (2007)\(^{72}\) finds that around 88% of young Romanians, aged between 15-24, would consider leaving the country in search for better job opportunities abroad. Only 20% of those, though, would consider migrating permanently. As the opportunity cost to migrating or commuting to urban localities, where most of the new jobs are expected to be created, is still high, external migration seems to remain a better option for the unskilled.

Stabilizing at between 7-8% of the labour force\(^{73}\), Romanian unemployment is not high relative to European levels. It is actually slightly below the EU 27 rate. Registered unemployment, which measures the number of unemployment benefit claimants, is even lower, at around 4% on average, and less than that in the fast growing regions and cities. Men are more affected than women by unemployment, as their rate is over two percentage points higher, suggesting that the decline of the male-dominated heavy industries has taken a significant toll among the male workers. Female unemployment has been constantly declining since 2004, reaching around 6% of the labour force in 2006. While the overall level of joblessness is not large, it nevertheless has several important characteristics that need to be highlighted.

The decline in unemployment has not been matched by a proportional rise in formal employment, suggesting that external migration and other factors are playing a role in driving unemployment down. In the absence of job opportunities at home many have preferred to migrate rather than face unemployment. The large informal economic sector, estimated at 20% of GDP, may also explain the low formal employment figures and the low unemployment paradox. The grey economy appears to provide a large number of low paid jobs to mostly unskilled individuals who cannot find formal employment. Limited quality job opportunities and long unemployment spells discourage people from actively looking for jobs, and pushes them out of the labour force or into subsistence agriculture. The number of discouraged workers seems to be large, especially among the young.

Unemployment disproportionately affects the young population. The unemployment rates of the 15-24 years groups are particularly high and resilient, at around 22% for males and around 20% for females. These are among the highest in the new member states, only below Poland and Slovakia, two countries characterized by high unemployment, and above the EU 27 average. Evidence suggests that youth unemployment is high for practically all educational attainment levels, primary, secondary or tertiary, indicating low employment opportunities for the young irrespective of their level of formal education. This points again towards the limited relevance of education for the recent changes in the structure of the demand for labour and skills. This situation is particularly detrimental as it affects the long term human development potential of the country and encourages external migration.

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\(^{73}\) LFS figures, following largely the ILO definition of unemployment.
Romanian unemployment is long term, characterized by relatively low entry and exit rates and high average durations. Over 50% of the unemployed have been in the unemployment pool for more than one year, above the EU 27 average. There is also no indication that the numbers would decline in the future, as the current levels have been persistent for years. Older workers, the unskilled, those with lower levels of education and those with untransferable specific skills are particularly affected. As the demand for labour has clearly picked up in recent years, the incidence of long term unemployment indicates an effective labour supply constraint. The problem seems to be therefore not only related to the availability of jobs, but rather to the incentives to take advantage of those, and the skills that are required for these. This situation is however not unique to Romania, as many EU countries face similar conditions.

While employment levels are still far from the EU average and EU Lisbon targets, labour productivity is converging rapidly towards the EU average, although the gap remains large. As a result of substantial investments, labour shedding, resources reallocation towards more productive ends, as well as to improved corporate governance and business climate, productivity in industry has been growing at around 11% y/y for 2006 and 2007. At the same time, real wages are expanding even faster, at around 19-20% y/y, on average, in real terms, eroding external competitiveness and augmenting inflationary pressures. As a result, overall labour costs have increased by around 60% in real terms between January 2005 and June 2007. Nevertheless, labour costs remain substantially below the EU average. Average annual gross earnings in Romania, measured at PPP, have represented, for example, 20% of those in Spain and around 48% of those in Poland in 2006.

Figure 4

Romania: Males and females unemployment rates for age group 15-24 years, 2006 (% , LFS)

Source: Eurostat

Evidence\textsuperscript{75} suggests that the largest share of the recent productivity gains is attributable to within sector productivity growth, while the contribution of the reallocation across sectors component has been modest. As the contribution of the services sector, the engine of growth in mature market economies, to both output and employment remains low in Romania, this suggest the existence of further obstacles to a more rapid reallocation of labour across sectors, and especially towards services.

One can identify the still high taxes on labour and the rigidity of the employment protection legislation as important barriers affecting labour participation and impeding a more rapid reallocation of labour resources towards better ends. The tax wedge on labour in Romania is higher than the EU 15 average, and one of the highest in Europe, after Hungary. The high social security contributions (PAYG pensions, unemployment fund, health insurance, etc.) create a distortion affecting both the supply and the demand of the labour market and increase transaction costs for companies. The authorities also recognize that the high contribution rates encourage migration into the informal sector in a manner that undercuts collections and complicates tax administration. In recent years, the government has introduced a series of reductions in payroll taxes and plans additional cuts (up to 6\% be end-2008) to align them with the regional standards. However, in the short-run, the scope for large social tax rate reductions could be limited by budgetary constraints.

While the creation of new jobs per se is important, the quality of the human capital they embody is equally central. The distribution by levels of education of the labour force is positively correlated with value added, and hence with the overall competitiveness of an economy. Evidence suggests that in Romania the quality and relevance of education to the needs of the labour market affects participation and exacerbated skills shortages. To address

this challenge, the education system is undergoing a comprehensive reform, which has already produced changes, especially in compulsory education. Reform measures were piloted in the vocational education and training system. Nevertheless, more needs to be done, in particular by better aligning curricula with the demand for graduates skills. Improving the effectiveness of public spending on education, including by introducing performance related incentives, such as per capita financing, should be part of the reform agenda. Expanding the use of long life learning opportunities should better link the provision of skills to the fast changing sectoral and occupational profile of the demand for labour.

4. Policy options

Romania has potential for strong and sustainable growth, as long as fiscal and budgetary policies are reformed. Multi-annual budget planning is a must to improve the allocation of resources, particularly for large infrastructure projects. The budget deficit, forecast by the European Commission to exceed 3 per cent of GDP in 2008, must be reduced.

The international financial crisis puts additional pressure on restructuring an economy excessively based on consumption financed by foreign debt.

On the revenue side, a return to a progressive income tax, combined with large tax allowances for services such as education and health, would redirect consumption. VAT should also be increased. On the expenditure side, administrative costs must be cut.

With the current account deficit at 14% of GDP, and with the external adjustment ineffective (the trade deficit continued to increase even after the severe depreciation of the RON), the only sustainable solution is a domestic adjustment, based on limiting consumption of current consumption goods, by monetary and fiscal measures.

Structural reforms should also be enforced in sensitive sectors such as energy and agriculture, while research and development should be promoted. In the energy sector, it is important for Romania to build new transport infrastructure (the much awaited Nabucco gas conduct), and to reach a new deal with Russia for lower price on gas imports (currently, Romania pays the highest price on gas imports among EU members). In agriculture, it is important to fight for keeping EU subsidies for small farmers, and to gradually shift the focus towards rural development (which includes other services and activities than agriculture alone).

A big problem that requires attention is the mismatch between labour market and education. Education should be better suited, through various incentive and performance-related measure, to prepare young generations for the skills required by the labour market. Moreover, expanding the use of long life learning opportunities should better link the provision of skills to the fast changing sectoral and occupational profile of the demand for labour.

Labour policy reforms need to focus on bringing back into employment those labour categories which are unable to take advantage of growth as well as on reducing the transaction costs for companies. The youth, older workers, women and the long term unemployed are particularly affected by high unemployment and/or low participation. Non-wage labour costs, among the highest in Europe, need to be reduced, while employment
protection legislation, among the most rigid in the EU, should be made more flexible to allow companies to effectively respond to economic opportunities. Opening segments of the labour market to foreign workers should also be considered in order to fill the gap between the existing supply of labour and the expanding demand.

Regarding foreign investments promotion, Romania should try to avoid state aid controversies; it lost 3 cases in the last year, at the European Commission, on state aid grounds. Instead, Romania should focus on a better investment environment, a changed fiscal policy with more deductions for R&D expenditures and for reinvested profit from an increased profit tax, and a lower withholding dividend tax, and on encouraging public-private partnerships.

Maybe most important, Romania needs to make a clear commitment for the adoption of euro, and to set a clear target date for it. This would help reforms; EU accession experience shows that Romania performs better under foreign pressure, at least in terms of macroeconomic targets.
LJERKA MARIC*

PREPARATION OF BOSNIA HERZEGOVINA DEVELOPMENT STRATEGY 2008-2013 AND THE SOCIAL INCLUSION STRATEGY

Abbreviations

BHAS  Agency for Statistics of Bosnia and Herzegovina
BH    Bosnia and Herzegovina
BD    District Brčko
CEEC  Central and Eastern European countries
CDS   Country Development Strategy
CSO   Civil Society Organisations
COM   Council of Ministers of Bosnia and Herzegovina
CWG/WG EPPU- PIMO consultative working groups
DEI   Directorate for European integration of Bosnia and Herzegovina
DEP   Directorate for Economic Planning of Bosnia and Herzegovina
DFID  Department for International Development, United Kingdom
DPA   Dayton Peace Agreement
SEA   State Employment Agency
EC    European Commission
ESSC  Economic and Social Security Council
EPA   European Partnership Agreement
EU    European Union
GDP   Gross Domestic Product
GoBiH Government of Bosnia and Herzegovina
IC    International Community
M&E   Monitoring and Evaluation
MDG   Millennium Development Goals
MTDS  Medium Term Development Strategy
PNDP  Preliminary National/country Development Plan
NHDR  National/country Human Development Plan
OMC   Open Method of Coordination
PRSP  Poverty Reduction Strategy Paper
SAA   Stabilisation and Association Agreement
SAP   Stabilisation and Association Process
SPAC  Social Policy Advisory Council
SPAG  Social Policy Advisory Group
SPUG  Social Policy User Groups (on local level)
TA    Technical Assistance
ToRs  Terms of Reference
UNDP  United Nations' Development Program
WB    World Bank

* Ljerka Maric, Director, Directorate for Economic Planning, Bosnia-Herzegovina
1. INTRODUCTION

The process of adopting the original document of the Medium term Development Strategy BH 2004-2007 (MTDS BH) on the state and entity level ended in March 2004. This was a transition from a phase of preparation of documents to a phase of their implementation. MTDS BH was created during the period of time when it was necessary that BH achieved rapid progress in all spheres (areas) of life and work, which meant that the Strategy had very wide bases and did not conclude completely developed list of priorities in within and among the sectors. MTDS BH defined three overall goals and nine priorities, as well as the action plan (AP) consisting of 850 measures. While defining the measures was a big step in the process of reforms, this wide approach insured just a lightly balanced hierarchy of priorities.

From 2004, when the MTDS was adopted, until today, in BH existed two types of development documents that defined basic strategic development directions of our country:

a. the documents oriented towards the World Bank / IMF => these documents were sighted as a frame for getting the international loans and grants (PRSP, MTDS, etc)

b. the documents oriented towards the EU => these documents were defined as a frame for the EU accession process (EU Accession Strategy, EU partnership, etc.).

In order to secure conditions for a harmonised socio-economic development of the country as well as the EU accession, BH had to lead its development process in such a way so that these two processes could be consolidated during determined period of time. The significant step in this direction was made during the period of 2005 and 2006, when the MTDS was revised.

An appropriate re-organisation of priorities into the structuralised hierarchy, which was done during the process of the MTDS revision, most certainly added the quality to the MTDS document and thanks to the additional activities, such as designing the Medium term Expenditure Framework (SOR), the better allocation of limited government resources was made possible for the implementation of the most prioritised measures. Additionally, the revision process eliminated existing duplications in same working spheres and shorter version of document was produced which referred to the other existing development documents but avoided the unnecessary repetitions. Also, the revised goals now included a strategic note to balance the economic growth, the poverty reduction and the EU accession, which happened to be one of three main goals in the original MTDS.

As the MTDS BH was prepared for the period 2004.-2007., the end of this year meant bringing to an end the official monitoring process of the above mentioned document. Therefore, it was necessary to start with the preparations for creating a new development platform which ought to completely comprise the facts and figures about the BH reality, already prepared (existing) development documents and progress made in different areas of life and work. Beside that, it was necessary to take into account that the process of poverty reduction during the late period of time, even though it gave certain effects especially in Republica Srpska, was not carried out in wanted pace. The process of EU integration demanded a complete adjustment of work methodology, institutional frameworks and legal systems, in order to obtain the European standards in all areas. The process of legal adjustments and adoption of EU standards were about to include detailed internal reform, general consolidation of system, stronger economic development and more intensive action.
taken in the field of foreign politics which influenced dynamics of relationships between the EU and BH. The perspective of EU membership functioned as both a very important guide for carrying on already started reforms in BH and as a catalyst of processes that ought to insure creation of economic, legal, organisational and social structure, which would be able to undertake actions according to EU rules.

Having in mind the above mentioned, BH now ought to prepare two new and key development documents: the BH Development Strategy 2008-2013 and the Social Inclusion Strategy. These strategies aim at securing the developing framework for disposal of limited governmental and other resources in order to make it possible to respond on the needs of defined priorities. They have to facilitate bigger and targeted investments and bigger refund of invested funds. Without them, the distribution of resources as well as the tools for prioritised budgeting cannot respond effectively on the strategic development needs in the budgeting cycle, which is the main policy implementation instrument for the government.

The components of these documents will be the action plans, with priorities clearly defined. In reference to the planning period of time, noteworthy is that the schemes of two above mentioned new development documents are synchronised to the schemes of the EU development documents, which later on will be use as a basis for the preparation of the national development plan (NDP).

For the purpose of faster BH development and its integration into the EU streams, these new development documents, among other things, ought to accept those earlier defined strategic development directions. This means that the strategies, which are about to be designed, have to be derived out of already existing development documents and processes that are happening in our country and in the region. Furthermore, it is necessary that the methodology applied in designing these documents, as well as the methodology applied for the implementation and M&E, will be organised in a such way that enables, as a imperative, an active roll of all structures and levels of both the government and the society.

2. THE STRATEGIC FRAMEWORK FOR THE PREPARATION OF THE BH DEVELOPMENT STRATEGY 2008-2013 (SD BH) AND THE SOCIAL INCLUSION STRATEGY (SIS)

1. BH is formally not yet accepted as an EU candidate state even though the process of EU integrations have already started and has considerably proceeded. The full EU membership will reflect on all political and economic aspects of our life. The economic implications will most certainly be seen but the social, political, security, cultural and all other aspects should not be neglected too. In regards to those reforms that are already started, BH wishes to create and maintain a stable economic environment and implement other measures so that, in the final phase, will be able to join the economic and monetary union. On this path, BH will focus on the social dimension as well, through ratification and implementation of the European Social Charter.

In due time, the European Commission will demand from BH, as it was the case with the former candidate countries, to prepare the National / Country Development Plan (NDP)
which will put a strategic framework necessary for programming the financial aid for economic and social BH cohesion (in accordance with the EU structural and cohesion funds).

2. It is common procedure that the development strategy of a country represents either a separate document or an introductory part of a main strategic plan (NDP), and a country strategic framework. Having in mind the fact that the socio-economic situation in BH is rather complex, and the index of social exclusion (calculated for BH in 2006 for the first time) is as high as 50,32%, improving the social inclusion process is one of the key goals which have to be supported through out the NDP. This fact implies that a multidimensional approach has to be adopted in order to improve social inclusion, meaning even the targeted investments aimed at the areas and user groups affected by the poverty and social exclusion. The key principle of the overall strategy is the sustainable economic development that creates jobs, that requires considerable investments in education and training, child protection and recreational infrastructure, as well as the investments in the human capital done through vocational learning and skills development, development of the community and the family services.

3. The above mentioned refer to a fact that the BH development strategy ought to define such socio-economic development vision which would relate its medium to long-term socio-economic development goals and priorities to the overall economic achievements, the international relationships (related to the World Bank, MMF, WTO, EU etc) and the donors aid. BH has to improve its control mechanisms and methods of using the donors’ aid. It will contribute to better targeting and efficient improvement when using the financial aid in order to achieve the BH strategic development goals, which refers to the MTDS BH and the new development documents. In that way we will insure that the process is grown up from the stage „the initiative led by the donors’ community“ into the „the development initiatives led by the BH society, financially assisted by the donors“. By applying this kind of approach, BH ought to create a precondition for realisation of strategic goals regardless of the EU accession processes and the financial aid programmes given by the European Commission.

4. The general framework of the BH development strategy may be analysed through out these three levels:
   a. Medium to long-term universal development strategy;
   b. Determined number of development goals and priorities related to the medium term development strategy. (It is recommended that there are five to six development goals but the final number can be determined by the BH Council of Ministers' decision).
   c. Strategic directions towards the economic and social cohesion with the EU.

The financial framework will include the consolidated public budget of the BH governments as well as the financial aid from the donors.

5. The Directorate for Economic Planning is responsible for the process of co-ordination of preparation these new strategic documents in BH. The role is defined through the revised MTDS 2004-2007, which was adopted by the BH Council of Ministers and the entities' governments. Nevertheless, in March 2007, after that the Directorate for European Integration of BH proposed, the BH Council of Ministers ratified a decision that the Directorate for Economic Planning coordinates the preparations of the above mentioned documents.
3. INSTITUTIONAL FRAMEWORK FOR PREPARATION OF BH DEVELOPMENT DOCUMENTS

Institutional framework for all the phases of the process for preparation and implementation, monitoring and evaluation of measures from BH development documents action plans, has to involve state structures on all levels of authorities. By now, in this process were involved only governments on state and entity levels, while Government of District Brcko was only partly involved. The process of preparation of new development documents should transfer the old experiences and based on them, work on the necessary improvement.

3.1. Role of Government – Coordination process of preparation of BH Development documents

Such complex and responsible process should start with a strong commitment and governance of BH Council of Ministers which should govern the process with the support of entity governments. All the phases of preparation of documents, before discussing it by the BH Council of Ministers, should be analysed and harmonised on Coordination board for economic development and EU integration that are going to be in the charged of the process.

BH Council of Ministers during the process of preparation of original and revised document of MTDS BH 2004-2007, named Academic Council as advisory board. This showed to be a good practice, not only from the side of technical support but from the aspects of credibility of complete process, too. This experience should be repeated and used for the preparation of the new development documents.

3.2. The Role of BH Parliamentary Assembly and Entity Parliaments

In preparation of BH MTDS 2004-2007 (PRSP) the BH Parliamentary Assembly, FBH Parliament and RS National Assembly did not have the role that they should have. Their role was mostly to have discussions about the document. From the aspects of responsibility for the realization of the goals, their discussions were very useful but not for being obliged to them and for that reason it does not provide ownership rights, general consensus and responsibility for realization of these measures and especially those that Parliaments are responsible for. BH Council of Ministers and Entity governments are being criticized as the only responsible state institutions for the realization of the measures on the parliament meetings because of this situation.

Because of the things that were mentioned before it is needed to step up activities during the preparation of new development documents for determining strategic policies and goals through parliamentary bodies and parliaments.

Cantonal governments and parliaments, that are as the organizational structures exist only in FBH and have important responsibilities, should be included in this process. The way they should be included would be defined based on the DEPs proposal that is defined with FBH government and approved by Coordination Board for economic development and EU integration that would lead the process. This way all the levels of government would be
included in the process, parliaments and governments from one side and private sector, academic communities and civil service organizations from the other side, and for that in the phase of preparation of document, the strategic goals could be rightly defined and later successfully realized.

3.3. Role of Local Community

Until now the local communities were not included in preparation and other phases of activities of BH development documents except in public discussions. As it was mentioned before and according to EU practice, the active role of all structures and levels of government and all segments of society is imperative in defining and implementing socio-economic and development process. For that reason local communities must be included in this process. DEP is with the technical support by LSE Consortium underwent the activities on setting up networking of representatives of local communities on whole BH territory, that in the preparation phase of the document should be advisory support.

3.4. Positioning the Role of BH Presidency

BH Presidency by now did not have an active role in the process of preparation of development documents. Practice from the neighbouring countries showed that the Role of BH Presidency could be very important from the aspects of insuring the great support for defining strategic vision of country, especially from the academic side, and we think that those practices should be used in BH, too.

3.5. Coordination of overall activities on creation of the document

a.) Directorate for Economic Planning (DEP) should coordinate the whole process. Organizational structure of DEP, that has the Sector for coordination of preparation, M&E implementation of development documents and sector for Social Inclusion Analyses and a Sector for Economical researches, is like that fully able to monitor the whole process. In the process of coordination of activities, DEP should very closely cooperate with DEI, BH Agency for Statistics (BHAS) and Entity statistics, PARCO and other state agencies and ministries. Establishment of certain coordination mechanism that would include all the participants in the process vertically and horizontally is very important for the overall process of preparation of the document. DEP (EPPU) in the process of preparation of the revised document BH MTDS 2004-2007 had the role as head coordinator of activities and has positive experience in this area. The mechanism of coordination was done by DEPs direct contact with ministries and through working groups. The process of coordination for the preparation of new development documents is more complex than the one before because it involves a greater group of stakeholders and new approach that considers the analysing greater number of already developed strategic documents from different sectors.

b.) For the preparation of the original document BH MTDS 2004-2007 the working groups were established on entity levels for all the sectors that were done in the document. Each entity working group had 5-7 members and head of the working group, that was usually
deputy of minister from the ministry that is responsible for that area. Working groups were active in writing the initial documents for the strategy. Work of the entity working groups was coordinated by local expert. From the above mentioned the working group for each sector involved 11-15 members.

By adopting the strategy, number of members of each working group was reduced to 3-5. The main members of each working group are one representative from the authorised ministries of BH Council of Ministers, FBH Governments and RS Governments. There are 24 working groups for 24 sectors with over 80 members that are deputies of ministers. Members of some of the working groups are representatives from BH Central Bank, Agencies for statistics, Labour agencies, other state agencies and civil society. RS Government has nominated coordinator of RS working groups through which all the organizational activities and contacts with DEP will go through. DEPs experience by coordination with RS coordinator working groups is extremely good and our proposal is to establish the same coordination mechanism in FBH Government.

c.) The role of working groups is important in all the phases of preparation of the document. Their main responsibilities is to help in defining the key strategic development activities, measurements and programs for achievement of medium term development goals and long term expectancy results. They should be the network through which DEP will have direct and permanent contact with all ministries on state and entity level, BH CB, statistical and other agencies. Working groups should identify possible resources including public, private and were possible international resources that will integrate into realization of defined strategic activities and to give inputs for preparation of reports on monitoring and implementation on measures from BH MTDS 2004-2007. They need to give inputs to the local experts who are preparing the initial material for development documents and to be the first instance on which the prepared materials are being discussed and changed before sending it to Coordination board for economic development and EU integration for a public discussion.

d.) In addition to the already mentioned initial framework and main participants that would administer and coordinate in the process of preparation of development documents, as the next phase in this process should be establishing framework for:

- Communication with private sector
- Communication with civil society
- Communication with media in BH

With the goal of realization of these activities the Strategy for consultation and communication should be prepared, which would be an essential part in preparation of activities. Preparation of this document should be finished by the end of October 2007 and send to the Coordination board for economic development and EU integration.

4. PHASES OF PREPARATION OF DEVELOPMENT STRATEGIES

1. BH has already prepared its first Medium-Term Development Strategy (MTDS) for the period 2004-2007 (other countries have similar country development strategies) and it is now necessary to prepare a new strategy for the following few years.
2. The process of the preparation of development documents of BH, the Development Strategy for 2008-2013 and the Social Inclusion Strategy, should proceed in 3 key phases of which each has several steps that will during the preparation process be developed in detail.

3. Phases of preparation of the documents:

**Phase I. Phase of preparation and political support**

Step 1: Securing the leadership role of the Council of Ministers of BH and defining the roles of key stakeholders at the state level, including the Coordinating Board for Economic Development and EU integrations, DEP and members of WGs

Step 2: Securing political support, determination and reading of key stakeholders at the entity and other levels of government

Step 3: Securing necessary resources within the budget funds as well as support of the international community. In the present preparation for the beginning of the process of the creation of the above-mentioned strategic documents a rough estimate was calculated of the necessary financial resources (cca 1,2 million KM)

Step 4: Organization of necessary training for the key activity bearers

**Phase II. The development of the strategy and action planning**

*a) Development of the strategy*

Step 1: Analysis and diagnosis – Situation and SWOT analysis, planning of scenarios as the foundation for options of policy prioritization and definition of the development vision

Step 2: A comprehensive vision, identification of main objectives and strategic steps for their completion – Preparation, connection and harmonization of sector documents within the national/state framework

Step 3. Public consultations

Step 4: Preparation of the first draft of the development document – Harmonization of the solutions recommended by the entities, proposals received during the public discussion, as well as proposals regarding sector strategies

Step 5: Preparation of the first version of the financial plan – Strategic distribution of resources

Step 6. Public consultations
b) Action planning

Step 7: Preparation of the second draft of the document – Specified sector priorities and medium-term goals, drafting of the action plans and measures, including regional aspects of sector plans/entity plans

Step 8: Financial cross-section of measures (by sectors and entities) financial tables

Step 9: Institutional arrangements (for implementation and monitoring)

Step 10: Public consultations

Step 11: Preparation of proposals of development documents

**Phase III. Document adoption procedure**

Step 1. Document sent to adoption procedure

Step 2: Preparation of final version of document (final corrections of the document after the first phase of reviewing in relevant state bodies)

It is necessary to emphasize that DEP started preparation activities for the development of new strategies immediately after the adoption of the Revised Medium-Term Development Strategy 2004-2007 (MTDS). According to the present circumstances it is realistic to state that Phase I and the first step of Phase II (analysis and diagnosis) can be completely realized during 2007. Step 2: A comprehensive vision, identification of main objectives and strategic steps for their completion – may be completed at the beginning of 2008 (January and February)

5. CONTENT OF THE DEVELOPMENT DOCUMENTS OF BH

**Structure of development documents**

1. It is first necessary to determine what the basic structure of the document will be. There are two possible alternatives:
   a) One comprehensive development document that will be composed of two integral parts – Development Strategy 2008-2013 and Social Inclusion Strategy. Both parts need to have the related action plans, from which the future NDP will be defined.
   b) Two independent development documents – in this case the Development Strategy 2008-2013 with the its respective action plan should be one document, while the Social Inclusion Strategy, with the associated action plan, should be another. The action plans of these documents would be the foundation for the later definition of the NDP.

2. As the above-mentioned development document(s) for the National Development Plan (NDP) that should establish a strategic framework for programming financial aid for economic and social cohesion of BH, in accordance with the EU Structural and Cohesion...
Funds, the alternative for the preparation of a comprehensive document (the alternative stated in under a) seems more acceptable, as unnecessary repetition would be avoided, that would be inevitable in the case of the preparation of two independent documents.

The final decision on the structure of the document will be made by the Council of Ministers of BH that should manage the process.

The content of the Development Strategy 2008-2013

1. The content of the Strategy should be defined according to need and taking into consideration the organizational structure of BH. This document will endeavour in medium and long term development issues. The content will be defined after preparation of Situation analyses and definition of the goals and priorities. The possible content would be the following:

   a. Macroeconomic development, including:
      i. Economic growth and employment
      ii. Foreign trade, balance of payment and external debt
      iii. Monetary policy, exchange rate and inflation
      iv. Financial sector and banking
      v. Public finances and fiscal policy
      vi. Public investment/development finances

   b. Competitiveness, including:
      i. Agriculture and rural development
      ii. Industrial development and Small and Medium Enterprises (SME)
      iii. Trade and services
      iv. Transport, communications and infrastructure
      v. Energy, water and other resources
      vi. Labour market and human resource development (including professional education)

   c. Sustainable environment and regional development, including:
      i. Disparity between localities, regions and areas in the sense of economic and social development
      ii. Local and regional development programs (for entity and local regions, and for regions that demand special arrangements)

   d. Social cohesion, including:
      i. Unemployment and social investment
      ii. Social provision, protection and aid
      iii. Education
      iv. Health protection
      v. Inclusion of socially excluded and discriminated groups
      vi. Demographics

   e. EU integrations, including harmonization with EU standards (defining key priorities from SAA)

Depending on the circumstances in BH, and considering the remarks and suggestions by the stakeholders in the process, other areas of specific sector development may also be defined. Naturally, a completely different structure of the document is possible if this is the standpoint of the stakeholders who are leading and/or managing the process.
2. This Development Strategy will represent not only the basis for the NDP, but for other possible plans, which BH will need to prepare in the EU accession process, such as the National Development Plan (NDP), National Action Plan for Social Inclusion (NAPSI or SIAP), National Action Plan for Employment (NAPE); National Action Plan for Rural Development (NAPRD). CDS will also be the foundation for NPAA.

Social Inclusion Strategy

1. In order to prepare the National Action Plan for Social Inclusion, it is first necessary to prepare the Social Inclusion Strategy. This Strategy should also be composed according to EU principles.

2. In March 2006, the European Council adopted the new framework for social protection and social inclusion processes. At present there is a new set of common expected results: three comprehensive objectives and objectives for each of the three areas of social policy: social inclusion, pensions, and health and long-term protection. In June 2006, the EU Committee for Social Protection adopted a set of common indicators for social protection and the process of social inclusion.

3. The Lisbon European Council has since March 2000 demanded from member states and the European Commission to make the deciding step towards eradicating poverty and social exclusion by 2010. EU accession is considered the key element in achieving the ten-year strategic goal of sustainable economic development, the creation of more substantial employment and greater social cohesion. Member states are coordinating their policies for the fight against poverty and social exclusion based on the process of exchange of policies and participation in joint learning known as the Open Method of Coordination (OMC).

4. Five basic elements of the Open Method of Coordination are:
   a. Agreement on EU common objectives
   b. Establishing common indicators as a means of comparison of best practice and measurement process.
   c. Incorporating EU expected results of the state/regional policy/action plan and based on them the preparation of National Reports on the Strategy of Social Protection and Social Inclusion
   d. Publication of reports that will analyse and assess the National Reports.
   e. Participation in the Community Action Program that promotes cooperation and creation of policies and trans-national exchange of acquired and good practice.

Since 2006, these policy areas are providing additional framework for the following processes: a) exterminating poverty and social exclusion; b) adequate and sustainable pensions; c) accessible, high-quality and sustainable health and long-term protection. Taking into consideration the current position in BH, it could be useful to include in the development document(s) the EU goals from the EU Employment Strategy 1997.
5. The key agreed principles of implementation of the process of social inclusion are:
   a. Integration of economic and social policy that will have an effect on social exclusion
   b. Activation of all government representatives at all levels
   c. Definition of coordination procedures and mechanisms
   d. Definition of authorized institutions
   e. Promotion of social dialogue and partnership
   f. Actively include social partners and organizations of civil society as well as those who offer social services within the process
   g. Include citizens in all phases of the process
   h. Promotion of corporative social responsibility

6. The fight against social exclusion requires not only the government response, but a wider social response to this challenge. The development and implementation of the Strategies, therefore, must include social partners, employers, unions, farmers, the community and volunteer sector. Continuous economic development is a necessary support to the Strategy, and the redistribution of resources to the less fortunate may be better achieved through consensus from all sides in the partnership process.

7. The phases of preparation of the Social Inclusion Strategy are identical to the above-mentioned phases of preparation of the Development Strategy 2008-2013 and should be carried out in parallel.

6. GENERAL PLAN OF ACTIVITIES FOR THE PREPARATION OF DEVELOPMENT DOCUMENTS

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<tr>
<td>Definition of approach and provision of necessary resources</td>
<td>Feb Mar Apr May Jun Jul Aug Sep Oct Nov Dec</td>
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<tr>
<td>Securing the leadership role of the Council of Ministers of BH and defining the roles of the Coordinating Board for Economic Development and EU integrations and other key stakeholders</td>
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<td>Securing continuous political support at all levels of government</td>
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<td>Drafting all necessary base analytical studies and recommendations</td>
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<td>Vision workshops at all levels in BH</td>
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<td>Consultations with entity governments and municipalities</td>
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<td>Consultations with CSOs</td>
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<td>Consultations with social partners</td>
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<td>Regular meetings with members of all working groups (individual and joint)</td>
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<td>Sector meetings of working groups and external experts, including the state and entity level in designing draft proposal</td>
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<td>Separate activities of working groups in designing sector priorities</td>
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### Perspectives of Sustainable Economic Growth in the Countries of SEE

#### International Conference – Budapest, November 6-8, 2008

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**DEP in collaboration with working groups and external experts finalize the first draft of the strategy and draft action plan for selected fields**

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<tr>
<th>Phase of preparation of development documents</th>
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<tr>
<td><strong>Initial support</strong> – DEP will prepare a draft working document concerning preparation of the Development Strategy and Social Inclusion Strategy. The document will be forwarded to the Council of Ministers in order to secure additional support for initiation of the process of preparation of these strategic documents. The support should also be obtained from the Brčko District and the entity governments.</td>
</tr>
<tr>
<td><strong>Working material</strong> – The draft working document will be forwarded to the Coordinating Board for Economic Development and the EU for review of the proposed main steps in the process, tentative deadlines, roles and the responsibilities of the key actors.</td>
</tr>
<tr>
<td><strong>Common discussion</strong> – Following a joint discussion, the key relevant actors at the state and entity levels need to give their support for the proposed process. The consultations with the senior level civil servants, and other key actors, including the ministries from all levels of government should begin as soon as possible. DEP will establish this process through the working groups that now need to be reorganized according to the new requirements.</td>
</tr>
<tr>
<td><strong>Leadership</strong> – DEP, as the key actor, and the Coordinating Board for Economic Development and the EU need to maintain constant contact with the Council of Ministers Chairman in order to secure political leadership.</td>
</tr>
<tr>
<td><strong>Core Studies</strong> – It is necessary to gather, compare and analyse already existing strategic documents. In order to start the process it is also important to conduct appropriate research. This will allow for the consultations and discussions at the early phase of the process. The process will be coordinates the DEP.</td>
</tr>
</tbody>
</table>
7. IMPLEMENTATION OF DEVELOPMENT DOCUMENTS

The experiences gained in the preparation and monitoring of the implementation of measures from the Medium Term Development Strategy BH 2004.-2007.(PRSP) have pointed to the fact that the monitoring is until now an administrative process that provides information about the level of implementation of measures, but does not allow insight into the real effects of certain measures. Therefore, it is important to include all levels of government, including the local level, because only that way it is possible to obtain information about the effects the implemented measures have on citizens of BH.

This is a highly set goal the realisation of which demands considerable time, human and other resources, but at the same time it is also a unique opportunity if we strive toward social inclusion and giving full support to development processes at all levels as well as to ensure a general acceptance of the process.
MAJA DRAKIC *

ACHIEVEMENTS AND CHALLENGES OF ECONOMIC REFORMS IN MONTENEGRO

Historical background

Montenegro is the youngest country in the world. It was added to the world’s list of independent countries on May 21st 2006 after 88 years as part of various Yugoslav and Balkan unions. The name Montenegro (Black Mountain) was probably derived from the thick "black" forests that in medieval times covered the Lovcen Mountain and the other alpine areas of "Old Montenegro". This name was first mentioned in 1276, and has since has gradually replaced the former names of this geographic and administrative area – Duklja and Zeta.76

After Montenegrin army won Turks at Grahovac in 1858 state borders of the country were established and representatives of the great powers formally recognized Montenegro as a sovereign state at the Constantinople Conference in 1858. After two military victories against Ottoman forces at Vucji Do and Fundina during the Eastern Crisis of 1875-1878, Montenegro returned the coastal towns of Bar and Ulcinj, and thus secured access to the sea; and the towns of Podgorica, Niksic and Kolasin. In 1878 Montenegro gained full international recognition in the Congress of Berlin. The successful struggle of tiny Montenegro against the centuries-long pressure of the powerful Ottoman Empire won the sympathy and support of all of Europe. Montenegro proclaimed itself a kingdom in 1910.

Montenegro lost its sovereignty after the establishment of the Kingdom of Serbs, Croats, and Slovenes in 1918, which was renamed Yugoslavia in 1929. In 1945, after the Second World War and German expulsion, Josip Broz Tito took control over Yugoslavia, including Montenegro, which was one of Yugoslavia’s six states. He developed his own brand of socialism. For the next forty years, Tito steered a society that was more open than that of its communist neighbours on a path between the Warsaw Pact nations and the West. Yugoslav economy operated under unique mechanism called labour-self-management.

“Starting with a system that was a carbon copy of the Soviet economy, the Yugoslav leaders, driven by their own survival requirements in the aftermath of the Tito-Stalin rift, embarked on a series of institutional changes that aimed at approximating the production efficiency of capitalism while preserving the socialist character of the economy. Perhaps the most important difference between the institutional structure in Yugoslavia and elsewhere was in the mode of entry into decision making. In the West, the mode of entry into decision making is the prerogative of ownership, either directly or through hired manager. In the East, the mode of entry into decision making is the prerogative of the ruling group. In Yugoslavia, the

mode of entry into decision making is the prerogative of the working collective subject to the formal and informal limits imposed by the ruling group.  

Inheritance of the Yugoslav socialism is very important for understanding break-down of old Socialistic Federative Republic of Yugoslavia and all events that followed. Breakdown of the Communist party was beginning of the end of “old Yugoslavia”. In the early 1990’s four Republics declared sovereignty, while Serbia and Montenegro formed a new "Federal Republic of Yugoslavia" (FRY) in 1992. Serbian political leader at the time, Slobodan Milosevic lead several unsuccessful military campaigns with goal to unite Serbs in neighbouring republics into a "Greater Serbia”. This resulted in wars within the territory of former Yugoslavia, thousands of dead and refugees. War and military conflicts had not happened on the territory of Montenegro, but as a part of FRY the country and its citizens suffered influence of international sanctions, NATO bombing, economic collapse and hyperinflation.

It shouldn’t be forgotten that early 1990’s are the years of political changes and struggle for power; era of rising nationalism, that lead to establishment of “third Yugoslavia”. National romantics and supporters of idea of unifications with Serbia had advantage over supporters of independent Montenegro. But, establishment of FRY was not a solution of problems in political and economic relations between Montenegro and Serbia. Permanent tension in the FRY that existed from its birth in 1992 resulted in division of the ruling party in Montenegro on two wings, pro-Milosevic and contra-Milosevic oriented. The turning point in modern history of Montenegro was the victory of anti-Milosevic oriented political forces at the elections held at the end of 1997.

**Building Economic Sovereignty: One Country – Two Economic Systems**

Even though there were some attempts, rigid attitude toward reforms and conflicts in the region prevented entering the transition. Real economic reforms in Montenegro have started in 1998 and it was the only transition country, which has taken the responsibility to conduct changes of economic system without previously completing the process of state independence (internal and external). One of the major steps in reform processes was introduction of DEM as legal tender. Aiming to prevent its economy from political influence from Serbia, Montenegrin government established monetary independence through “dollarisation” model.

Political changes in Serbia in 2000 and removing Milosevic and his party from power seemed like a right time to negotiate redefinition of the relations between Serbia and Montenegro. Despite the obstacles that were coming from Serbia, Montenegro has built completely independent economic system and used differed legislation. It took over all economic functions, involving those that belonged to federal level such as customs, monetary regime, foreign-trade regime, bank system, etc. Reforms were oriented toward private property and protection of property rights; freedom of contracts and protection of investors; increasing

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economic freedoms, encouraging entrepreneurship, private initiatives and innovations; rule of law, openness, national treatment of foreigners, deregulation and economic liberalization.

Federative Republic of Yugoslavia was unsustainable, from many reasons. The most obvious one that couldn’t allow Serbia and Montenegro to stay under a federation cap, and keep constitutional framework based on equality of the states, is the size difference (95%: 5%). Such a big difference tend to cause permanent suspicions that one side exploits the other, leading to mistrust and thus creating non-favourable conditions for development. Besides, these two countries had different strategic concept that lead economic reforms in opposite direction. Foundations of Serbian economic programs lied in protection of inherited industry and agriculture, while Montenegro has been developing concept of small, open, service oriented economy, based on free-market principles. There was a real danger that the differences would be used as some kind of precondition in political negotiations, leading to negative consequences for further development in both Serbia and Montenegro.

The differences in strategic development concepts were obvious even for ordinary people, who used first DEM, and later EURO as legal tender in Montenegro, and dinar, the world’s worst currency at the time, as estimated by Steve Hanke, in Serbia. By introducing DEM/Euro Montenegrin Central Bank lost authority to print money and primary emission could not be used in order to solve social problems.

Average tariff rate on import in Montenegro was several times below Serbian level. Privatization process in Montenegro went much further then privatization in Serbia. There was no company in Montenegro, at the time that was completely in the hands of state, and more than 90% of all citizens have become shareholders through process of mass voucher privatization. Trade relations between Serbia and Montenegro were almost abolished until political changes in Serbia in October 2000. Even though trade between two Republics intensified afterwards, some problems remained, such as a problem with payment system related to different legal currencies and different tax systems (VAT and sales tax, in Montenegro and Serbia, respectively).

The main argument used by the supporters of keeping Serbia and Montenegro under a federal hat is that a federation would provide economic integration and a larger market for Montenegro. This argument has no solid ground in the era of globalization and regional integrations.

Nevertheless, political solution has been reached in March 2002, when representatives of Serbia, Montenegro, (federal) Yugoslavia, and EU (Solana) signed the Constitution Chapter of the Union of Serbia and Montenegro (hereafter: S&M Union). At the moment this state was established, date of its death was set too. Namely, all sides agreed that the two republics would hold a referendum in early 2006 to allow the citizens to vote on continued integration or outright independence.

A major function of S&M Union was to secure considerable political and economic autonomy for Serbia and Montenegro. Since Serbia and Montenegro have different economic systems, that was not an easy task.

### Harmonization of the economic systems between Serbia and Montenegro

In March 2002 Montenegro and Serbia officials signed a Belgrade Agreement, about establishing State Union "Serbia and Montenegro". Most important element of the agreement is harmonization of the economic systems of the state members. According to agreement harmonization will be conducted in order to meet EU standards with protection of reform achievement, which are already gained. In order to fulfill obligation defined by agreement Parliament of the Serbia and Montenegro (29. August 2003.) accepted Action Plan for Harmonization of the Economic Systems of the Member States of The State Union of Serbia and Montenegro. Basic goal of Action Plan is removing obstacles to free movement of people, capital, goods and services. Realization of the Action Plan is precondition for signing Association and Stabilization Agreement in process of joining EU.

Basic tasks of the Action Plan of harmonization are in following fields:

1. **Free movement of people**
   Activity in that area would be realized through harmonization related to: (i) labour and employment; (ii) public health and (iii) education. Republic's regulation of those fields is pretty similar and there are no identified obstacles for harmonization.

2. **Free movement of goods**
   Harmonization will apply in customs territory and procedures; tariff rates; international treaties; foreign trade system; free trade agreement; veterinary- sanitary and fitosanitary control etc.

3. **Free movement of services**
   Free movement of services comprises harmonization in field of the tourism; catering; relations with international organizations; financial mediations; insurance; accounting; auditing; legal; intellectual and commercial services.

4. **Free movement of capital**
   Following areas will be harmonized in scope of free movement of capital: direct investment; investment in real estate; capital market; money market; investment funds; individual investments; competition rights and prevention of money laundering.

According to matrixes for implementation of the Action Plan harmonization should be completed until March 2005.

Goals and tasks of the Action Plan for Harmonization of the Economic Systems of the Member States of the State Union of Serbia and Montenegro are given in the box above. The harmonization of customs systems is the first major test of the future of S&M Union. At the moment implementation of the Action Plan started average tariffs in Montenegro, Serbia and EU were 2.8%, 11% and 4.2% respectively. Tariffs on food were 11% in Serbia and 1% in Montenegro. European Union insisted on immediate harmonization of Serbian and Montenegrin customs system. That meant that Montenegro immediately make its custom taxes equal to those charged by Serbia. Then, Serbia and Montenegro should gradually decrease tariff rates toward the EU level. Otherwise, Montenegro would bear the consequences of its non-cooperation. On the other side, Montenegro preferred not to increase its custom taxes. European Union experts argued that Montenegro should suffer no losses from raising its tariffs to match those in Serbia. The argument was that since current prices in

Montenegro are higher than prices in Serbia, raising tariffs in Montenegro should have no effect on consumers and entrepreneurs. The effects of substantial subsidies in Serbia, which practically do not exist in Montenegro, on relative prices, were ignored. The issue of harmonization raised many debates.

The important fact here that should not be forgotten is that all slowdowns or pauses in the realization of a reform agenda towards a free-market system have devastating effects. Even if the regression is small and technically irrelevant (like a small tariff on imports or an increase in taxation), it gives the wrong signal, and a very powerful one indeed. It shows that the reform program is subject to political negotiation. It therefore encourages all existing or potentially new rent-seeking groups to actively engage in the market for law-making. On the one hand it would bring reform to a complete standstill, if not to some sort of socialist dirigisme; on the other hand it would delegitimize the incumbent political elite and create a fertile ground for social tensions. Attempts to harmonize reform programs across countries would just multiply the effects associated to the two phenomena.

Montenegro harmonized tariff rates with Serbia for 93% of products, resulting in increasing of average tariff rate from 2.81% on 6.13%. Tariff rates for remaining 7% of tariff positions, consisting mostly of agricultural products, have not been increased. S&M Union failed at its first test.

**Struggle for Independence – State Sovereignty Regained**

Three years of S&M Union existence gave no much result. Each of the states within the Union has all levers of authority in their hands. The S&M Union and its bodies represented the country in international bodies, and verify, but cannot implement international agreements. On the other side, S&M Union administration was still spending significant funds raising tax burden for citizens, entrepreneurs and companies in both member states. S&M bureaucracy wasted hours of taxpayers’ money sitting around big tables and approving decisions, while the real decision-making power and the power to implement those decisions were and still are in the hands of member states. Existence of S&M Union safeguarded the legacy of sixty years of socialism at the expense of real free-market reforms.

As already had been mentioned above, S&M Union was a unique state with the limited time of existence; state that has clause on its death in the Constitution. According to Belgrade agreement each of the member states has a right to hold a referendum in early 2006 to allow the citizens to vote whether they would continue to live in common state or in independent, sovereign, internationally recognized state.

Montenegro had decided to exercise this right and organize referendum to recover its independence lost 90 years ago. For the referendum to be passed, the Montenegrin law required (a) participation of at least 50% of registered voters, and (b) a simple majority. However, under the pressure of EU, the Parliament of Montenegro adopted a new law on

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80 Enrico Colombatto, 2003, “Four Points on harmonization”, *Postgraduate Studies Entrepreneurial Economy*, Podgorica, Montenegro
referred that required, besides the first condition, not simple majority, but a majority of 55% that voted for independence in order to proclaim sovereignty.

Around 87% of electoral body of Montenegro voted at the referendum, out of which, 55.5% voted for independence. More the 3000 observers from different international organizations supervised the referendum process and all of their reports confirm that all democratic standards were highly respected. Very soon after the referendum almost all countries officially recognized Montenegrin independence. On June 28th 2006, Montenegro became a member of United Nations.

Montenegro – the youngest state in the 21st century

“The Process to create Montenegro was evolutionary. Montenegro was created in a different way than any other new Eastern European Country. After the Berlin wall fell, new countries were created by splitting three federations: Soviet Union, Check, Slovakia and Yugoslavia. The Soviet Union was split by ethncial principle; Czech and Slovakia by agreement made by elite; Yugoslavia by war.

Montenegro was created by applying original liberal principles from books; a free choice of its citizens, individuals. Montenegro was not created in any revolutionary, army process; neither by self proclamation nor secession. Also, Montenegro was not created as an ethncial state. Montenegro was created by political debates between two equal ideas: YES (for independence) and NO (against independence). Everything was realized in civilized, democratic debate. Representatives of the EU said that the referendum was organized even beyond the standards of the international community. Even with a lot of emotion, no disorderly incidents took place. Everything was peaceful and civilized! Is this the sign that the Balkan region has started to change?

This country was not created by a King, but by Individuals!

…This is the first generation of Montenegrins (citizens who live in Montenegro, no matter what nationality) which have not experienced war on its territory, but instead experienced parties, celebration, dancing and happiness in each central square of every town in Montenegro, beside rivers, in front of private houses… For several days thousands of people celebrated, flagged, cried from both happiness and excitement. Even very emotionless and reserved Montenegrins have become extremely emotional and excited.

Even though emotions were strong, no one made any negative statements toward our neighbors, or toward people in Montenegro who have a different (opposite) opinion.

The referendum was a point in a process of cultural, economic and political maturity of the mindset and behavioral code of Montenegrins. It was an internal emotional boom (or explosion) experienced by each individual that voted – no matter on which politcal option. It was a conflict of two ideas which were deeply felt by both sides. Many people did not have decent sleep for nights prior to the referendum… It made their energy free and woke up their expectations. The referendum made Montenegro as individualistic country. Now, the issue is how to transform that individual energy into an economic and political system that has synergy? It is reasonable to expect that a country created on liberal principles will create liberal economic and political system, and because of that Montenegro will be different than any other in the region.”

Soon after the referendum the first local and parliamentary elections were held. As was to be expected, coalition that formed Government in previous term achieved a majority in Parliament again, and thus the ability to appoint members of new Government (i.e., the cabinet) for the next four years. In the past it was possible to blame the poor results of reforms on things outside of Montenegrin control, but for the first time the newly elected

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politicians must take responsibility for the success or failure of reforms. Montenegro answered one more important challenge that was ahead of it – new Constitution was adopted in the Parliament in October 2007.

Concept of Economic Reforms

The breakdown of Communist Party and fall of Socialistic Federative Republic of Yugoslavia marked the beginning of economic reforms in Montenegro. However, wars in the region, refugees, international isolation, NATO strikes, and permanent political conflicts caused delay in the real transition processes. The direction of the reforms has changed in 1998.\textsuperscript{82} Reform activities in Montenegro were performed in two waves. First wave were reforms from 1998-2002, and other wave are activities within Economic Reform Agenda, 2002-2007, which are still underway.

Results of economic reforms are best represented through table of main macroeconomic indicators given below:

<table>
<thead>
<tr>
<th>Macroeconomic indicators in Montenegro 2003-2007</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>GDP (mil EUR)</strong></td>
</tr>
<tr>
<td>GDP per capita</td>
</tr>
<tr>
<td>Nominal GDP growth rate (%)</td>
</tr>
<tr>
<td>Real GDP growth rate (%)</td>
</tr>
<tr>
<td>Inflation rate (u %)</td>
</tr>
<tr>
<td>Unemployment rate (%)</td>
</tr>
<tr>
<td>Average gross salary (in €)</td>
</tr>
<tr>
<td>Average net salary (in €)</td>
</tr>
<tr>
<td>FDI (as % of GDP)</td>
</tr>
</tbody>
</table>


Key pillars of the new economic system in Montenegro are:

1. A stable currency;
2. An open economy;
3. Privatization and protection of property rights;
4. Low level of business regulation;
5. Entrepreneurship encouraging tax system.

1. Importance of stable currency

Montenegrin citizens had a bad luck to go through a bad experience of hyperinflation. After the fall of Socialistic Federative Republic of Yugoslavia, the crash of common market, and simultaneous outbreaks of war in two former Yugoslav republics inflation rates exceeded 100%, generally taken as a threshold for hyperinflation. Moreover, at the end of 1993, inflation amounted to 3,508,091,786,746 % which represents the longest in duration, and the second highest hyperinflation rate in the world.83 After the stabilization program in 1994, inflation rate decreased but still remained on, generally speaking, extremely high level.

High inflation, permanent devaluation of dinar and developed informal currency market – more than 60% of transactions have been realized in legally not permitted DEM – are just some of the reasons why Montenegro entered monetary reforms. That was one of the first reform steps, and keystone of many that followed. »Dollarization« was the only way Montenegro could protect its economy from Belgrade’s political influence: where Milosevic’s authorities were running the dinars’ printing machine. Montenegrin government at the time considered three possible solutions: 1) Currency Board; 2) introduction of a national currency; 3) dollarization.

Since, Montenegro met all theoretical requirements for a successful implementation of dollarization, as small, highly open country with experience of hyperinflation in the past; with almost no seigniorage income; and a great contribution of foreign trade with the EU, in November 1999 Montenegro adopted the DEM as a parallel currency to, by the time used, dinar. In November 2000, dinars were completely abandoned and DEM was the only official currency in Montenegro. In January 2002, it switched to the Euro.

Despite this change (and the accompanying loss of monetary policy instruments, particularly those impacting the money supply), inflation continued to persist. This is largely due to the liberalizing economy and the Government’s reform program. However, having euro as a strong and stable currency drove the inflation to single digits and at the moment Montenegro is the country with lowest inflation rate in the region.

2. Importance of Free Trade

Undoubtedly introduction of EURO as legal tender in Montenegro significantly reduced inflation, but it also contributes to increasing openness. Namely, the introduction of Euro have a significant impact on the trade and investment flows by making them simpler and easier, and thus lowering the transaction costs of international transactions.

As already mentioned above, one of major pillars of economic reforms in Montenegro is openness. Trade policy was one of the functions Montenegrin government took from federal level, while Montenegro still had been part of FRY. Striving for openness Montenegro significantly reduced all custom tariff rates on import. There are no tariffs on export and Montenegro abolished all import/export quotas. But, after the Belgrade agreement was signed

83 Source: Central Bank of Montenegro
and Action Plan on harmonization started to implement Montenegro was forced to increase tariff rates on import, thus increasing average tariff rate on import for around 3%, and going in the direction opposite from the wanted. Average import tariff rate is at the moment at the level of 6%. Process of WTO accession is underway and it is expected Montenegro will become WTO member during 2008.

3. Importance of Private Property - Privatization and Protection of Property Rights

As in other transition countries, privatization was one of the first steps in Montenegro’s reform process. Its privatization process can be divided into two phases. The first phase from 1996 to 1999 used insider privatization as the dominant model. State owned companies sold shares to employees at a discount, and management participated in buyout procedures. That phase didn’t deliver the expected results, but it did show that the privatization process required clear and legal institutional foundations.

There were several problems with the privatization concept before 1999, including the following:

“(1) Privatization was oriented toward employees (insider privatization) and domestic buyers. No substantial improvements were made to the management of the enterprises themselves. Instead, the new boards of directors were quite incapable of dealing with the main issues relating to enterprise organization, restructuring, etc. In effect, managers were put in control but did not bear the consequences of their decisions.

(2) Privatization was not transparent enough, particularly in the case of the sale of controlling share blocks and the sale of indivisible enterprise parts. The inadequate transparency was due to the following: rather vague procedures and rules; “exclusivity” of the process, i.e., giving preference to the existing enterprise management; inadequate information on companies, especially ones that covered up bad debts that the buyers discovered subsequently; non-observance of payment terms; direct arrangements between the funds and buyers concerning the newly made changes.

(3) Property rights were not adequately protected. There were many cases in which the employees of enterprises protested when the business was sold and demanded from the new owner more than was stipulated in their contracts or the collective agreement (in terms of wages, job security, and other benefits). Some buyers were prevented by the employees from entering the premises of the companies they had, regardless of having full ownership. In cases such as these, the bodies in control of privatization decided to cancel contracts, often to the disadvantage of the buyers.

(4) Many debates about privatization cases adversely affected the public image of privatization. These debates were brought about by poor information supply (Crna Gora Coop, Danilovgrad), inaccurate and vague contracts (Trebijesa, Nikšić), vague procedures (Dr Simo Milošević Institute, Igalo) and problems of restitution.

(5) The demand for shares was low. The privatization model gave preference to domestic buyers. However, domestic savings were completely depleted in consequence of the long-lived (ten-year) economic and political crisis. Moreover, individuals and some banks were moving a lot of capital outside of Montenegro. At that time, the quality of the Montenegrin banking sector (eight domestic banks and one foreign bank) was low.

(6) Potential foreign investors were cautious. Foreign investors were cautious because of the political situation, vagueness of some of the methods of privatization, inadequate protection of property rights, and general slow conduct of all reforms in Montenegro.

(7) The institutional and legal framework in Montenegro was inadequate for a radical phase of privatization. Furthermore, the management of privatization reforms was excessively dispersed (Economic Restructuring and Foreign Investment Agency, Development Fund, Employment Office and Old Age Pension and Disability Insurance Fund). Foreign consultants were actually suggesting increased centralization of, and greater control over, privatization.”

The new Law on Privatization, adopted in 1999, established these foundations. The implementation of this law marked the beginning of the second phase of privatization. Different methods were used for privatizing state-owned companies from 1999 onwards, including mass voucher privatization, international sale tenders, and auction sales of companies’ assets. The results of privatization have been very encouraging: at the end of 2005, around eighty percent of the total value of capital in the Montenegrin economy was in private hands.85

<table>
<thead>
<tr>
<th>Value of capital at the beginning of privatization process</th>
<th>4,695,490,243.37</th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Privatized</td>
<td>3,991,166,706.86</td>
<td>85.00%</td>
</tr>
<tr>
<td>Non-privatized</td>
<td>704,323,536.51</td>
<td>15.00%</td>
</tr>
</tbody>
</table>

Figure 1

Ownership structure in companies in Montenegro

4. Business Environment Promoting Entrepreneurship

Along with the privatization process, Montenegro has conducted reforms aimed at improving the overall business environment. The first step toward deregulation of the business environment was the adoption of the Law on Enterprises, which was enacted by the Parliament in 2001. The main goal of this law was to ease business entry and provide incentives for greater entrepreneurship. As a result the process of business registration became simple and less costly. According to the World Bank’s Doing Business Report 2007, these reforms have made Montenegro stand out in the region, but there still exists room for improvement.86

According to the World Bank’s Doing Business 2007, these reforms have improved Montenegro’s business environment relative to the region, but there still exists room for improvement.87

86 Doing Business 2007
According to *Doing Business*, starting a business in Montenegro takes about 15 procedures and 24 days.

Montenegrin law permits the establishment of six types of companies, which are:

<table>
<thead>
<tr>
<th><strong>Limited Liability Company</strong></th>
<th><strong>Limited partnership</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>Minimum capital requirement: € 1</td>
<td>Two or more people</td>
</tr>
<tr>
<td>Registration fee: € 10</td>
<td>Minimum capital requirement: no minimum equity requirement</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th><strong>Joint Stock Company</strong></th>
<th><strong>Entrepreneur</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>Minimum capital requirement: € 25,000</td>
<td>Minimum capital requirement: no minimum capital requirement</td>
</tr>
<tr>
<td>Registration fee: € 10</td>
<td>Registration fee: € 10</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th><strong>General partnership</strong></th>
<th><strong>Part of a foreign company</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>Two or more people</td>
<td>Minimum capital requirement: no minimum capital requirement</td>
</tr>
<tr>
<td>Minimum capital requirement: none</td>
<td>Registration fee: € 10</td>
</tr>
<tr>
<td>Registration fee: € 10</td>
<td></td>
</tr>
</tbody>
</table>

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Another long standing problem in Montenegro was the liquidation of insolvent businesses. In the past, bankruptcy procedures could last more than ten years. The newly passed Law on Bankruptcy simplifies the process, capping the procedure period at eight months.

As it has done with the bankruptcy laws, Montenegro has also made business regulations friendlier to entrepreneurship than they were in the past by changing regulation in the following areas: the status of foreign investors in the Montenegrin economy, the free movement of capital and tax free profit repatriation. Montenegro has adopted the euro as its legal currency. In addition, the prices of goods and services are (almost) entirely freely determined.

Moreover, the legal framework in Montenegro seeks to encourage foreign investment. Foreign investors can establish companies and invest capital in the same way as Montenegrins. Foreign investors are given national treatment; the same regulations apply for domestic investors and foreign investors. Also, there are no restrictions on the ability to remit profit, dividends, or interest.

5. Importance of Low Taxes

Like many of its other reforms, Montenegro’s tax reforms seek to stimulate entrepreneurship, as well as make the country an attractive business destination. In July 2002, the old sales tax system was replaced with a value added tax (VAT). The VAT general rate is 17 percent, with a 7 percent rate for basic food, books, and other commodities.

In 2005, Montenegro replaced its two-tier corporate tax rate of 2002, which taxed corporate profits below 100,000 Euros at 15 percent and those above that threshold at 20 percent, with a single flat rate of nine percent, the lowest rate in all of Central and Eastern Europe and one of the lowest rates in the world.

<table>
<thead>
<tr>
<th>Marginal Corporate tax rates of some Eastern European countries</th>
</tr>
</thead>
<tbody>
<tr>
<td>Czech Republic</td>
</tr>
<tr>
<td>Albania</td>
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<tr>
<td>Estonia</td>
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<tr>
<td>Bosnia and Herzegovina</td>
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<td>Croatia</td>
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<td>Slovakia</td>
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<tr>
<td>Hungary</td>
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<tr>
<td>Macedonia</td>
</tr>
<tr>
<td>Serbia</td>
</tr>
<tr>
<td><strong>Montenegro</strong></td>
</tr>
</tbody>
</table>

Source: PricewaterhouseCoopers Corporate tax guide, 2005

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89 The legislation is based on the national treatment of foreigners; foreigners have the same rights as domestic citizens, including the right to buy and own land in Montenegro.

90 The old sales tax system had rates of 15 percent and 24 percent on goods, as well as 12 percent on services.
Progressive taxation of personal income is replaced with flat personal income tax in 2007. Marginal personal income tax rate of 15% has been applied in 2007 and 2008. In 2009, the rate will drop to 12 percent, before finally declining to 9 percent in 2010, thereby eliminating the wedge between labour and capital taxation. These policy changes will simplify the tax system and make it more robust by creating a broad-base, low-rate tax system\textsuperscript{91}.

Montenegro has tax system which is the most attractive for business in the region of South East Europe. This is one of the reasons Montenegro attracts investors from all over the world.

\begin{center}
\textbf{Table 4}
\end{center}

<table>
<thead>
<tr>
<th>Country</th>
<th>Corporate income tax</th>
<th>VAT</th>
<th>Tax on capital gains</th>
</tr>
</thead>
<tbody>
<tr>
<td>Montenegro</td>
<td>9%</td>
<td>17%</td>
<td>Is not being paid</td>
</tr>
<tr>
<td>Serbia</td>
<td>10%</td>
<td>18%</td>
<td>20%</td>
</tr>
<tr>
<td>Croatia</td>
<td>20%</td>
<td>22%</td>
<td>Is not being paid</td>
</tr>
<tr>
<td>Bosnia</td>
<td>10%</td>
<td>17%</td>
<td>Is not being paid</td>
</tr>
<tr>
<td>Macedonia</td>
<td>15%</td>
<td>18%</td>
<td>12%</td>
</tr>
<tr>
<td>Slovenia</td>
<td>22%</td>
<td>20%</td>
<td>20%</td>
</tr>
</tbody>
</table>

\textit{Source: Institute for Strategic Studies and Prognoses}

Low tax rates and favourable business environment brought to significant growth of business activities and large inflows to government budget. Thus in 2006 Montenegrin Government had budget surplus for the first time in modern Montenegrin history. Budget revenues remained to exceed expenses in 2007 and 2008.

\section*{Challenges ahead of Montenegro}

After regaining state independence, entering international organization as sovereign state and adoption of new constitution reforms in Montenegro focused on economic issues.

Economic facts given in the paper show that Montenegro has achieved macroeconomic stabilization and can be summarized as follows:

1. The lowest inflation rate in the region;
2. The highest FDI per capita in the region;
3. The highest level of economic freedoms in the region;
4. Largest share of privatized capital in the region;
5. Budget surplus
6. The most dynamic capital market in the region;
7. The lowest unemployment rate in the region.
8. Besides, Montenegro is the only state in the region which use internationally convertible currency (EURO)

\textsuperscript{91} Drakic, M; Sautet, F; McKenzie, K. (2007) “Montenegro – Challenges of a Newborn Country”, Mercatus Policy Series, Mercatus Center at George Mason University, Arlington, VA, USA
As stabilization phase of economic transition has ended, focus of economic reforms now have to move to the development – Montenegro has to undertake all steps necessary in order to improve the quality of life of each individual. Main post-transition challenges Montenegro has to face with are further reduction of unemployment, further improvement of institutional framework and improving the rule of law.

These goals in the economic area are consistent with the key political goal - implementation of Stabilization and Association Agreement in order to fulfil all requirements for EU membership. Montenegro has submitted application for EU candidate country in December 2008.

Once more, main challenge in economic area ahead of Montenegro is to improve living standards of each individual, which can only be achieved through continuous growth of productivity and employment. Sustainable economic growth on long term can be achieved if Montenegro continues implementation of economic concept that promotes high level of economic freedom, low taxes, attractive business and investment environment. In other words Montenegro must keep its economic system competitive and attractive. When speaking about competitiveness of economic system several elements are important:

1. Political system and its influence on economic competitiveness
2. Fiscal system
3. Labour market
4. Business environment
5. Investment environment
6. Public services

**Political stability** of the country is necessary in order to attract investment. This means that Montenegro has to keep reliable and safe political system, and to work on further development of institutions and the rule of law, which will give significant contribution of European integrations. Having in mind all of this, anticorruption programs and its implementation that is monitored by new established Commission on national level, will send good signals to investors and thus have positive influence on competitiveness.

As noted above **fiscal reforms** were one of very important elements of economic reforms in Montenegro – fiscal consolidation brought to the reduction of budget deficit and public debt! In order to keep fiscal policy sustainable and competitive public finance must be strongly consolidated. Montenegro has implemented strong fiscal consolidation in the period 2003-2007 – one of the strongest in Europe.\(^2\). While in 2002. Montenegro had budget deficit of 4% and public debt that exceeded 80%, in 2008 budget is in surplus of 7%, while public debt amounts to 30%.

In order to provide competitive fiscal policy Montenegro should adapt tax system and move tax burden from employment cost to consumption. This can be achieved through already mention single-digit corporate income flat tax rate - 9%, the fact that reinvested profit is not being taxed and reduction of personal income flat tax rate, which is gradually decreasing.

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from 15% - in 2008, 12% - in 2009, to final 9% in 2010. Besides, Montenegro will continue reduction of health contributions, which decrease from 12% - in 2008, through 10,5% in 2009, to final 9% - in 2010. The final goal is - flat tax of 9% on all sorts of income. Pension contributions also decrease from 21% - in 2008, through 20,5% - in 2009 to 20% - in 2010.

The strongest challenge is probably limiting public spending. If budget spending grows as fast as budget revenues, which rise strongly thanks to growing investments and import, then budget stability can be endangered. Thus the Government set the goal to reduce public consumption from around 40% of GDP (in 2008) to 36.5 (in 2011). Final goal is to reduce the role of state in economy, which will provide rise of private sector competitiveness, followed by the growth of employment and real wages. Along with the reduction of public spending Montenegro must work on further improvement of public services in infrastructure, which is the reason that capital budget has been set on the level of 3.5% of GDP for following few years.

Competitiveness of labour market is one of the key and critical components of competitiveness policy. Namely, enhanced economic activity causes rising labour demand so unemployment can be reduced in fast growing countries, as Montenegro is, even if labour market is rigid. Unemployment rate has significantly been reduced in Montenegro in last several years. It is also evident that several tens of thousands of foreign residents (up to 45,000-50,000) are employed in Montenegro, especially in tourism and construction sector. But rigid labour laws have negative influence on long term, as it causes slow growth of employment, on one side, and unsustainable growth of salaries that don’t follow rise of productivity. This can undermine economic growth and enhance inflation. Greenspan warning that the growth of employment expenses can be a source of inflation pressures on global level must be kept in mind. That’s why it’s extremely important to open the borders for employing non-residents, even though that is politically unpopular measure. Implementation of new Employment law in Montenegro, which promotes individual contract as the mean to arrange relations between employer and employee, should transform labour market. Implementation of the new Law is expected to reduce employment barriers, encourage employment, reduce informal unemployment and consequently positively influence public finance. Other measures needed to improve competitiveness of labour market are investments into education sector – conditions for development of both private and public education must be improved.

Business environment is as important element of competitiveness policy as tax system or labour laws. It is already said above that Montenegro has achieved great results in improving business environment, but business barriers remain strong in construction and energy sectors. Time needed to obtain all licenses and approvals for construction must be shortened and implementation of new adopted Law on physical planning should simplify and short these procedures, and thus reduce opportunities for corruption. One of the significant business barriers are different electricity prices for business and households – businesses pay higher electricity price. Equal treatment of business and households would be important step in further improvement of business environment. It would also be important to adopt and implement new Law on property and Law on concessions.

93 http://www.ministarstvo-finansija.vlada.cg.yu/
Competitiveness and productivity growth on long term can only be provided through high level of investments. All elements of competitiveness policy explained above are oriented to attract investments. FDI per capita inflows prove that Montenegro had achieved good results in attracting investments. In order to keep high level of investments, both foreign and domestic privatization process must be completed. As already stated around 85% of economy has been privatized, but several big companies still remained in the hands of state - Port of Bar, Railway company, Airports, Electro power plant, Plantaze – big wine company. They will be privatized in following few years. Experience shows that privatization in Montenegro is followed by green-field investments, especially in tourism and energy sector and if keeping the development of economic system on the same path of rising economic freedom that trend will continue.

When speaking on competitiveness of public services it is necessary to mention need to work on improvement of roads and public utilities. Construction of high way to Serbia will start in 2009, while different forms of private-public partnership should be the framework for new investments in this area. Improvement of education and health system are as important constituent of competitiveness of public services. Reforms and privatization in this area is very sensitive issue, but necessary in order to increase overall country competitiveness. Competitiveness of the country can also be significantly improved through as the development of information society and introducing e-government, which was the reason to established new Ministry for information society within the Government.

Conclusions

Stabilization phase of economic transition in Montenegro has ended. That’s why focus of economic reforms now have to move to the development – Montenegro has to undertake all steps necessary in order to improve the quality of life of each individual. It means that Montenegro must maintain and further develop flexibility of its economic system and improve its competitiveness.

Issue of economic competitiveness must be considered in the context of main political goal of Montenegro – to become EU member country. Development of attractive economic system, which should be kept unique and different from other European countries, is not inconsistent with process of EU integration. On the contrary, EU integrations should only encourage the decision makers to permanently look for market niches, i.e. opportunities for competitiveness growth. This approach also reduces risk of vulnerability and exposure of small economy as Montenegro to external shocks.

Only appropriate answer of Montenegro to potentially damaging external events (as financial and economic crisis world is facing with) is to create condition for productivity growth through economic policy oriented to further growth of economic freedom, institutional development and the rule of law. These three elements are key contributions of EU integration process in this phase.
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SANDRA ŠVALJEK *

THE IMPACT OF FISCAL POLICY ON CURRENT AND FUTURE MACROECONOMIC DEVELOPMENTS IN CROATIA

Introduction

This paper briefly describes main economic trends in Croatia since 2000 with an emphasis on fiscal policy. It argues that the government has missed the opportunity to redefine its role during the period of relatively favourable economic developments and that more profound public sector restructuring has been essential for establishing solid ground for sustainable economic growth in the future. The first section of the paper gives a short overview of recent economic developments in Croatia in an international comparison. Development of the size and structure of government expenditures is presented in the second section. Third section gives a list of arguments for the necessity of government expenditure reduction and restructuring, and fourth section concludes.

1. Recent economic developments

From 2000 to 2007 Croatian economy went through a period of relatively high and stable economic growth. The rate of real GDP growth was quite stable and ranged from 2.9 to 5.6 percent or 4.7 percent on average. Compared to the 10 new member states (Czech Republic, Hungary, Poland, Slovakia, Slovenia, Latvia, Lithuania, Estonia, Romania and Bulgaria), Croatian economy performed rather well in 2001-2003 period (see Figure 1). However, since 2004 Croatian growth rates fell below those of the new member states and this can to some extent be explained by the economic benefits the accession countries had from the EU entrance. It is interesting that in 2004-2007 period other South-East European countries (Albania, Bosnia and Herzegovina, FRY Macedonia, Montenegro and Serbia) have also outperformed Croatia in terms of GDP growth rate, which probably has to do, among other things, with considerably lower starting development level of those countries.

Macroeconomic environment in Croatia in the same period was relatively stable, with low price inflation and kuna exchange rate changing only within very narrow band. CPI inflation was among the lowest in the region, or 2.9 percent on average (see Figure 2). Only at the beginning of that period the inflation rate exceeded 4 percent in Croatia, whereas a majority of the new member states and South East European countries could not preserve price stability either at the beginning of the period (Poland, Slovak Republic, Serbia and Montenegro) or at the end of the period (Hungary, Bulgaria, Latvia).

*Sandra Svaljek, Director, The Institute of Economics, Croatia
Although two basic macroeconomic indicators could lead to the conclusion that Croatian economy is growing steadily without bigger difficulties, other indicators clearly point at inherent structural problems. Throughout the period trade balance was negative with current account balance ranging from 2.8 percent of GDP in 2000 to 8.6 percent of GDP in 2007 (see Figure 3). Large and persistent current account deficits characterized not only Croatia, but also majority of the countries in the region – only Poland, Czech Republic and Slovenia among the new member states, and FRY Macedonia among the South East European countries had lower average current account deficits than Croatia in that period whereas some of the countries in the region faced extremely high levels of current account deficits of even 20 or more percent of GDP (Latvia, Bosnia, Montenegro and at the end of period Bulgaria).
In the same time, Croatia also belongs to that group of countries with negative general government balance. In the 2000-2007 period the average size of general government deficit was as high as 5 percent. The size of the deficit declined constantly from 2000 to 2007, but since the same trend can be observed in all the neighbouring countries, Croatia still has one of the largest government deficits in the region (see Figure 4). In 2007 higher deficit than in Croatia was recorded only in Hungary, Romania and Bulgaria.

With relatively high current account deficit and sizable government deficit Croatia thus belongs to the club of countries in the region running “twin deficits”. In 2007 a majority or eleven out of sixteen countries (10 new member states, Croatia and other South-East European countries) were characterized by deficits both in current account of the balance of
payments and in government balance. Since such an unbalanced situation went hand in hand with relatively high economic growth, it could be argued that the countries in question had a surplus of investments over total domestic savings, and had to sacrifice some instability at the expense of higher economic growth and catching-up with more developed European countries.

However, high and stubborn current account and general government deficit which, in case of Croatia resulted in external debt exceeding 90 percent of GDP in 2008 can also be understood as indicator of structural weaknesses of the economy and of its low international competitiveness.

There are numerous reasons for low competitiveness and insufficient productive capacity of Croatian economy that could be found and elaborated such as inherited economic structure and governance, consequences of Homeland War at the beginning of 90-ies, problematic privatisation, late inflow of FDI in comparison with Central and East European countries, still underdeveloped institutions and inadequately functioning legal system etc. All those factors certainly hampered the development of well functioning and growing market economy in current decade. However, there is yet another factor that is usually omitted from the list of obstacles to higher and more balanced economic growth - a very large and insufficiently reformed government sector that is due to its size and scope limiting the manoeuvre space for effective fiscal policy.

2. General government in Croatia

It is a mixture of economic, social and political factors that in Croatia more than in many other countries in the region resulted in particularly large government sector. This is reflected in high share of total government expenditure and revenue in GDP and high overall tax burden measured by ratio of tax revenue in GDP. In the 2000-2006 period total expenditures in Croatia were as high as 50.7 percent of the GDP. In spite of the fact that ten new member states were also centrally planned economies and thus prone to creating large government sector, in those countries the size of government is considerably lower than in Croatia (see Table 1). When looking at particular countries, only Hungary and Slovenia had government sector of similar size as Croatia, with the average share of government expenditures in GDP of 49.8 and 48.3 percent, respectively. Similarly, share of tax revenues in GDP was lower than Croatia in all countries except Slovenia. Due to the constant fiscal imbalances, size of accumulated debt in Croatia is also larger than in other countries in the region except Hungary.

<table>
<thead>
<tr>
<th>Consolidated general government ratios, Croatia, 2000-2006 average</th>
<th>(% GDP)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>CEE</strong></td>
<td>45.5</td>
</tr>
<tr>
<td><strong>Baltic states</strong></td>
<td>36.1</td>
</tr>
<tr>
<td><strong>SEE-2</strong></td>
<td>37.8</td>
</tr>
<tr>
<td><strong>Croatia</strong></td>
<td>50.7</td>
</tr>
</tbody>
</table>

*Source: The World Bank.*
Studies trying to explain differences in size of governments and their growth find different potential determinants of the government expenditure ratio, like the initial size of the government, level of per capital income, age structure, frequency of elections, degree of openness, nature of political system (federal or unitary systems), fiscal illusion etc. (Mueller, 1987; OECD, 1985). In case of Croatia, it seems that many socioeconomic characteristics as well as recent history of the country predetermined its strong inclination towards the big government sector.

First, Croatia belonged to the centrally planned socialist state where bureaucracy was powerful, citizens were used to have free access to wide range of social services provided by government sector, and economy was dependent on various aspects of state support. In other words, initial size of the government created high expectations in terms of government size, power and scope. Second, due to the war and consequent reconstruction in the 90-ties, a classical “displacement effect” took place – citizens wanted the government to deal with the situation effectively and therefore accepted higher tax burden which remained high even after the fundamental reasons for it have vanished. Third, a small and underdeveloped, but open economy needed strong support from the government. In addition to these three dominant factors, many others also worked in the same direction – tax structure based on consumption taxation and deficit financing that contribute to fiscal illusion and make citizens tolerant towards big government sector and enhance government growth, logrolling that is common in Croatian political decision-making and permanently reproduces government involvement in various programs, powerful bureaucracy that is capable of inflating government budget in order to obtain higher salaries. In addition, Croatia, like the other transition countries, had inadequate infrastructure, so that large government investments were needed in order to create favourable conditions for doing business. In that respect, government capital expenditure that in 2000-2007 period amounted to 7 percent of GDP on average could be justified. However, even if one takes capital expenditures as growth enhancing, the remaining government expenditures reach very high level of close to 43 percent of GDP on average.

In the period of time 2000-2007 government expenditure in Croatia did not rise in relative terms – their share in GDP fell by almost 5 percentage points (see Figure 5). Behind that clear trend towards smaller government sector there was undoubtedly a conscious government action and its recognition of the detrimental effect of big government sector on economic growth. However, it could also be said that since the economic conditions were quite good, and therefore the need for government actions was less pronounced, there was a room for even more profound redefinition of government size and role in the economy. But in good times, when tax collection was surprisingly good, access to financing easy and cheap, bureaucracy was tempted to spend all the collected money and even some more, and an incentive to rationalize and control government expenditures was particularly weak.

94 Preparation of the 2009 government budget is the most recent example of bureaucracy exercising its power to affect size of government expenditure. Although it seemed unreasonable in current economic situation, government accepted a 6-percent rise of the salaries of public sector employees which led to an expansion of government expenditures by 0.5 percent of the GDP.
95 It should be mentioned that the government expenditures presented here do not include off-budget pensioner's debt repayment equal to 1.2 percent of GDP.
In other words, a moderate reduction of government expenditures since 2000 is just a reflection of slow progress in introducing structural reforms in various segments of the government like social assistance, subsidies, public administration, health, pensions, transport, education etc. Recent World Bank study has identified possibilities to take measures aimed at improving efficiency and reducing spending in those segments that would at the end result in expenditure reduction by more than seven percentage points of GDP in the medium term (The World Bank, 2008).

3. Why cutting government expenditure?

It is not self-evident that by cutting government expenditures economic growth can be automatically intensified. According to the economic theory, the relationship between government size and economic growth is non-linear meaning that it depends on the structure of government consumption, but also on the level of economic development (Pevcin, 2004). In addition, many economists agree that there is the optimal size of the government and that, according to the so-called Armey Curve output-enhancing features of government dominate when government is very small, but they diminish with the rise of government spending due to the falling productivity of government projects, crowding out and rising tax burden (Šonje, 2007). However, the optimal size of the government is different for each economy and, according to some empirical studies ranges from 36 to 42 percent of GDP for the EU countries (Pevcin, 2004), so how can one be sure that optimal size for a small and less developed economy is not 45 or even more percent of the GDP?

On one hand, it seems that both the theory and the empirical work give some, but still not enough convincing implication that in Croatian case the government size should be further reduced. On the other hand, a closer look at fiscal developments in the past and challenges laying ahead lead to a quite straightforward conclusion that fiscal policy should be changed and government role significantly reduced. Otherwise, government sector behaviour could jeopardize macroeconomic stability and hamper economic growth.
Such opinion is based on the following observations: first, at the end of 2008 it became obvious that big government cannot react flexibly on economic slowdown. In order to allow automatic stabilizers to operate during downturn, an increase in government deficits would be a proper answer to economic developments, but it was not an option in Croatia. Due to the high accumulated public debt and necessity to roll-over big part of existing liabilities, higher deficit could not be financed given the low supply of credits and insufficient liquidity on financial markets, and it would cause serious crowding out of private sector investments. The other fiscal policy responses – introducing programs aimed at boosting economic activity and curtailing some other expenditure items, or reducing tax burden happen to be unfeasible. The first was unfeasible since the government found any restructuring of government expenditures as politically to costly, and the latter was out of the question because it would require either deficit increase or expenditure cut.

Second, Croatia’s EU accession will have significant effects on government budget. It will both bring some revenue losses due to the harmonization of tax policy with the EU standards, and require additional spending to build adequate administrative capacity and co-finance the EU-funded programs. Since the net effect on government budget is projected to range between -1 and -3 percent of GDP, a serious fiscal consolidation would be needed to offset the fiscal costs of EU accession and bring deficit in line with the Maastricht criteria (Švaljek, 2007; The World Bank, 2008). In addition, entering NATO will also cause budgetary costs of around 1.5 percent of GDP (The World Bank, 2008).

Third, in the long run Croatia could face relatively high fiscal effects of demographic ageing. Structure of Croatian population is changing rapidly due to very low total fertility rate and increasing life expectancy, and empirical studies have shown that it might lead to an increase in health-related expenditures by more than 1 percent of GDP by 2050 (Nestić, Švaljek, 2007). Thanks to the pension system reform introduced in 2000, with unchanged pension system expenditures are not supposed to rise in spite of demographic changes. However, since that system leads to significant reduction of the replacement rate if the overall economic performance is bad, there will be constant pressures to change the main features of pension system. This could cause an explosion of pension expenditures in the long run.

Even without resorting to listing usual drawbacks of big government sector, there seem to be good reasons to start thinking about major changes in fiscal policy and in government’s spending behaviour. It is, however, plausible that the government whose expenditures are equal to half of the GDP creates a great burden to the economy because it creates high allocative inefficiencies due to the large deadweight loss, aggravates public control over public sector spending, paralyzes economic structure by making firms concentrated on making deals with the government and not on competing on the free market, widens the space for corruption, crowds out private investments and finances less productive public projects.

4. Conclusion

Croatian economy is rising at stable rates, but those rates are modest compared to the ones of the other countries in the region. In addition, persistent current account deficits and general government deficits indicate structural weaknesses of Croatian economy. Since Croatian government sector is large in international comparison, it can be seen as one of the obstacles
to swifter economic restructuring, rising competitiveness and stronger growth. This conclusion is based on several observation related to the challenges fiscal sector is facing in the present and will with high certainty face in the future. It is high time for the government to give up activities that can be performed more efficiently by private sector, to improve efficiency and effectiveness of public sector, and consequently to reduce its spending.

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GJERGJI FILIPI *

FACTORS OF ECONOMIC GROWTH IN ALBANIA

A panorama of Albanian economic performance

The Albanian economy has been experiencing a yearly average growth of close to 6 percent in the last period. Since the beginning of its transition towards a democratic state and a free market economy in the early 90's, Albania's cumulative growth has been impressive and is considered amongst the highest in all transition economies. From 680 USD in 1990, real GDP per capita fell sharply during the early 1990s but has been growing steadily over recent years, to reach an estimated 2,882 in 2006.

However, the country remains one of the poorest in Europe. Having started the transition from an extremely low level, the Albanian economy has still a lot to do in order to catch up with its neighbouring economies. Unlike some of the other countries of the East Block, Albania did not undertake any pre-transition reforms before the '90s. During 1991-1992 the economy encountered a sharp decline in output accompanied with high levels of unemployment and inflation. The adverse economic situation led to mass exodus of the work force abroad, especially to neighbouring countries, where Italy and Greece became the destination for most of the Albanian emigrants.

\begin{table}
\centering
\begin{tabular}{|l|l|l|}
\hline
Country & GDP per capita & \hline 
Luxembourg & 276 & Germany & 113 & Slovakia & 69 \\
Norway & 184 & France & 111 & Hungary & 63 \\
Ireland & 146 & Spain & 107 & Lithuania & 60 \\
Switzerland & 137 & Italy & 101 & Latvia & 58 \\
Netherlands & 131 & Greece & 98 & Croatia & 55 \\
Austria & 128 & Cyprus & 93 & Poland & 54 \\
Sweden & 126 & Slovenia & 89 & Turkey & 42 \\
Denmark & 123 & Czech Republic & 82 & Romania & 41 \\
Belgium & 118 & Malta & 77 & Bulgaria & 38 \\
Finland & 116 & Portugal & 75 & Serb Republic & 35 \\
United Kingdom & 116 & Estonia & 72 & FYROM & 29 \\
Albania & 22 & \hline
\end{tabular}
\caption{GDP per capita in 2007, expressed in Purchasing Power Standards}
\end{table}

Source: EUROSTAT

Immediately after transition, real GDP contracted sharply by a cumulative 39 percent between 1990 and 1992. Since 1993 the economy started an intensive recovery with growth

\footnotesize

96 INSTAT, Main Macroeconomic Indicators 1996 - 2006, at current prices.

\* Gjergji Filipi, Research Director, AGENDA Institute, Albania
rates of almost 10 percent. This was a combined result of successful macroeconomic stabilization, liberalization of prices and external trade, and privatization of agricultural land, as most of the growth during this period was driven by agriculture.

Albania’s growth experience since transition can be divided into two separate periods. Year 1997 signed a sudden interruption of growth due to the collapse of the pyramidal savings schemes. The situation degenerated into a total domestic chaos while the economy contracted sharply by 7 percent in its real output. As a result of diligent policies of economic stabilization and a period of political stability in the immediate following years, the Albanian economy rerouted fast and achieved high positive growth rates starting from 1998, while in 1999 real GDP exceeded for the first time its level of 1990.
Between 1998 and 2007 real GDP growth has averaged almost 7 percent yearly, amongst the highest in Eastern Europe. For the same period, only the Latvian and Estonian economy have shown an average real growth rate higher than Albania with less than one percentage point in difference. While, in relation to its closer neighbouring economies of South Eastern Europe, the average real growth rate for Albania marks the highest score.

**Figure 3**

Per Capita GDP and Year-On-Year Inflation

![Per Capita GDP and Year-On-Year Inflation](image)

Inflation has remained quite stable during the same period, within the levels of 2 to 4 percent, which is also the target set by the Bank of Albania. The relatively high and sustained growth led to an estimated GNI per capita of almost 3,000 USD in 2006 upgrading Albania to the group of middle income countries.

**But, which driving forces underpin this economic performance?**

In order to interpret Albania’s economic performance during the past years, the determinants will be grouped into three different bundles: macroeconomic policy, factors of productivity and expansion of consumption.

**On the policy level**, macroeconomic stability has provided a favourable economic environment over most of the past years. A cautious fiscal approach has helped to consolidate the public finances by reducing the domestically financed government deficit from 6.74 percent of GDP in 1998 to 2.86 percent in 2005 and also by reducing the public debt to GDP ratio from 75 percent in 1998 to 55.5 percent in 2006. Prudent monetary policy has sustained price stability and rather steady inflation expectations while contributing to an elevated degree of confidence in the local currency LEK.

The second determinant of growth for Albania is total factor productivity. During the initial years of transition, as expected, the chaos resulting from the removal of central planning and control produced a fall in economic output and the capital stock was idled. Consequently, as the economy achieved macroeconomic stability and introduced structural reforms, the reallocation of resources to more productive activities stimulated rapid growth with low rates
of investment, allowing for total factor productivity (TFP) growth rates to increase. This has led to the reallocation of resources from low productivity sectors like agriculture to high productivity sectors like services and construction. Mainly as consequence of improved allocation of resources, Albania’s economic growth during transition has been driven primarily by high rates of total factor productivity growth. Growth accounting reveals that during the period 1993-2003, total factor productivity growth contributed 6.14 percent of the average annual real GDP growth of 6.27 percent, accounting for almost 98 percent of the total.

Another important determinant of Albania’s economic performance is the rapid expansion of consumption, following years of very restricted demand under the communist centralized economy. There are two main elements fuelling this expansion, bank credit and remittances from emigrants, but the latter is particularly specific for the Albanian case. In the case of credit to the economy, the situation does not offer any unexpected development compared to similar transition economies.

The remittances, however, appear to be specifically distinct. In order to put this in context, according to INSTAT calculations based on the latest population census of 2001, the number of Albanian emigrants accounted for more than two-thirds of the total number of persons employed in Albania. In terms of figures, the overall number of emigrants living and working abroad was calculated to amount to about 650,000 while the number of the domestically employed workforce was 920,000 for that same year. More or less the same trends have continued to present, with minor increases in employment figures and with similar expectations on migration.

Figure 4

Domestic credit (end-year, % change)

Data Source: EBRD, Transition Report 2007

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98 World Bank Country Economic Memorandum, Albania - Sustaining Growth Beyond the Transition, PREM Unit, ECA Region, Report No. 29257-AL, (2005), pg.22 [Table 7: Albania Growth Accounting Results]
Official estimates indicate that remittances are the largest source of foreign exchange in Albania, bigger than the combined value of exports and foreign direct investments. In 2005, remittances amounted to 14 percent of the GDP and 65 percent of Albania’s trade balance.\(^{100}\) In absolute figures, the Bank of Albania estimates the level of remittances sent to Albania from abroad to be over 1.3 billion USD in 2007.

<table>
<thead>
<tr>
<th>Table 2</th>
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<tbody>
<tr>
<td><strong>Inflow of remittances to Albania</strong></td>
</tr>
<tr>
<td>(in million USD)</td>
</tr>
<tr>
<td>Year</td>
</tr>
<tr>
<td>1998</td>
</tr>
<tr>
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<td>2003</td>
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<td>2004</td>
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<tr>
<td>2005</td>
</tr>
</tbody>
</table>

*Source: Bank of Albania*

In a nutshell, during the past years of Albania’s transition, the high growth rates have been mainly fuelled by total factor productivity improvements and strong domestic demand, primary sustained through high levels of remittances sent from abroad. The economy has been driven by rapid expansion of consumption, following years of very restricted demand under the communist centralized economy, and of productivity growth as the old industries collapsed while a new service sector emerged, and workers migrated. Adequate monetary and financial policies encouraged a stable and therefore favourable economic environment.

However impressive the Albanian economic performance, serious concerns arise in regards to the sustainability of these growth trends for the following years. Total factor productivity growth from post-transition reallocation will gradually come to an end while remittances cannot constitute a solid basis for long term economic development. The actual tightening of the global economy will pose additional threats which, together with the risks accompanying the internal factors of economic growth, necessarily call for a vigilant approach towards sustaining the recent year’s positive trends in the Albanian economy.

**Sectors supporting economic growth**

The four main sectors composing Albania’s productivity are agriculture, industry, construction and services. During the last ten years, non-tradable sectors such as construction and services have constituted the main driving force of Albania’s economic growth, counting together for almost two-thirds of the GDP in 2006.\(^{101}\) There is still room for productivity gains in the non-tradable sector. In retail and distribution, where near-monopolistic price setting seems prevalent, there are opportunities for improved allocation of resources.

Agriculture constitutes the most important traditional sector. After an initial droop in early 1990s, Albanian agriculture experienced a prolonged expansion, which was mainly sustained

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\(^{101}\) World Bank: Albania, Urban Growth, Migration and Poverty Reduction, December 3, 2007, pg 2
by changes in incentives as people were moving from collective farms to private holdings. However, a number of constrains have been holding back further developments in the sector, some of which include fragmented land ownership resulting in small land size, limited use of modern inputs, poor infrastructure and low market access, weak processing capacity, and the absence of a proper land market. The slowdown in agricultural growth and the surge in the output of other sectors have narrowed its share of GDP to 21 percent in 2006 from its high of 35 percent in 1995. However, the importance of this sector remains still high as it constitutes the main source of income for nearly 40 percent of the Albanians.102

![Figure 5](image)

The necessity for improving housing conditions, extending productive capacities and creating a modern infrastructure has encouraged the flourishing of the constructions sector. For some years, this sector was transformed into one of the surprises of economic development while doubling its GDP share in 2005 to amount to 16.5 percent compared to the previous year.103 However, during the past year, the construction sector has faced a considerable drop mainly due to a halt in permission granting by the authorities, plunging by 25 percent in terms of new constructions only during 2007.104

The services sector has been the most expending sector in terms of contribution to the country’s total economic output. During the first years of transition the services sector became important especially with the expansion of trade, while more recently the banking system and retail sector have been the driving force behind the increase of the sector’s share in the country’s output. The numbers show a rapid and sustained growth of the services sector which, according to the Bank of Albania, constitutes the most dynamic sector of the Albanian economy.105

After the complete breakdown of the industry sector during the initial years of transition, the industrial production has been picking up slowly. Some of the constrains that have held back

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103 Bank of Albania, Annual Report 2005, pg.14
105 Bank of Albania: Monetary Policy Statement for the first half of 2008, pg. 10
the industry sector are the lack of investments, little interest of domestic and foreign business, low profitability and high costs.\textsuperscript{106} After the recent increases in the international mineral prices, the industry sector has picked up in minerals extraction and processing. Mineral exports, together with fuel and electricity, continued their recent surge in the second quarter of 2008, increasing by 87 percent year on year.\textsuperscript{107}

**Factors of productivity, the cocktail fuelling the economic engine**

Total factor productivity growth justifies the expansion of Albania’s output, which for the entire period of transition accounts for over 80 percent of the total output growth.\textsuperscript{108} Meanwhile, the contribution of factor mobilization and accumulation of capital has only picked up modestly and faces constraints. With consumption persistently high, domestic savings have declined after 2001. Both the migration of young workers and the modest savings rate will continue to limit the growth of factors of production, and confirm the need for finding new sources of TFP growth.

**Table 3**

**Sources of Growth in Transition Economies, 1993-2007**

<table>
<thead>
<tr>
<th>Contribution to growth</th>
<th>Cumulative Real Growth</th>
</tr>
</thead>
<tbody>
<tr>
<td>TFP</td>
<td>96.1</td>
</tr>
<tr>
<td>Capital</td>
<td>80.5</td>
</tr>
<tr>
<td>Labour</td>
<td>20.9</td>
</tr>
<tr>
<td>-5.1</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>17 transition economies</th>
<th>49.8</th>
<th>49.0</th>
<th>4.8</th>
<th>-4.3</th>
</tr>
</thead>
<tbody>
<tr>
<td>Of which:</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Baltic States</td>
<td>73.5</td>
<td>73.2</td>
<td>11.7</td>
<td>-11.1</td>
</tr>
<tr>
<td>CEE Countries</td>
<td>51.3</td>
<td>45.6</td>
<td>8.7</td>
<td>-2.9</td>
</tr>
<tr>
<td>PRGF transition economies</td>
<td>37.9</td>
<td>43.0</td>
<td>-5.9</td>
<td>0.9</td>
</tr>
</tbody>
</table>

*Source: IMF*

The neoclassical growth model underscores the important role of investment, school enrolment, trade integration, and institutional quality in economic growth. In such a model, investment and school enrolment rates are key determinants of the steady-state level of output per worker. Given current levels of output per worker, a higher steady-state level will generate faster growth. Another important element is the level of technology, which can itself depend on the degree of trade integration and the quality of institutions.

In an attempt to understand the factors that lie behind the TFP growth for Albania, the determinants can therefore be grouped into four categories: capital accumulation, education enrolment rates, the degree of trade integration, and institutional quality. Since specific developments for each of these determinants will play a crucial role in Albania’s economic future, let us take a closer look at each of the groups of determinants.

\textsuperscript{106} Bank of Albania, Annual Report 2005, pg.12
\textsuperscript{107} The Economist Intelligence Unit, Country Report, September 2008, pg.20
The contribution of *capital accumulation* to growth during most of the transition in Albania has been negligible, only to pick up in the last period. According to the IMF and World Bank calculations, the contribution of capital accumulation to growth started to steadily increase after 2002.\(^{109}\) From the graph below, becomes evident that what sets Albania apart from other transitioning economies is the high and growing contribution of capital accumulation.

\[\text{Figure 6}\]

![Contribution of Capital Accumulation to Growth](image)

Source: IMF

Yet, Albania's FDI attractiveness remains modest, to say the least, with the exception of some major strategic privatizations in selected recent years. FDIs peaked in 2004 and 2007, because of the privatization of two important state owned companies in the banking and the telecommunication sector.

\[\text{Figure 7}\]

![Net Foreign Direct Investments to GDP](image)

Source: EBRD

\(^{109}\) World Bank, Country Ec Mem, pg. 22 [Table 7: Albania Growth Accounting Results]
In 2004, the level of FDIs reached the amount of 341 Mln. USD when the Austrian Raiffeisen Zentralbank (RZB) acquired full ownership of the Albanian Savings Bank for 126 Mln. USD. FDIs boosted again in 2007 after the Albanian government sold 76 percent of the state owned fixed telephony company, Albtelecom, to a Turkish consortium Çalık Enerji Telecommunications for over 160 Mln. USD.

Italy and Greece are the predominant sources of FDI in Albania, with roughly 48 percent originating in Italy and 34 percent in Greece. These two countries are also Albania’s major trading partners for both import and export. Foreign investments are concentrated mostly in commercial cities, with approximately two-thirds of all FDIs targeted toward either the capital, Tirana, or the main cargo port of Durrës.

Some of the constrains that the foreign investors face while entering the Albanian market are weak and often conflicting property rights that seriously hamper their transactions. Meanwhile low labour and transportation costs have been indicated from the survey as key advantages of investing in Albania.

As TFP growth deriving from post-transition reallocation draws to a close, it will become increasingly important for Albania to generate TFP improvements from alternative sources. Educational attainment is one such alternative source of TFP improvements.

Even after 17 years, the Albanian education system’s organizational structure and overall quality lives a lot to be desired. Education policies have been unable to develop alongside the rapidly changing economic environment. The period was characterized by a noticeable increase in school drop-out rates as supportive education policies, necessary to efficiently upgrade from the previous system, have been completely non-existent. In comparison with its neighbours, Albania is considered to be one of the countries that suffered most severely from inadequate education policies during the transition period.

Table 4

<table>
<thead>
<tr>
<th>Year 2005</th>
<th>Percentage of age group 18-24 that have not finished high school and do not follow any other educational or training process</th>
</tr>
</thead>
<tbody>
<tr>
<td>Albania</td>
<td>61.9</td>
</tr>
<tr>
<td>Croatia</td>
<td>5.4</td>
</tr>
<tr>
<td>Macedonia</td>
<td>36.2</td>
</tr>
<tr>
<td>Serbia</td>
<td>11.4</td>
</tr>
<tr>
<td>Lisbon’s Objective for 2010</td>
<td>10.0</td>
</tr>
<tr>
<td>EU-(15 countries) average</td>
<td>17.3</td>
</tr>
</tbody>
</table>


110 World Bank, Benchmarking FDI Opportunities, Investment Horizons: Western Balkans (2006)

111 Policies for business in the Mediterranean Countries, Albania, Centre for Administrative Innovation in the Euro-Mediterranean Region
The fact that approximately 62 percent of Albania’s youth has not completed secondary education and is not currently enrolled in any alternative educational or training program is a clear indicator that the policymakers have failed to utilize the proper channels and to harness the right tools to adopt the education system to contemporary challenges. These numbers, however, also bring to light the fact that Albania currently holds an unexploited resource in its hands – the youth workforce potential is vast and, if harnessed, could exert positive effects upon the nation’s human capital.

Another important determinant of TFP is the degree of \textit{trade integration}, which allows an economy to specialize in the production of those products in which its relative productivity is highest and also facilitates the transfer of technology and ideas from other more advanced economies. Albania’s real growth in total trade of goods and services has decelerated from an average of 18.1 percent in the early 2000s to 8.6 percent in 2007, being positioned below the Europe and Central Asia countries average. Albania’s trade integration ratio remains substantially low, declining slightly to 68.8 percent of GDP in 2007. Services, including tourism, accounted for about 65 percent of Albania’s total exports in 2007. This is noticeably different from similar countries, for which goods dominate their exports with more than 75 percent of the total. These facts show that there is a lot to be done in understanding the specific comparative advantages of the Albanian economy and setting up adequate stimulating policies in order to improve the country’s trade integration. Such instruments will also help narrowing the trade deficit, which, in combination with a potential decline in remittances, could pose extreme risks not only to output growth of the economy but also to its overall economic stability.

However, a potentially positive factor in this perspective is Albania’s proximity to the massive EU market. European countries are the destination of 85 to 90 percent of Albanian exports. Imports are primarily obtained from Italy, Greece, and Turkey. As the European Union is its main export market, Albania has a very favourable market access thanks to the uniform Autonomous Trade Preference scheme, which provides duty and quota free access for practically all Albanian exports to the EU markets, and the Stabilization and Association Agreement with the EU signed by Albania in 2006. In addition to these arrangements, Albania, which is a member of the WTO, has also recently ratified the Central Europe Free Trade Agreement (CEFTA) in 2007 as well as an FTA with Turkey that entered into force in May 2008.

Therefore, deeper trade integration is favourable to be pursued by Albania. Priority sectors and policy areas must be identified in order to stimulate Albanian exports targeting both the Western Balkans and also the EU market. Given the existence and complexity of non-trade barriers in the European Internal Market, perhaps a more reasonable short to medium term policy approach would be the one attempting to intensify trade integration with the countries of the region. However, in the long term the Albanian economy must necessarily aim at preparing to confront the spiky competitive pressures present in the European markets, since European Union membership is already a firm objective for the country.

The region of the Western Balkans offers some specific characteristics that make it particularly well suited for regional trade integration. First, all the Western Balkans countries strive for EU membership and are required by the Union to converge towards the same regulatory framework. Second, the region comprises mostly small economies which would
benefit from participation in a larger regional market, and therefore enhance their potential for economies of scale in production processes. Montenegro’s and Kosovo’s independence further added to the number of small economies. Third, most countries used to be part of the same bloc and some economic gains could be reaped from (re)integrating fragments of infrastructure systems. Last, but not least, the geographic, ethnic and cultural similarities can play a positive market integration role. The current politics in most of these countries attempt to emphasize the differences between these societies. Nevertheless, from the perspective of a citizen of the Balkans, I can personally testify the great similarities in consumption preferences that could potentially offer an enormous advantage in deepening the integration of markets.

The fourth TFP determining factor is the institutional quality. Stable and responsible institutions could reduce transaction costs and stimulate the private sector to concentrate on products and sectors in which the economy is naturally most productive. Unfortunately, developing such institutions has proven to be a complex challenge for Albania over the entire transition period. The establishment of a functioning democratic system is still a process that, although with the strict supervision and assistance from important international institutions and actors, continues to represent one of Albania’s most serious challenges. To put this in context, Albania has not yet been able to organize non-contested free and fair elections that comply with international standards.

Notwithstanding the difficulties, once again, proximity to the EU and the focus of the international community on the stability of the region constitutes a major pull towards improving the domestic institutional environment. In April 2008, Albania was officially invited, together with Croatia, to join the North Atlantic Treaty Organization, and the end of next year might find these countries being full members of the organization.

When it comes to labour, for Albania, as in other transition economies, labour was not a major factor of growth. This is partly justified from high labour mobility to neighbouring advanced economies, but also by hidden labour inputs in the large informal sector. The size of the informal economy in Albania is believed to exceed by 30 percent of its formal economy and its undeclared household income was estimated at 52 percent of GDP only few years past, the largest among SEE and CEE countries.

Sustained growth rates have led to very modest job creation, although the official rate of unemployment appears to have fallen to slightly above 13 percent in 2007. Some of the reduction in unemployment is due to a reduction in active job search, as evident in the contraction of the labour force during most of the years, presented in the following table. According to INSTAT’s interpretation, this drop in labour force is largely as result of the increasing number of working age inactive people, especially housekeepers.

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113 World Bank Country Economic Memorandum, Albania - Sustaining Growth Beyond the Transition, PREM Unit, ECA Region, Report No. 29257-AL, (2005), pg.120.
However, most experts believe that the labour market data are not very accurate as they all come from the same and only source, which is the administrative source. Given the size of informality, the lack of incentives for people to register in the employment offices and, above all, the political sensitivity of these kinds of figures, there can be a number of questions raised in regards to their accuracy.

Table 5

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</tr>
</thead>
<tbody>
<tr>
<td>Labour force</td>
<td>1.5</td>
<td>-1.1</td>
<td>-1.7</td>
<td>-14.2</td>
<td>-0.8</td>
<td>-0.3</td>
<td>-0.3</td>
<td>-0.3</td>
<td>0.0</td>
<td>-0.6</td>
</tr>
<tr>
<td>Employment</td>
<td>-2.0</td>
<td>-1.8</td>
<td>0.3</td>
<td>-13.9</td>
<td>0.0</td>
<td>0.7</td>
<td>0.5</td>
<td>0.1</td>
<td>0.3</td>
<td>0.1</td>
</tr>
<tr>
<td>Unemployment</td>
<td>17.8</td>
<td>18.4</td>
<td>16.8</td>
<td>16.4</td>
<td>15.8</td>
<td>15.0</td>
<td>14.4</td>
<td>14.1</td>
<td>13.8</td>
<td>13.3</td>
</tr>
</tbody>
</table>

Source: EBRD, Transition Report 2007

In any case, one thing which can be clearly observed is that despite impressive expansion of the Albanian economy over the past years, not enough jobs are being created. According the World Bank, only between 2002 and 2004, 15 percent of the unemployed and 10 percent of those who were out of the labour force made the transition to formal sector employment. By contrast 38 percent of the unemployed found jobs in the informal sector during the same period.\textsuperscript{114}

Table 6

Annual Gross Salary or Wages for Various Labour Categories

<table>
<thead>
<tr>
<th></th>
<th>Management</th>
<th>Professional</th>
<th>Technical</th>
<th>Skilled Labour</th>
<th>Unskilled Labour</th>
</tr>
</thead>
<tbody>
<tr>
<td>Albania</td>
<td>13,538</td>
<td>8,123</td>
<td>6,497</td>
<td>3,569</td>
<td>2,215</td>
</tr>
<tr>
<td>B &amp; H</td>
<td>22,521</td>
<td>14,250</td>
<td>12,600</td>
<td>7,667</td>
<td>5,467</td>
</tr>
<tr>
<td>Croatia</td>
<td>35,383</td>
<td>22,317</td>
<td>12,600</td>
<td>11,408</td>
<td>7,714</td>
</tr>
<tr>
<td>Serbia &amp; Mont.</td>
<td>NA</td>
<td>10,649</td>
<td>3,878</td>
<td>5,715</td>
<td>4,293</td>
</tr>
<tr>
<td>Czech Republic</td>
<td>21,193</td>
<td>NA</td>
<td>6,031</td>
<td>9,389</td>
<td>6,583</td>
</tr>
<tr>
<td>Hungary</td>
<td>37,170</td>
<td>NA</td>
<td>16,862</td>
<td>8,744</td>
<td>7,618</td>
</tr>
<tr>
<td>Slovakia</td>
<td>21,189</td>
<td>NA</td>
<td>10,797</td>
<td>5,152</td>
<td>3,699</td>
</tr>
</tbody>
</table>

Source: World Bank

While cheap labour costs may have been an advantageous competitive feature of the Albanian economy, upward pressures on wages are mounting as indicated by increased earnings. Albania still has some of the lowest wages in the region, despite its strong economic growth. The still underexploited labour contribution to growth combined with the low cost of labour could prove to be a competitive advantage for Albania in the regional context. Several analyses of the sector show evidence for an underexploited contribution of labour in the productivity of the country’s economy. The situation could be turned around if proper stimulating policies are put in place, combining the low labour cost advantages with adequate policies in education and training, which would also improve the skills of the country’s labour force.

How sustainable are these growth trends? Challenges ahead.

The Albanian economy has performed positively over the past years and it will potentially continue its strong economic performance while the country advances towards its goal of European integration. However, the country's economic growth and competitiveness remain constrained by some potential risks linked to the specific nature of the Albanian economy. Additionally, the current global economic situation does not favour transition economies, and the Albanian economy is especially exposed given its financial dependence from emigrants residing in economies that either are or are soon expected to be hit by a slowdown. These traits and the coming electoral year could make macroeconomic and financial stability harder, all the more so if tight budget policies were to be relaxed.

Some threats to the Albanian economic stability have already been present for a period of time and are supposedly been considered by the policymakers for retrieval. Low levels of exports, modest private and foreign investments, weak institutions, and bottlenecks in infrastructure sectors are issues that have dominated the debate about the future developments of the country’s economy. Despite repeated attempts, turning around the loss-making

electricity sector and realizing its potential has proved elusive over the entire transition period.

In terms of factors influencing growth that could pose an immediate risk to the economic stability is the economy's excessive reliance on remittances. Remittances have been fuelling the performance of this country with almost 1,000,000 Albanians employed internally and approximately 700,000 emigrants exercising their economic activity abroad. Financing of the trade deficit has depended largely on remittances, estimated in 2006 to amount for 55 percent of the trade deficit. Nevertheless, Albania suffers from large current account deficits. Significant inflows of current transfers and positive service balances in recent years have helped dampen the rising trade deficits. Imports have steadily grown reaching 49 percent of GDP in 2007 with exports lagging behind at 23 percent of GDP leaving Albania with a trade deficit of 26 percent. However, remittances cannot constitute a solid basis for long term economic development. Based on the country’s competitive advantages, supportive policies and instruments must be put in place in order to intensively stimulate its exports.

Some concerns can be raised in regards to the financing of the country’s investment needs. Albania’s graduation from IDA eligibility, which has until present supplied preferentially rated financing, as well as expectations to access international capital markets, pose another major challenge. Although the public debt to GDP ratio has been substantially reduced over the recent years, it still remains over 50 percent of the GDP. Further fiscal consolidation, advances in fiscal and debt management, and deeper financial markets are required as Albania moves away from concessional finance and starts accessing international capital markets. As the IMF” role is expected to be reduced after the Program comes to an end in two months time, alternative anchors for policies must be found.

A reasonable option for such an anchor could be the European institutions, since both the EU and Albania have committed to a potential membership of the country in the Union. Albania was the first of the countries of the region to start negotiations with the EU for signing a Stabilization and Association Agreement in 2003.

The Agreement was signed in June 2006, denoting the country’s first major step toward EU accession. The Interim Agreement, which mostly covers SAA provisions related to the free movement of goods and services, is in force since December 2006 and its implementation is continuing smoothly. Last March, the EU Troika noted the country’s progress pursuant to the Interim Agreement and it welcomed, amongst other aspects, Albania’s achievements in its economic reforms.

From 2001 to 2007, the Assistance for Reconstruction, Development and Stabilization (CARDS) programme has served as the main EC financial instrument for Albania. Until 2006, total CARDS assistance allocated to Albania amounted to 282 million EUR. As of January 2007, the CARDS programme has been replaced by the new Instrument for Pre-Accession Assistance (IPA), under which Albania will receive a total amount of 212 Mln. EUR from 2007 till 2009.

116 International Development Association, the World Bank’s poverty reduction wing.
However, in contrast to its more outspoken competitor countries of the region, Albania has not yet handed in an official request for joining the European Union. In April 2008, just after the signing of a conditional SAA, the Serbian President Boris Tadic, told a press conference in Luxemburg that Serbia aims “to become an official candidate by the end of the year.” During a recent meeting with EU Enlargement Commissioner Olli Rehn, the Deputy Prime Minister of Montenegro, Gordana Durovic, announced that Montenegro intends to officially apply for EU membership by the end of this year. Macedonia has obtained the candidate country status since 2005, while Turkey has continued to push its case, as has Croatia, with great success since 2002.

It is time for Albania and its leaders to defeat their current timidity and to set themselves and the country an ambitious goal. Albania needs to find a way to express politically the strong social consensus concerning its EU membership aspiration. The political class must stop saying to itself that it wants to join the EU and take the most essential, basic, logical first step: to announce its intention and the commitment of its people to other Europeans and EU institutions.

References

11. INSTAT, Main Macroeconomic Indicators 1996 - 2006, at current prices.
Introduction

A country may be deemed economically viable when the available human, physical and financial resources are effectively used to provide economic growth and to increase the welfare of its inhabitants. While resources endowment matters, the effective use of resources to provide sustainable growth and increasing welfare is even more important. The process of growth is associated with a broad spectrum of policies, including: the financing of development and public infrastructure; a regulatory framework; governmental intervention and industrial policies. Strong market oriented reforms and achieving economical and political stability, have proven to be very important factors, especially in transition economies.

Research and experience from many countries suggest that economic growth increases with improvements in education, financial depth management, trade openness and the availability of public infrastructure. It decreases with an extensive tax burden, in the absence of policies favourable to macroeconomic stability (including processes as, inflation, overvalued exchange rates and banking crises) and, also, by negative terms of trade. An appropriate mix of economic policies accompanied by an increased institutional capacity and quality will generate a beneficial pattern of self-sustaining growth.

The limited participation of Kosovars in governance has had negative effects on economic growth and viability. The absence of sovereignty increases political uncertainty and reduces the possibility of choice, which can have negative effects on the economy, for instance regarding the uncertainty of ownership and the use of natural resources. Kosovo could take competitive advantage of its human and natural resources and demonstrate economic development. In terms of resources, Kosovo is not lacking compared to its neighbouring countries. However, in addition to the political status of Kosovo improvements in governance, the rule of law, education and public infrastructure are all critical factors for creating a viable and sustainable economy. This will contribute to a better investment environment, which will mobilise local and Diaspora resources and Foreign Direct Investments (FDI), and channel them into investments. Moreover, achieving high GDP growth rates after 2009 (7-9%) is necessary, in order to absorb new entries in the labour market and to reduce high level of unemployment. Dynamic growth too, is a precondition in addressing imbalances in macroeconomic configuration that is: imbalances between GDP and consumption, a very high trade deficit, imbalances in the labour market and the size of the budget compared to the capital investment needed.

*Alban Zogaj, Research Director, Riinvest Institute, Kosovo
Muhamet Mustafa, President of the Board, Riinvest Institute, Kosovo
Despite the fact that Kosovo, as an emerging and developing country, is relatively well endowed with resources, it faces many challenges to achieve the needed dynamics in economic development. Structural problems such as: the lack of proper public infrastructure, unemployment, deindustrialisation and trade deficit originating from the difficult heritage (especially during 1990s), require further support from the international community through effective technical and financial assistance and cooperation. Due to its structural problems and based on the experiences so far, one can expect that Kosovo will face difficulties in the mid-term to ensure necessary capital public investments. Therefore, the international institutions’ and donors’ support is necessary in this segment. The main destinations of further support could be: support for further capacity building in the area of development management and governance; financial assistance when facing current budgetary difficulties for public investment (especially in the mid-term) and support for the establishment of proper and full capacity relations with international financial institutions.

Economic growth does not occur randomly but is a response, *inter alia*, to the quality of public policies, especially those affecting investment, productivity, technological innovation and externalities. While the growth of production contributes to human development, high quality growth requires fair access by all members of society to the increased opportunities for education, health and income generation. The process of growth is associated with a broad spectrum of policies including financing development, public infrastructure, regulatory framework, government intervention and industrial policies. In transition economies strong market oriented reforms and the achievement of economic and political stability are key factors.

**Economic Viability: Theory and Experiences**

In an increasingly global economy, developing countries face major challenges in achieving economic growth due, especially, to: inadequate savings and investment; a labour force with a low level of education and skills; deteriorating terms of trade and weak institutions.

Recently, in countries of East Asia, such as China and the “tiger” economies - South Korea, Singapore, Taiwan, and Thailand\(^{117}\) - and also member states of the Organisation for Economic Cooperation and Development (OECD) have experienced long-term growth. However, there are two opposing views as to the main driving force. One view cites capital accumulation together with the increased quality (rather than productivity) of the labour force as the major factor; whilst the other cites the assimilation or acquisition and mastery of foreign technology. Total Factor Productivity (TFP), that is the share of physical capital in output, and channels through which human capital influences output, also play an important role. In the case of East Asia, many would agree that capital accumulation, rather than TFP, was the driving force of growth. However, the long run is of key importance and here TFP, rather than capital accumulation, is considered to be the major source of growth. Accordingly, the ideal combination to ensure growth would be capital accumulation in the mid-term and technological progress in the long run.

The main conclusions of a recent overview, named “The Sources of Economic Growth”: An Overview\(^{118}\), based upon a comprehensive econometric analysis of the experience of 78 countries, can be summarised under two headings: Structural policies and institutions and causes and characteristics of growth. According to this study, governments can influence long-term growth through structural policies, stabilisation policies and institutions.

The key policy areas are:

a) Education and human capital formation, which have impact on the effectiveness of other types of capital and facilitate technological absorption (measured through enrolment rates);
b) Financial depth, development of financial markets (measured by the ratio of private domestic credit to GDP);
c) International trade openness, which has an impact on the level of competitiveness, the market, the technological innovation and, also, the level of the TFP (measured by the ratio of trade volume to GDP);
d) Government burden (measured by the ratio of budget to GDP);
e) Availability of public services and infrastructure;
f) Governance (institutional capacity and quality, absence of corruption, enforcement of contracts, law and order).

“Can Kosovo be economically viable?”

This question, frequently raised in the context political status, is a very important one directly questioning the feasibility of an independent Kosovo as such and on the other hand the quality and dignity of life of Kosovars, specifically. The question is raised, usually, in terms of the size of Kosovo (population and area), its natural resources and the present and potential level of development. However, there is plenty of evidence that size per se (in terms of population and area) and the natural resource endowment, have bearing on economic viability (as cases like Hong Kong, Liechtenstein, Luxembourg, Monaco and Singapore show).

“Who will ensure economic viability for Kosovo if not Kosovars themselves?” could be the virtual response of Kosavars. Historical evidence suggests that the well-being and economic growth of Kosovo has been proportionate to the opportunity afforded to Kosovars to govern their own affairs and, also, to the level of political stability.

In the post-war situation – under UNMIK administration - the limited participation of Kosovars in governance and the government’s lack of capacities have had negative effects on economic growth and viability. Governance and sovereignty are closely interrelated, since sovereignty is critical to having ownership of, and accepting, the institutions of governance and the rule of law, as well as managing and having ownership of resources. All of these are critical for long-term investment in growth, including institutional and human development. The absence of sovereignty heightens political uncertainty and reduces the possibility for choice. In terms of the economy, negative effects include: uncertainty regarding the

ownership and use of natural resources (including land and minerals) for the assets of public and socially owned enterprises, which in fact was delaying, inter alia, their privatisation; difficulties in the enforcement of financial and economic legislation; limited scope for cooperation with regional and international institutions (such as the World Trade Organisation (WTO), the World Bank (WB), the International Monetary Fund (IMF) and the EU); constraints in the development of trade relations with other countries and barriers for the mobilisation of local and diaspora savings and the attraction of Foreign Direct Investments.

Sovereignty is a prerequisite for Kosovo for many reasons, among them the creation of the conditions necessary for long-term investment to ensure growth, overcome underdevelopment and enable Kosovo to prosper economically in an interrelated world. After the successful initial phase of reconstruction and growth involving a construction boom, UNMIK and Provisional Institutions of Self-Government (PISG) have not been able to establish a policy environment and conditions for stable and lasting economic growth.

The basic legal framework for business and commerce has been established, which for the most part meets the standards required for building a modern open market economy. However, enforcement mechanisms are still not in place and the progress in implementation and enforcement has not been sufficiently analyzed, for example concerning contractual obligations. In the northern part of Kosovo and in minority enclaves there is no compliance with UNMIK/Kosovor law and no action has been taken to secure compliance. These failures have straining effects on the market and have a negative influence on the business environment and the rule of law. Surveys on Small and Medium Enterprises (SME) conducted between 2000 and 2006, indicate that SME owners and managers consider the main barriers for doing business to be: unfair competition, insufficient legislation, corruption, taxation and limited access to finance (from among 14 reasons listed). All these indicators are typical of a turbulent business environment with a lack of capacity and commitments to implement the rule of law. Increasing capacities, creating accountability and responsibility for the implementation of existing laws and ensuring the rule of law, appear to be very critical factors for further advances in building a business environment conducive to economic growth.

Euro based financial transactions have contributed positively to macroeconomic stability in Kosovo. Inflation has been low while, from November 2005, deflation was associated with a negative growth rate. The budget is moderate in relation to GDP - 26% on the revenue side and 28.5% on the expenditure side, with the difference financed from a cumulative cash surplus. Credit is also moderate at 16% of GDP. However, medium to longer term macroeconomic stability is seriously threatened by critical imbalances including: Imbalances between GDP and consumption, a very high trade deficit, imbalances in the labour market and the size of the budget compared to the capital investment needed.

Total consumption, according to IMF estimates, is 8-9% higher than GDP and is covered by remittances from Kosovars working abroad. Secondly, the trade deficit is very high, with exports covering only a tiny part of imports - 2000: 2.9%, 2001: 1.2%, 2002: 2.7% and 2003: 3.7%, 2004: 5% while in 2007 around 10%. This situation is either a result of the complete

collapse of the industrial structure in the 1990s, or of the de-industrialisation, which affected the export to a great extent. Between 1991 and 1998 exports dropped from USD 212 million (not counting the trade with other Yugoslav entities) to USD 38 million. In any case, tackling this huge deficit depends upon the successful implementation of integrated policies that lead to the development of businesses able to compete in the domestic market, and the development of exports involving both foreign investment and privatisation of socially owned enterprises. 120 Thirdly, the present levels of growth show no prospect for creating sufficient jobs for the net annual inflow of some 25,000 new job-seekers into the labour market. This is a long-term problem (83.1 % of the unemployed in Kosovo have been unemployed for more than one year). Finally, the Kosovo Consolidated Budget of approximately 714 million Euro accounts for approximately 28.5% of GDP. While current expenditures have been capped and revenue is increasing only slowly, there is an increasing need to finance essential capital investment. There is a high demand to improve transport infrastructure (especially in the rural areas), public infrastructure to support business development and employment, as well as investment for improving the quality of education. All these tasks represent a serious challenge. Despite the progress in building a sustainable budget, revenues cannot cope with the demand for capital investment. Kosovo is an emerging economy with an inherited seriously deficient social and economic infrastructure. Needs must be prioritised and funding must be obtained from international and regional financing institutions, as well as through the EU pre-accession processes. Delays in addressing critical investment in public infrastructure, including education will have serious knock-on consequences for local private investment, as well as for Foreign Direct Investment and, consequently, for the process of economic development.

Existing public infrastructure provides, at best, only for the basic needs of the population and the economy. The supply of electricity is not reliable because of frequent blackouts and substantial imports, despite the fact that Kosovo is, at least potentially, the lowest cost supplier in the region. The existing supply deficit coupled with the resumption of mining and smelting activities and the potential for exporting electricity has resulted in proposals to rehabilitate Kosovo by building a thermal plant and construct a new 1000 MW plant and associated lignite mine. The public provider currently competes with a new private company in telecommunications sector, but is unable to provide a quality service while the mobile network is also a virtual monopoly with prices that are among the highest in Europe and the Balkans. Poor and costly telecommunications, including IT services, are a serious deterrent to business and poor publicity for promoting the development of high value services.

While the infrastructure of the main roads may meet basic needs, secondary and particularly rural roads are in a very poor condition. The condition and capacity of the main roads, taking into account the traffic volume on these roads, causes a 50-75% increase in time expenditure than might normally be expected on routes between the main cities and Prishtina, having serious implications on transportation costs. Kosovo is currently left out of trans-European traffic corridors. Improvements to the main corridors Durrës - Prishtina - Niš and Mitrovica - Skopje are necessary to reduce transport costs, to increase competitiveness and to facilitate regional and trans-regional integration. With 85% of Kosovo’s population living within a radius of twenty kilometres from one of the seven main cities, the development of the

interurban and suburban transport networks is necessary to support urban and rural development. Such enhancements of the transport facilities would assist in securing a more productive use of resources in rural areas and in reducing internal migration trends to the cities.

**The need for economic growth**

As discussed earlier, although post-war reconstruction was largely successful, Kosovo has yet to establish a sustainable growth path. Many challenges remain – 40% of the rapidly growing workforce is unemployed, much of it long-term as job prospects are poor; the level of education of the workforce and the capacity of higher education are inadequate; there is a massively negative trade balance, exports are negligible; economic and social infrastructure is generally inadequate and often in poor condition; investment is low at 25-26% of GDP while consumption is high; the estimated share of the agriculture at GDP is 25%, of services 60% and industry about 15%. These structural challenges and imbalances can be resolved only with strong long-term economic growth.

Several Central European countries and some South-Eastern European countries have achieved high rates of growth during transition periods, which Kosovo must equal to be able to meet the challenges outlined above. These countries success has been due, mainly, to effective liberalisation processes, increasing their competitive advantage as well as creating a business friendly environment. The following three “What if?” growth scenarios are based upon current conditions and lessons learned from experience in other transition economies with high growth rates, including key factors which have impact on investment and increasing competitiveness. Scenarios are dependent on the political and institutional developments and other improvements in the political and economic environment and the following scenarios have therefore been constructed using these factors.

The so called “status quo scenario” whereby a stagnation in growth, or a low 1–3% growth rate is expected if there will be problems with political status of Kosovo or if there are changes regarding reforms and economic governance. The consequences of this scenario would be reflected in an increased political and economic instability. In addition, the pressure to emigrate would increase, and the institutions would not be able to address unemployment and poverty. The 5% growth scenario would perhaps overcome many of the aspects outlined above, but it would not be sufficient to generate the immense amount of employment needed, nor would it increase the competitive position of Kosovo. The last scenario shows a 7% growth rate by 2005. Kosovo should opt for 7% and higher growth rates after 2009.

It is clear that sustainable economic growth in Kosovo is unlikely to be driven by any one sector or industry, but will come from exploiting opportunities in several sectors of which the following are considered to have the greatest potential. In the agricultural sector, farmers - given their small sized farms and plots - are moving from cereals and other low value field crops, to the production of high value products, such as fruits, vegetables, livestock and meat production, where more market opportunities exist. Some brand products could also be developed for export, especially if environmental and ecological healthy food programmes could be launched.
The SME-sector is currently the most vital, having potential for further development as the business environment improves. Within this sector, the agro-processing industry is already engaged in import substitution within the domestic market and it has started to export to neighbouring countries (e.g., milk, meat and juices) with scope for expansion. Similarly, construction material suppliers, the construction industry with related services, have substantial scope for expansion in a growing economy. At a later stage, given expansion and improved quality of higher and tertiary education, there could be opportunities in high value added services. Possibilities for these services exist for example in IT and the financial sector. Also tourism, especially winter and ski tourism should be considered and explored.

In the energy sector proposals are currently being developed to meet the large and growing regional power shortage, by rehabilitating an existing thermal power plant and building one or more large new plants, which run on the abundant reserves of relatively high quality, and low cost, lignite in Kosovo. Given the high level of investment required (some billions of Euros for the power plant, the mines, the transmission systems etc.) and the technical complexity, the first phase of such a development would extend over a period of at least seven to eight years with substantial long-term benefits thereafter in terms of employment and exports. It would also ensure Kosovor businesses of a low cost, reliable source of power. However, even in the shorter term, say within two to three years, construction activities and other services would bring significant benefits in terms of employment. The development would involve large scale FDI.

The mining of minerals and metals is also a potential sector for economic growth. The recent privatisation of the Ferronickel enterprise with FDI will generate some 1,000 jobs and enable the resumption of exports. There is potential for the redevelopment of other mines and smelters - lead, zinc, nickel and manganese - that have currently ceased production, including Trepca mines in Stantërg, Kizhnicë, Novobërdë, and Hajvali. However, the potential scale and commercial viability of the resumption of mining and smelting is not clear. Privatisation is a prerequisite for possible resumption, as is commercial viability, which would involve substantial capital investments from FDI. Metals used to be one of the main former export products of Kosovo. The production of galvanised sheets has resumed at the Ferronickel and Balkan plants. There may be scope for the resumption, or partial resumption, of production for export (as was the case in the 1980s) of other metal products such as automobile parts, electro motors, radiators, galvanised zinc sheets, tubes and pipes, batteries and rubber conveyor belts. Kosovo’s industry’s position has been lost on most of these markets, but through cooperation with foreign investors these markets would be regained. This depends mainly on the privatisation process, which would presumably increase exports and economic growth. Excellent examples are Llamkos (Factory of galvanized zinc sheets in Vučitrn) and Ballkani (Rubber Conveyor Belt Company in Therandë).

**Becoming “Investment Friendly”**

According to the growth scenarios presented above it is clear that the factors that will stimulate economic growth will be heavily dependent upon effective, democratic institutions and the rule of law. Meanwhile, a resolved status for Kosovo will help create a better investment environment, with normal access to the International Financial Institutions (IFI) and through the mobilisation of all necessary private and public, domestic and international
sources of investment. Although such investment is necessary it is not sufficient on its own to generate the growth desired. Other economic and institutional conditions must also be in place, such as necessary structural changes, institutional capacities, managerial competence and skilled labour, along with an ability to plan and implement projects.

Given that the status of Kosovo is resolved and that the technical and financial assistance of the international community will continue, the above mentioned two conditions could be achieved. Thus, the national economy will most likely depend upon the ability of institutions and human resources to both generate and absorb investments, transforming them into feasible projects and sustainable economic growth. This will be a constitutive part of Kosovo’s new image as a destination for FDI, which will need to be promoted aggressively.

The current policy environment (taxation, financing, etc.) is mostly technically and theoretically adequate. However, the policies should again be tested against their effects on economic growth in concrete Kosovor conditions. This has proven to be a problem so far. In that respect it is necessary that taxes are reconsidered and become friendly for investment (free custom duties for all capital goods for investment, and longer period VAT credit for equipment). Also taxes on profits could be reviewed. Secondly, measures should be undertaken to increase competition in the credit market, so that interest rates become appropriate for long-term investment, especially in manufacturing activities where export products are concerned (cooperation with IFI and banks for credit lines). Finally, reform and restructuring should take place, whilst more competition in public utilities has to be created.

The preferred scenario (described above) indicates that by 2010 the Kosovo budget should be more than one billion Euros. Budget revenues in 2006, budgetary income (656 million Euro) will reach approximately 26.5% percentage of GDP. From an economist’s point of view, a share of the budget consumption of 30 to 32% of GDP is not considered a problem for the economic growth of Kosovo. Nevertheless, if expenditures exceed this level then, based on some international experiences, this might have a negative impact on economic growth.

The most evident problem for the budget is how to cope with needs for capital investments. Some of these needs have already been described above. Capital Investment Projections that were designed in absence of a development strategy were not based on well-defined priorities. Therefore, the PIP, which is drafted and approved by government, should be harmonised with the mid-term Kosovo Development Plan and with the main goals of economic development, which are currently being prepared. Based on experiences so far, one can expect that, due to its structural problems, Kosovo will face difficulties in the mid-term with acquiring capital public investments. Therefore, the support of IFIs and other donors is necessary in this area. A further increase in budget spending will be necessary in the future. For example, new jobs will be created for new ministries, where office space and other running costs will arise.

The process of restructuring public companies such as Kosovo Energy Company (KEK), Post and Telecom Kosovo (PTK), Prishtina Airport, Railways, and regional heating, water supply and sewage companies, has not progressed according to budget projections. A significant part of the budget has been used to cover the operational losses of these companies, notably for KEK. For the 2005 budget reserved powers part, it is predicted that 80.5 million Euro will go to Kosovo Trust Agency (KTA), of which 55.5 million Euros is for electricity, i.e. KEK
(7.5% of budget consumption). In the budget projection for 2006, 67.7 million Euros is reserved for KTA, of which 44.9 million Euros (6.5% of budget consumption) is set aside for electricity.

Dependency on budgetary funds is a reality for some of these companies, while the level of quality of services provided is very low, though at quite high cost. It is clear that budgetary funds compensate for inefficient management and for delays in restructuring and liberalisation of this market. Such a practice has created a paradox, where taxpayers pay for the shortcomings of the KTA and KEK management. Moreover, in the energy sector this has been accompanied by a low level of charging consumers.

The solution should be sought in the liberalisation of the public services industry, by creating conditions for private investments and larger competition on the market. This would discharge the budget from unreasonable obligations and would increase the responsibility of the public companies.

**Technical Assistance and Cooperation**

Despite the fact that it is relatively well endowed with resources, Kosovo has an emerging developing economy and as such it will face many challenges before it can achieve the necessary dynamics for economic development. Its structural problems, such as lack of proper public infrastructure, unemployment, deindustrialisation and trade deficit originating from a difficult heritage, especially during the 1990s, require the continued support of the international community through effective provision of technical and financial assistance and cooperation.

Future international support might be provided through various channels. Kosovo has a need for further technical assistance from the international community in order to continue the trend of capacity-building in the area of governance of the economy and finance. However, the character and volume must be modified. In this aspect, the transfer of competencies must also continue during the process of determining the country’s status. After the status issue has been solved, all competencies of UNMIK in the field of the economy and finance must be transferred to the institutions of Kosovo. Full competencies over fiscal policies, the Banking and Payment Authority, the Pension Trust, the Agency for Privatisation, the customs administration, public enterprises and foreign economic relations must be transferred to Kosovor institutions.

Following this, an assessment of the needs for international consultancy within these institutions must be prepared. Also the preparation of an intensive training programme for macroeconomic management and development finances is necessary. The monitoring role of the international community, along with cooperation with the World Bank and IMF in this field in a certain period of time, would have to do with law enforcement and enforcement of general international standards as well as human rights issues. Another channel of international support could be the organisation of a donor conference. Whereby support for the strategic needs for economic development of Kosovo, particularly those in public infrastructure, would be realised. By the end of the year the National Development Plan for economic development of Kosovo will be prepared and will clearly inaugurate policies and
priorities aiming at a sustainable economic development of Kosovo. Establishment of the political status is a prerequisite for avoiding an uncertain future. It is a factor for improving economic governance, setting up trade and economic relations with other countries, being a member of, and having cooperation with IFIs and other international organisations.

The international community, through the UNMIK administration, UN agencies and other agencies such as European Agency for Reconstruction (EAR), USAID, DFID, GTZ, SDC, SIDA etc., have contributed towards overcoming the terrible consequences of the war and rebuilding Kosovor society, including the establishment of an institutional infrastructure based on free elections. However, further development of these institutions requires a new type of support, especially to increase the capacity of law enforcement, governance and management of development. Also, further support in improving the quality of education will pay its dividends in increasing Kosovo’s absorption capacities for investment and development. The next phase of this assistance should be directed entirely at increasing capacities rather than at doing the jobs that the Kosovars themselves should be doing.

Discontinuation of development and lack of investment in public infrastructure and utilities during the 1990s have had very negative consequences for Kosovo, particularly on the current conditions for development. The Kosovo Consolidated Budget will face difficulties, at least in the mid-term, in providing necessary investment until economic growth is fostered and an improved tax administration further improves tax collection which will strengthen the budget. Supporting the Kosovo Consolidated Budget will require direct international financial assistance in this area.

Cooperation with the IMF and WB, which have been present throughout the post-conflict period, contributed significantly, with technical assistance and direct budget grants during the first years. With the advancement of status talks and their finalisation in sight, new capacities are expected to be established due to this cooperation. At the moment, both sides, particularly the Kosovor institutions, should work on preparing feasible bankable projects and having proper management systems for the implementation. Along this line, some initiatives already taken for creating cooperation with the European Bank for Reconstruction and Development and the European Investment Bank, need to be reinforced. Cooperation with IFIs need to be established and organised within the Ministry of Economic Finance and government because of its key importance for building conditions for sustainable development through lasting economic growth.
TRADE AND CAPITAL FLOW

ERJON LUCI* ET AL.

WESTERN BALKAN INTEGRATION AND THE EU:
AN AGENDA FOR TRADE AND GROWTH121

Motivation for the Study

The last decade, especially the last five years, has been relatively good for SEE5 countries. With the exception of FYR Macedonia, all other countries of SEE5 have witnessed annual growth rates over the last decade in excess of 5 percent, and even FYR Macedonia has seen acceleration in its growth rates since 2003. As a separate entity, Montenegro has witnessed accelerated growth since 2002. UNMIK/Kosovo’s growth is estimated at 3 percent in 2006, which is also up from lower or negative growth in previous years. Growth has accelerated in most countries in the last few years, as recovery from conflicts and disturbances takes root. Only FYR Macedonia is a candidate country within SEE5 for EU accession, while the others are potential candidates at different stages of the pre-accession process.

However, SEE5 countries now need to improve and then sustain their past growth performance, amidst concerns about sustainability and the need to avoid a possible “middle-income trap.” With still-high poverty rates and EU aspirations, SEE5 countries need to accelerate their growth rates and sustain them. However, this is made more difficult because much of the easier part of transition-driven growth has already been achieved. Future increases in total factor productivity (TFP) may need to depend more and more on within-sector improvements. In addition, much of the trade preferences enjoyed by SEE5 countries has been eroded. China, through the dynamic of multilateral trade liberalization, looms increasingly large in SEE5 markets for both low-skill as well as skill-intensive products, even as exports from SEE5 are dominated by low-skill and natural-resource-intensive products. Indeed, China’s export performance has led to some pessimism in neighboring Asian countries about their competitiveness (the middle-income trap). Finally, many SEE5 countries are also witnessing increasingly large current account deficits (CADs), which raise concerns about macroeconomic stability.

Sustaining and improving growth in SEE5 countries will require top priority being assigned to improving export performance. There is little doubt that the key response to the challenges of improving and sustaining growth would involve a sustained increase in exports, given small country size and the experience of EU8 countries. Exports also have to increase to keep pace with the likely increase in imports driven by increasing integration with the EU. So far, trade has not played a compelling role in the SEE5 growth story, and exports, especially merchandise exports, are in fact the weak link in growth. Despite recent faster growth in

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Exports, the region has been undertrading relative to its potential, and per capita exports of both goods and services are much lower than in comparator countries.

Bulgaria, Croatia, and Romania (BCR), which are at the same time regional collaborators, comparators, and competitors, show that faster development is possible in SEE5. Croatia (an EU candidate country) is by far the richest country in the region and has a current GDP per capita approaching $10,000, more than 70 percent higher than Romania’s. Compared with SEE5, BCR has seen steadier growth in the last five years, never falling below 4 percent. In Romania and Bulgaria, the latest EU members, growth has accelerated to an average of around 5.5 to 6 percent over 2004–06. The BCR examples demonstrate (as do those of other neighbors, such as Slovakia and Slovenia) that faster development is possible in SEE5, including in those countries that were part of former Yugoslavia (both Croatia and Slovenia were part of the former Socialist Federal Republic of Yugoslavia).

Key Messages

The association of convergence-driven, growing CADs in SEE with improved fiscal prudence means that exports and thus foreign direct investment (FDI) will remain a key determinant of external sustainability. While the CADs may be at least partially widening because of convergence factors, they will nevertheless create actual and perceived macro-economic vulnerabilities. In this situation, export growth becomes crucial for the sustainability of the CAD, in addition to its importance for GDP growth. Both in SEE and in ECA as a whole, FDI is strongly correlated with exports.

In addition, relatively inflexible currency arrangements and strong remittances in many countries place the onus for competitiveness and export performance on structural reforms and productivity growth. The exchange rate is a very important adjustment mechanism in an open economy. In many SEE countries, relatively inflexible exchange rate management would call more strongly for structural reforms, other things equal. In this situation, the onus for competitiveness and export performance shifts clearly to structural reforms – a line of thought pursued in this report – and implies primacy to improvements in productivity.

The report suggests that improving and sustaining export performance and thereby GDP growth will require sustained improvement in FDI inflows, pointing again to the need for significant structural reform. Despite recent increases, FDI inflows in SEE5 remain low and below potential. The onus for encouraging FDI falls on structural reforms, given the above limits on both fiscal and monetary policy.

Deeper integration within CEFTA countries will increase market size, improve service quality, and help attract FDI. Deeper integration among SEE countries – such as through the completion of the implementation of CEFTA 2006, the reduction of border frictions through the establishment of a single management of Border Crossing Points, the regionalization of the rules of origin among CEFTA 2006 countries, and the expansion of SEE participation in pan-European/Mediterranean Cumulation of Origin arrangements (an ongoing process) – would contribute to market contestability and the development of a larger market, thereby helping to attract FDI. Deeper integration among CEFTA countries in services could also contribute to improving service quality significantly, thereby enhancing the overall productivity of the economies. This report mentions several areas, in different sectors, where
there could be opportunities for regional harmonization and cooperation, including those areas where the agenda is defined by commitments to the *acquis*.

Benefits from EU and regional integration would be maximized by creating a “shadow customs union” with the EU for industrial products. Currently, CEFTA countries’ tariffs are higher and more dispersed than those of the EU, providing scope for trade diversion. It is suggested that all CEFTA countries (who are simultaneously adopting CEFTA and the trade components of their Stabilization and Association Processes) adopt EU MFN tariffs for industrial products. This would amount to creating a virtual customs union encompassing the SEE5 countries and the EU, and thus would reduce the extent of trade diversion. Also, speedy implementation of CEFTA would help ensure that firms in SEE5 countries have as much access to each others’ markets as would EU firms (following the SAAs).

Attracting more FDI in SEE5 would also require (apart from a larger market size and deeper integration) improvement in selected areas within each country. This report suggests that there are a few areas which may hitherto not have received as much attention as they deserve from policy makers. These areas include human capital, telecoms, and power.

Human capital development and return migration can help the region to attract FDI and prepare for faster and more export-oriented growth. Human development –both in terms of quality and quantity of skills – is critical to upgrade the skill content of exports and reduce vulnerability to low-wage competition (in exports as well as increasingly open domestic markets), to prevent human capital from becoming a bottleneck to FDI and investment in general, and to prepare for faster and more export-oriented firm growth. It is urgent that this process of upgrading skills start now, considering the region’s poor education out-comes, long gestation lags in human capital formation, the likely increase in demand for skills, and the fact that education and health are not part of the EU *acquis*. This apart, countries can also use return migration programs to encourage people to return to their countries, which would help reduce skill and other bottlenecks because the returning migrants bring with them skills, entrepreneurship, networks of contacts, and financial resources.

In the shorter run, reducing labor taxation can at least partially help address problems of relatively high wages and informality. While SEE5 wages may not be high compared with those of the EU or most EU8 countries, these wages are still high in relation to the product composition of exports, which are dominated by low skill-intensive and natural resource-intensive products, and which leave SEE5 vulnerable to competition from the lower-wage countries of Asia. This vulnerability can also affect FDI flows. In addition, the wage gap between SEE5 and neighboring countries has been insufficient to attract large volumes of FDI to SEE5, due in part to business climate disadvantages found in SEE5 when compared with EU8 or BCR. In this situation, lowering labor taxes aimed at reducing gross wages and the cost to business may provide at least a partial and temporary palliative, and could help increase the attractiveness of the wage component of the overall investment decision to investors, even as the long-run solution will continue to lie in accelerated skill acquisition. Lowering labor taxes is also expected to help reduce the pervasive informality in the work force in most SEE countries (recognizing that labor taxes are only one reason why workers/firms choose to remain informal).

Reduction in telecommunication costs can have high payoffs and also help deeper integration. Telecom costs in many SEE5 countries, including FYR Macedonia, Bosnia and Herzegovina, and Albania, are still very high. Potential payoffs for reduction in such costs can be large,
based on an analysis of infrastructure and productivity growth in ECA and on the ubiquitous application of telecoms in virtually every aspect of the economy. Better telecom infrastructure also helps in regional integration by enabling better coordination, specialization, and supply chain management. It can also help firms partially overcome diseconomies of scale arising from the small size of most countries in SEE5.

Preemption of energy shortages will help avoid potentially significant impacts on growth. In Albania and other countries (such as in South Asia) where there are power shortages, business surveys show that power availability emerges as one of the biggest constraints to doing business. The recent experience of Albania shows that such shortages can have a significant impact on GDP growth. Energy shortages can therefore have a major impact on both FDI and domestic investment.

In addition, each of these areas has a regional dimension. Each country can potentially benefit from exploiting regional integration in these areas by using the undefined part of the policy space that is not covered by EU agreements (if any):

**CEFTA agreement on movement of skilled labor.** This report argues that CEFTA could negotiate an agreement on preferential liberalization of professional services that focuses on the movement of natural persons (mode 4). A starting point for this would be mutual recognition of professional qualifications. Over time, this could progressively be extended to all labor, skilled or unskilled (following the Caribbean example in the CSME), and would help present the region as a single economic space. Regional cooperation could extend further upstream to the supply of skilled labor in tertiary and technical education, where different countries could seek to specialize in different areas (given high fixed costs and hence scale economies in tertiary education). This could help attract more FDI to the region and better utilize its labor force (people would move to maximize their private returns), while setting in place a mechanism to improve the supply of skills. Another, not mutually exclusive, approach is for countries to negotiate bilateral temporary worker agreements, which are classified as win-win for both host and source countries.

**Coordination in telecoms.** In telecoms, regulators in the region could gain from sharing experiences and information, because they often face similar problems requiring similar solutions.

**Progress in the regional energy market.** In energy, regional cooperation is well advanced through the Energy Community Treaty for SEE. Areas where regional-level initiatives could be useful include power-sharing arrangements between countries, cooperation in regulatory practices, and the creation of strong and independent regulators.

The suggested emphasis on human capital, telecoms, and energy implies an eye on the future. The above agenda does not mean that the most important current constraints (as revealed by business surveys), which include tax rates, anti-competitive practices of others, access to finance, the judicial system, etc., should be neglected. However, the report suggests that government priorities may need some reordering to avoid potential constraints to future and possibly faster growth in SEE5 (as well as in SEE in general). The italicized part of the last sentence implies that as the easier, post-transition phase of growth winds down, future growth will increasingly be led by the private sector, and based, among other things, on stronger export performance and improved labor skills.
Reordering priorities does not necessarily mean reordering government expenditures, and certainly not to the same relative degree as would be suggested by changes in priorities. In different countries, improving human capital formation may require more expenditure, but, knowing that expenditure and outcomes are very loosely related, it may need greater attention to improving the quality of education. In telecoms, the private sector could take care of most investment needs, but more competition and stronger regulators would be needed to further reduce costs of telecommunications. In power, too, more effort at attracting private sector investment within a sound regulatory framework and furthering regional energy cooperation could help alleviate current and future energy shortages.

The focus on human capital and productivity is also consistent with recent findings on poverty. Ongoing research in the World Bank is finding that the phenomenon of the working poor is quite common, arising, among other things, from low productivity and hence poorly-paid jobs. This report’s focus on human development and productivity enhancement would therefore be fully consistent with a focus on poverty alleviation.

A question that may arise is whether SEE5 should target EU integration and not be diverted by the process of intra-SEE regional integration. This study argues strongly in favor of intra-SEE integration. The reason is that for most of the Western Balkan countries (noting that Croatia and FYR Macedonia are candidates), accession is still some (indeterminate) time away. In the interim, regional integration can help to secure FDI and exports, and hence improve sustained growth prospects. Also, since much of the process of regional integration is best addressed by advancing the adoption of the relevant EU acquis, it can in fact help to reduce the time lag for accession. Moreover, even after EU accession, free movement of labor may not come about for a while (as recent experience shows). This paper, therefore, will suggest that SEE adopt economic integration as a key objective for economic reasons, including the goal of free labor movement (starting with skilled professionals) as a means to deepen its own integration and attractiveness as a single economic space.

Notes

1. In this report, SEE5 refers to all the former Yugoslav countries and Albania, irrespective of how many countries are actually being referred to. Thus, SEE5 refers to Albania, Bosnia and Herzegovina, the Former Yugoslav Republic of Macedonia (FYR Macedonia), and Serbia and Montenegro. UNMIK/Kosovo is usually not included in the discussions, because of a lack of data. For the same reason, Montenegro is not always included separately in the discussion, although for the period of the analysis of this report (with much of the data going up to 2005), Montenegro usually enters as part of Serbia and Montenegro. The Western Balkans refers to SEE5 plus Croatia (i.e., former Yugoslavia plus Albania); BCR refers to Bulgaria, Croatia, and Romania; and SEE refers to SEE5 plus BCR. In the case of Serbia and Montenegro, data may include Montenegro, but does not include Kosovo after 1999. UNMIK/Kosovo and Montenegro data is recent and often on a shaky foundation.

2. There could be nuances or variations of priorities between different countries in the region, which can only become apparent through an in-depth analysis at the country level. This report tries to suggest some broad directions, based on its interpretation of some common emerging constraints in the countries of the region. It is hoped that this work could be used as one of the starting points for further in-depth work (including for World Bank country economic memorandums [CEMs] in the region that are slated to be done in 2008 and 2009).

3. This report chapter does not examine health issues and the relationship between health and productivity, but it is undoubtedly important. Issues relating to health benchmarking, financing, sources of revenue, etc., are being studied in the regional context in the World Bank’s Human Development Department in Europe and Central Asia.
IVANKA PETKOVA *

FDI ABSORPTIVE CAPACITY MEASURED BY FINANCIAL DEVELOPMENT. THE CASE OF SEE COUNTRIES

1. Introduction

There is common understanding that foreign direct investment (FDI) is a much more stable form of external financing than all other types of financial flows. Even though FDI may have a debt-creating component, it is essentially equity investment. Profits are repatriated only when a project yields return and part of the profits is routinely reinvested in the host country. As such, most of the risks are born by the shareholders of the foreign companies. This has marked advantage over bank lending, which must be repaid with fixed interest regardless of the performance of the project for which the loan was used (Sun, X., 2002). Moreover, creditors often look towards taxpayers to hold them harmless when projects fail. This is especially true in times of systemic financial crisis, when government bail-outs are routinely sought and obtained by the banks, adding to the tax burdens of host country taxpayers. Therefore, FDI will by definition not lead to a debt crisis and debt relief will never be an issue (Sun, X., 2002).

Literature points out that domestic capacity is crucial to exploit FDI benefits. A liberal and competitive investment climate creates the basis for FDI to enter and raise the potential for productivity growth in the host economy. However, improvements will only occur if the domestic actors are capable of responding to the new incentives. The most serious restraint to wider diffusion of best practice is a lack of local capabilities to take advantage of the opportunities offered by FDI.

The second dimension envisages the absorptive capacity on macroeconomic level, expressed in effects on growth and productivity. There are two main dimensions of FDI absorptive capacity. The first one regards the individual, the direct ability of the local firms and organizations to benefit from FDI-generated externalities. In this case absorptive capacity refers to the ability of an organization to identify, assimilate and exploit knowledge from the environment (Cohen and Levinthal, 1989). It is argued that a certain level of R&D intensity is needed before firms make use of the positive impact of FDI. Absorptive capacity is usually proxied by the technology gap between the foreign and the domestic firms, R&D intensities of the local firms, or human capital embodied in local firms.

Empirical literature on FDI and growth shows, that FDI is more likely to have positive externalities in countries with a certain level of absorptive capacity for FDI. Some authors (Sun, X., 2002) stress on the improvement of education and infrastructure as the key policy measures to increase the domestic absorptive capacity of the benefits of FDI. FDI driven technology spillovers only take place when the host country has the sufficient level of infrastructure. Infrastructure has a subsequent positive feedback on further investment which

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leads the country to grow faster. If infrastructure falls short of the critical level, however, then FDI has little effect on growth as the country is trapped in a low-growth equilibrium. (Kinishita, Y. and Chia-Hui Lu, 2006)

The productivity benefit from FDI increases with absorptive capacity until some threshold level beyond which it becomes less pronounced. But there is also a minimum absorptive capacity threshold level below which productivity spillovers from FDI are negligible or even negative. On the contrary, no evidence of productivity spillovers is found in sectors where FDI appears to be motivated by technology-sourcing considerations (Girma, S. 2005). Empirical research on absorptive capacity is available in the electronics and engineering sectors (Girma, S. and Holger Gorg, 2002), distinguishing the effect of FDI in the same sector and region from FDI in the same sector but outside the region.

Out of education, infrastructure and technology gap, the literature discussing the second dimension of absorptive capacity (on macro-level) add to and consider of substantial importance the financial system of the host country. This kind of absorptive capacity is usually measured by the degree of financial development. The idea is that a well developed financial system contributes to a more rapid accumulation of physical and human capital, enhances technological progress through identifying and funding better investment projects. Thus the development of the domestic financial system of the host country is an important precondition for FDI to have a positive impact on economic growth. A well developed domestic financial sector enhances efficient allocation of financial resources and improves the absorptive capacity of a country with respect to FDI inflows.

2. The absorptive capacity as measured by financial development

Many authors highlight the role of structural reforms affecting the decision foreign investors are taking to invest in a foreign country. For instance, Alfaro et al. (2004) examine the links among FDI, financial development, and economic growth and find that countries with better developed financial markets are able to exploit FDI more efficiently. Prasad et al. (2003) argue that the absorptive capacity as measured by financial development of the recipient country is a precondition to the growth benefits of foreign capital inflows.

There are studies stressing even on the stronger effect on FDI from financial reforms than from privatization and trade liberalization. Recent findings (Campos, N. F. and Yuko Kinoshita, 2008) suggest that financial reform is not only more important than financial development but also financial reform is much more important than other structural reforms vis-à-vis FDI. Foreign investors recognize the positive effects of a host country's financial system that is able to allocate capital efficiently, monitor firms, ameliorate, diversify and share risk, and ultimately mobilize savings. The authors argue that financial reform is a precondition for the maximization of the benefits of spillovers to foreign investors via backward linkages as an efficient domestic financial system greatly facilitates the establishment and growth of domestic suppliers of the foreign firms. (Campos, N. F. and Yuko Kinoshita, 2008). Not only does financial reform matter, it is the most important reform a country can pursue in order to influence the decisions of foreign investors. (Campos, N. F. and Yuko Kinoshita, 2008).
3. Financial (banking) sector reforms in the South East European (SEE) region

Emerging markets from South East Europe are a bold example of the implementation of intensive reform programs in the financial sectors for two reasons. First, the financial sector reforms are part of the transition reform efforts towards market-based economy. They are aiming at developing market oriented financial systems making possible a more efficient allocation of resources. Second, the prospects and the preparation of the countries for membership in the European Union are additional impetus (and an external pressure) to following the reform path.

In the countries of the region (in this study Albania, Croatia, FYRM and Serbia will be targeted) the banking system play the most important role in the financial systems. For this reason this part of the analyses is focused on the banking sector reforms in the region.

A rapid financial development is taking place in the SEE region with several characteristics of the reform paths. First, during the second half of the 90-ies banking reform efforts were impeded both by internal setbacks and by external factors. Second, every banking system of individual countries suffered shocks, downturns and in the most cases they became the turning point to boost banking and structural reforms in the national economies. Third, through privatization in general banking sectors in SEE countries attracted foreign investors to acquire local universal banks. The phenomenal growth profile of banking industries in the host countries is to be significantly associated with the transfer of know-how, best practices in managing efficiently of the foreign bank subsidiaries, and broadening the diversity of the banks’ operations. (Altzinger, W. and Ivanka Petkova, ed., 2007). However strategies for FDI local market entrants and timing vary widely between countries. Major foreign players in the domestic financial markets of SEE countries are banking institutions basically from the Euro-zone countries.

Three basic characteristics of reform efforts in the banking sectors of the targeted countries are of interest for this study: legislative and supervisory efforts, structural reforms and risks.

3.1. Albania

3.1.1. Legislative and supervisory efforts

Amendments to the banking law envisaged important basic regulative framework issues for banking activities such as minimum capital requirements, capital adequacy, credit exposures and connected lending, to a high extent in line with the Basel Committee’s Basic Principles of Banking Supervision. Prudential measures were tightened, with the central bank given increased supervisory authority. A credit bureau within the structure of the Bank of Albania (BoA) has been established.

In 2008 capital adequacy is on average far above the minimum requirement (with ratios of 17.3% and 12%, respectively, in June 2008), albeit somewhat lower than at end-2006 (EC, 2008).
In the current unsettled global financial environment in October 2008, BoA approved additional banking supervision regulations, in particular on increased provisioning for foreign currency lending. The BoA is undertaking high-frequency monitoring of banking system transactions, including foreign currency exposure and is establishing memoranda of understanding with home country bank supervisors of resident foreign banks. The improvement of the legal infrastructure for interbank loan collateralization is expected (IMF, 2008a).

It is essential that further measures are on track, in particular the development of liquid government securities and inter-bank markets. A key initiative in this regard is the introduction of a delivery-versus-payment system for government securities, which will also support private party repurchase operations.

3.1.2. Structural reforms

In Albania structural reforms in the banking sector started in 1993, when the four state owned banking institutions were consolidated into three commercial banks: the Savings Bank, National Commercial Bank and the Rural Commercial Bank. The first financial sector privatization, those of the National Commercial Bank, was realized in support of the International Finance Corporation, the European Bank for Reconstruction and Development, and Kentbank of Turkey. Lack of consistent and straightforward reforms led to a severe financial crisis in 1997, when by the end of 1996, 12 out of 16 existing pyramid schemes collapsed. The emergence of pyramids schemes and their collapse pushed the authorities to introduce further banking sector legislative and structural reforms.

In 1997, the rehabilitation of the banking sector started. The Bad Asset Resolution Trust has been created to deal with the non-performing loans of banks. Simultaneously, the government recapitalized the National Commercial Bank and the Savings Bank in order to facilitate the privatization process. The National Commercial Bank was privatized in 2000 and the Savings Bank in 2004, when the total number of banks, operating in Albania composed of 16. A bank (the Popular Bank) was founded solely on domestic capital and started operating in 2004. In 2005 the banking sector was fully private and dominantly foreign-owned. (Mladenova, I in: Altzinger,W. and Ivanka Petkova, ed., 2007). With assets of 61 percent of GDP, commercial banks dominate the financial system in Albania (IMF, 2006).

Albania advanced reforms in the banking sector by developing of a deposit insurance system, improving the bankruptcy framework and collateral enforcement, strengthening of bank regulation and supervision, and developing of a Real Time Gross Settlement (RTGS) system.

3.1.3. Risks

Since 2006 credit growth accelerated strongly, pushing private credit to 30 percent of GDP. The large share of credit denominated in foreign currencies is a factor which demands careful handling of credit risks. The establishment of the credit registry brought additional transparency to the banking system.
The rate of increase of foreign currency deposits is higher than that of domestic currency deposits. Foreign currency deposits increased from 14.65% of GDP (2004) to 25.8% of GDP (2007), while domestic currency deposits increased from 34.0% (2004) to 36.1% of GDP (2007), (IMF, 2008a).

3.2. Croatia

3.2.1. Legislative and supervisory efforts

Upon independence in 1991, Croatia already possessed a set of market-like banking practices. The period of military conflicts in the Western Balkans and the reform reluctant political environment in the 90-ies prevented the country from leveraging this initial competitive advantage.

The Banking Act of 1998 finally provided a basis for decisive intervention by the central bank (the Croatian National Bank, CNB) to start key reforms in 1999, which were already a decade overdue: closure of insolvent banks, withdrawal of the state from the banking sector, injection of financial and human capital through privatization. Since 2002 a considerable progress has been made in banking supervision and the payments system.

Concerned with the credit risks taken by banks, in 2004 the CNB introduced marginal reserve requirement on commercial banks’ new foreign borrowings. In 2005 and 2006 CNB remained concerned by continued rapid growth of credit, especially foreign currency-linked loans. The CNB strongly encouraged banks to introduce a credit registry with 20 participating banks covering 98 percent of banking assets.

Prudential measures have contributed to a fall in the share of foreign currency-linked loans since 2006. CNB is actively seeking to upgrade home-host supervisory coordination. Preparation for Basel I, to become effective in January 2009, is on track. A new capital adequacy decision was introduced in early 2008 to support the credit limits and ensure an adequate capital cushion, by requiring banks to hold capital based on their credit growth and sources of financing.

The Credit Institutions Act and the Act on Electronic money were adopted in September 2008 and related regulations are expected to be completed by the end of 2008. The Acts and expected subordinate legislation aim to fully align Croatian banking legislation with the *acquis*, in particular with the Capital Requirements Directive (EC, 2008)

Some discriminatory provisions on capital movements still remain in Croatian legislation, in particular concerning institutional investors, including “golden shares”, and the use of assets in building societies. Clauses that are not in line with the *acquis* have even been introduced in privatization contracts concluded during 2008 (EC,2008a).

Banks’ capital adequacy (regulatory capital to risk-weighted assets) was 16.1% in 2007 and asset quality are at sufficiently comfortable levels to withstand a range of shocks.
3.2.2. Structural reforms in the banking sector

Legal access to the domestic market were allowed to foreign banks in 1994, but was hardly to make use of because of military conflicts. In 1998 foreign banks’ market share in terms of total assets was less than 7%. However, in 1999 and 2000 Croatia advanced in bank privatization. An important deal at that time was the sale of a 66% share package in Privredna Banka to the Banca Commerciale Italiana in late 1999. Shortly thereafter Unicredito Italiano acquired a 51% interest in Splitska Banka, and Bayerische Landesbank bought 60% of Rijecka Banka. Market conditions altered rapidly and led to new changes in the ownership structure of banks with foreign banks market share continuing to increase (to 91.3% in 2004.)

3.2.3. Risks in the banking sector

In 2006 banks faced significant interest and exchange rate induced credit risks: the majority of their loans is at variable interest rates and linked to foreign currency; and adverse shocks would erode borrowers’ debt-servicing capacity in circumstances of high corporate and household debt. (IMF, 2008b) The CNB has taken a range of measures to curb banks’ borrowing from abroad and domestic credit expansion. As a result, bank credit subsequently slowed.

Risks in the banking sector associated with rapid credit growth remain. Bank credit to the non-government sector increased rapidly in recent years, taking the stock above 70 percent of GDP. In contrast to most other countries in the region the volume of lending to the non-government sector is above the average.

3.3. FYROM

3.3.1. Legislative and supervisory efforts

In 2000-2004 the euroization of the banking system and the upsurge in foreign currency lending put the supervision of exchange rate risks as a priority of the central bank (NBRM). However, little progress has been made in addressing the weaknesses of a few (small) banks under enhanced supervision. (IMF, 2004)

The new Law on banking is designed to strengthen banking supervision. It is protecting governor’s decision in the areas of bank licensing, receivership and bankruptcy from reversal by the courts and establishing clear frameworks for consolidated supervision and corrective action against weak banks. It also eases restrictions on foreign bank branching which should encourage competition and banking consolidation. (IMF, 2007)

In 2008 implementing legislation to the Law on banking was adopted, relating to supervision of commercial banks. The law was approximated to the EU banking directives in the areas of risk management, exposure limits, reporting and audit requirements and capital adequacy. However, further efforts are needed in order to continue the alignment with the banking acquis, especially with the Capital Requirements Directive (EC, 2008b). The NBRM has moved further towards risk-based supervision.
Preparations in the area of financial market infrastructure are advanced. A Law on financial collateral was enacted. It is regulating the security of transactions between financial institutions, which aims at aligning with the *acquis* (EC, 2008b).

Banks’ capital adequacy (regulatory capital to risk-weighted assets was 17.2% in 2007).

### 3.4.2. Structural reforms in the banking sector

The reforms of the banking sector started at the beginning of 1995, when the Bank Rehabilitation Agency (BRA) was established. As part of the restructuring procedures, the largest banks were audited. The BRA undertook the bank loans of the largest bank (Stopanska Banka) and converted them into equity in the indebted enterprises.

Reforms advanced steadily especially through privatization and opening the market to foreign investments. End of 1999, equity investments in Stopanska Banka made National Bank of Greece (NBG), the European Bank for Reconstruction and Development (EBRD) and the International Finance Corporation (IFC). It was also the largest bank privatization in the country. A bank partly owned by a political party (in violation of the law) has been sold to a strategic investor. In 2000 – 2004 the banking system was still anchored by large banks. (IMF, 2004)

Foreign bank presence is low compared to the region. Banks owned by foreign and domestic private shareholders have approximately the same share in the total capital as the banks owned by foreign shareholders. The new Law on banking eases restrictions on foreign bank branching which is expected also to encourage competition and banking consolidation.

### 3.3.3. Risks in the banking sector

Credit is growing at more than 30 percent annually. Unhedged foreign exchange borrowing by residents is a significant vulnerability of the banking sector. The share of foreign currency lending to total credit to private sector amounted to 25.2% in 2007 (IMF 2008e).

A contingency plan in case of spillovers from the international financial crisis on Macedonia's financial sector as well as new legislation strengthening the central bank's power in dealing with troubled banks and enhancing its independence is needed. (IMF, 2008d)

### 3.4. Serbia

#### 3.4.1. Legislative and supervisory efforts

In 2004 the credit registry was reinforced. The pledge registry and legislation on enhancing creditor rights over collateral was activated in 2005. The new banking law of 2005 established the basis for enforcement of Basle Core Principles. The law reflects international and EU best practice.
In 2007 banking system’s vulnerabilities were partly manifested in high euroization and rapid growth of household non-performing loans due to rapid credit expansion. The high mandatory reserve requirements introduced by the central bank, the NBS, however prompted some disintermediation through increased cross-border borrowing by banks. (IMF, 2008c) The supervision authorities are moving gradually to a transition from a compliance-oriented regime to risk-based supervision. The average capital adequacy ratio of the banking system in 2008 stood at 27.7%, well above the required minimum of 12% of risk-weighted assets for each bank (EC, 2008c). The National Bank of Serbia adopted additional implementing legislation with the aim of further liberalising capital flows. However, outward payment and current account transactions are not yet fully liberalized and restrictions on short-term credit and portfolio investments are still in place (EC, 2008c).

3.4.2. Structural reforms in the banking sector

The reform of the banking system was launched in May, 2001, when the Bank Restructuring Strategy was adopted. The first step of the restructuring and privatization was the establishment of the Agency for Deposit Insurance, Rehabilitation, Bankruptcy and Liquidation of Banks in 2001. A total of 25 banks were put into liquidation. As a result of the restructuring measures the number of banks has steadily decreased.

Although well advanced, the privatization of the banking system is still not completed. The entry of foreign banks has progressed in line with privatization. A bold privatization and restructuring of banks started in 2005, when six banks were offered for sale. However, there are still eight majority state-owned banks (out of a total of 34), while 20 banks are now majority-owned by foreign shareholders. Six banks are under majority ownership of domestic natural persons or legal entities.

While competition between banks is well established, privatization of banks is lasting longer than in other SEE countries. The efficiency of intermediation is still not benefiting on privatization.

The five largest banks in terms of assets account for 46.5% of the total banking sector. In May 2008, the NBS issued a new license to a non-EU bank for a green-field investment (EC, 2008c).

3.4.3. Risks in the banking sector

Rapid credit expansion of highly euroized credit to unhedged borrowers underpins rising vulnerabilities. In recent years indirect risks are stemming from growing currency mismatches in credits for the private sector.

On the other hand, strong competition and overoptimistic and ambitious return and market share targets make banks underestimate direct credit risks. (Serbia, 2007) It resulted in some decline in the asset quality of household credit. For this reason, the central bank (NBS) is keeping high mandatory reserve requirements helping to maintain much-needed financial buffers.
4. Degree of financial development in SEE countries

The analyses show that financial sector reform are made a priority for targeted countries of SEE and the outcomes of the financial sector privatization, liberalization and deregulation policies are well advanced. The main impression is that what remains to be done regards the completion in some of the countries of the second stage and entering the next third-stage of reforms. To improve the governance and structure of financial sectors will be a step to expect later.

On the basis of the analysis of the legal framework, structural reforms and risks in the banking sectors of individual countries the following concrete conclusions can be drawn: First, financial intermediation in the countries of SEE expanded significantly in recent years, but in some countries its level remained low. For example, bank lending to the private sector in Albania is 31.4% of GDP as of June 2008 (up from 21.4% at end-2006). Second, well advanced in the region are the legislative and supervisory efforts of the authorities. A special impetus to the progress in these areas is available due to the harmonization of domestic legislation with those of the EU. Third, structural reforms in the banking sector in SEE are well advanced and foreign ownership in banking increased substantially in recent years, supporting the conclusion that foreign banks (Austrian, Italian, Greek and German banks) now dominate the banking sectors in the region. However as regards the ownership structure the picture in individual countries is much diversified, starting from 54% foreign ownership in FYROM, 60% in Serbia, 90% in Croatia and reaching 95% in Albania. Fourth, fast growing rates of credits to the non-government sector, unhedged foreign exchange borrowing by residents and euroization underpin rising vulnerabilities in the banking sectors. Appropriate measures are taken by central banks and supervisory authorities to manage the problem.

For the purpose of the analysis of the absorptive capacity as measured by the degree of development of the financial sector concrete measures could be and are usually applied. Typically, financial development is measured by a small set of quantitative variables, such as the ratio of broad money (M2) to GDP, the ratio of private sector credit to total credit, credit to the private sector etc. Of course, these simple quantitative measures, taken individually, do not necessarily capture what is broadly meant by financial development (Creane, S., 2003). For example, while a higher ratio of broad money to GDP is generally associated with greater financial liquidity and depth, the ratio may decline rather than rise as a financial system develops because people have more opportunities to invest in longer-term or less liquid financial instruments. However, when analyzed carefully, these indicators could produce a basic information for the purposes of the assessment.

Targeted countries show a different degree of financial development measured by the simple indicators mentioned. In Albania financial intermediation is growing, companies and households are trusting the banking sector: the share of deposits in GDP increased from 48,6% (2004) to 61,9% (2007), (IMF, 2008a). End of 2006 the ratio of credit to GDP reached 19.5 per cent. In 2007 the share of bank assets to GDP amounted to 75,9 percent. The share of the loan portfolio to GDP was 29,9 percent. (Bank of Albania, 2006) Credit to business was the main contributor. In Croatia there is a rapid development of the banking system: the ratio of banks assets to GDP reached 67% and the ratio of bank deposits to GDP 59% (2006). The bank credit to the non-government sector increased from 14,6% of GDP (2003) to 23,1%
At the same time an extensive euroization is going on with about 80% of bank loans and time deposits denominated or indexed in foreign-currency. In 2008 the share of foreign exchange deposits in total deposits decreased to 62% and the share of foreign exchange loans on total loans was 61%. In FYROM broad money growth is 30% (2007) reaching 51% of GDP (2007), with the local currency (denar) deposit share increasing slightly. Credit growth is higher (40%), but from a low base. Private sector credit as a share of GDP shows a remarkable dynamic: from 17% (2002) to 49% (2007). In Serbia the annual M3 growth rate is following a dynamic development in recent years: reaching 43% and of 2007 and slowed down to 34% year-on-year in June, 2008. In 2007 lending activity of banks increased by 39%. Loans amounts to 35% of GDP and 53% of the banking sector's total balance sheet. The share of total loans granted to the enterprise and household sectors stay at 58% and 40% respectively. Deposit activity of banks grew by 44% in 2007. The largest share of deposits was accounted for by the household sector (46%), followed by the enterprise sector (33%) and bank deposits (12%). Foreign currency deposits made up 67.7% of total deposits. Overall, financial intermediation continued to grow, but from a still relatively low level. However, the high degree of euroisation of assets and liabilities, combined with potential currency mismatches, could give rise to substantial balance-sheet risks for banks, households and corporations. (EC, 2008c)

5. Financial development in the financial crisis

There is a complicated relationship between the degree of financial reforms and the impact of the financial crisis on the economies and financial development in the SEE countries. There is no doubt, that financial development has progressed. The achievements in implementing financial sector reforms are increasing the degree of financial development.

On the other hand, they are exposing these countries to the fallout of the financial crisis. It is important to note that the current financial crisis has evolved differently: it is an “imported” crisis, with origins outside for the countries of SEE. This makes all the impacts on the financial development of these countries of external nature.

The exposure of the financial systems of the SEE countries to the financial crisis increased gradually. There were several both economic and genuine financial sector reasons for the risks to increase. First, in most of the countries, (except of Albania) there is a high dependence of banks on the interbank market. Second, as local banking sectors are dominated by foreign banks, much financing from abroad is needed. This depends however, on the relations between the parent bank and its subsidiary in the host country of SEE. In current times, when foreign parent banks are deleveraging, this dependence from a positive advantage in the near past is turning to a negative feature accompanying the activities of the subsidiaries in the host countries. Third, the ongoing global repricing of credit risks is pushing up external costs for domestic borrowers, both banks and non-financial enterprises. Fourth, credit expansion was typical for all the countries reviewed in the period before the outbreak of the crisis. Foreign direct and local investments in real estate were also very popular because of affordable financing via banking credits and low indebtedness of households until recently.
The reform policy measures were focused on the entry of top international banks into the financial sectors in the region by setting up subsidiaries through acquiring domestic institutions. Soon credit systems became focused on lending to individual households, leading to growing personal debt. Foreign banks reoriented credit away from the production of goods and services, and towards loans to individuals (dos Santos, 2008). Lending denominated in euros and Swiss francs. The high degree of euroisation of assets and liabilities, combined with potential currency mismatches, could give rise to substantial balance-sheet risks for banks, households and corporations. Foreign banks introduced or expanded credit card lending, consumer loans, mortgages. (dos Santos, 2008)

One of the main negative effects of the financial crisis is the decrease of economic growth rates, which would require respective incisive adjustments in some of the countries (Croatia, Macedonia). The slowing growth rates feed back into financial sector stress, a slowdown particularly in finance and trade is on the way. Falling economic growth rates in partner countries, especially in the Eurozone countries contribute to the evolvement of this trend. Some of the countries (Serbia, Croatia) are facing also fiscal difficulties.

There are indications, that the impact of the financial turmoil will depend on the behaviour of parent banks and foreign direct investment in the coming year. In the SEE region, where foreign banks dominate, support from foreign parent banks is likely to be reduced as their balance sheets and capital adequacy are tested by the market (Berglof, 2008). Although some countries have limited integration into global financial markets they could be affected by contagion from neighbours or investors.

Bold signals of tightening the conditions for a smooth banking activity in SEE countries were manifested in September 2008 as a result of liquidity problems of parent banks.

First, access to capital for domestic banks has been decreased simultaneously with an increase of its price. It was due to significant dependence of local subsidiaries on the interbank market, where the usual smooth inflows of fresh funds has been rearranged in accordance with the new behaviour of the parent banks in the crisis. Large external private refinancing needs are dominating the picture in the region. Parent banks started to re-evaluate the allocation of available funds to their foreign subsidiaries in SEE respecting the country risk. Second, banks faced at the same time the price erosion of real estate. Under these new circumstances the previous links of subsidiaries with parent banks had to be reassessed, in some cases to the direction of becoming a disadvantage.

There is a high degree of foreign ownership in banks in SEE countries, most of them from the Eurozone countries. As financial-intermediation channels are functioning under the conditions of the crisis, so the financial systems in these countries are hesitating in servicing the financing needs of the economy. This makes foreign owned local banks in SEE exposed to additional risks, when parent banks are facing problems. First, the financial crisis affects asset quality of banks as the prices of financial products fall sharply. Banks may hold some of these assets and then may have to price them at significantly written-down values or make provisions or even write them off. Their customers may also hold some, and this may affect their ability to service their bank loans. Second, banks are facing the doubt on the stability of customers’ deposits as a funding source. Third, the slowing economy will inevitably hurt the ability of borrowers to service bank loans. The parent banks have subsidiaries in the host
countries of SEE supervised by the local authorities, but the asset and liability management and cash and liquidity reserves are centralized. At periods of stress, the parent company will decide how to react.

The timely short term measures of governments, like the temporary deposit-protection arrangement, should help to stabilize the deposit bases of banks as a source of funding. The provision of term liquidity to individual banks is also helping to enhance banks operating and bear the important responsibility to keep the economy going. However, there is still a lot of uncertainty and lack of sufficient reliable information as to how will be banks models changed.

6. Prospects of financial crisis impact

First, still the international financial crisis has only a limited direct impact on the economies and financial sectors of the SEE countries. However, widening current account deficits (especially of Serbia and Croatia) and a growing level of external debt require external financing by significant capital inflows. To that extent, the external imbalances render the economies vulnerable to possible disruptions in capital flows. In particular, a decline in cross-border lending, which has become an important financing source for the domestic corporate sector (of Serbia and Croatia), could be affected.

Second, economies, which have experienced especially rapid credit increases, with foreign banks playing a dominant role in the domestic market, could be most at risk. The risks of a sudden stop or reversal of capital flows are growing and higher risk premiums and refinancing costs could put further pressure on the external side of the economies of SEE countries.

Third, the global economic slowdown and the global financial crisis will make a negative effect on transition tasks and programs in the SEE countries, because efforts will have to shift to more urgent goals to be met. One of them is to re-establish conditions for intermediation, as lending by local banks, many of which are owned by parent banks based in the Eurozone countries, has widely contracted. Due to the crisis financial development is likely to regress, with most immediate impact on SME sector (Berglof, E., 2008).

Fourth, for governments the immediate task is to protect domestic financial institutions and mitigate the impact on the real economy. There is an urgent need to increase capital and liquidity buffers for banks. Such an increase of buffers to be successfully implemented is associated with well-coordinated, especially among home regulators of internationally active banks.

Fifth, there are also positive consequences of the lower level of financial development. The overall low level of financial intermediation and a limited integration to the international capital markets are factors protecting these countries from the direct negative impacts on destroying lending channels. The comparatively milder impact will be manifested rather in an increased price of bank credits. The well capitalized banking sector, mainly financed by households’ deposits is an advantage in the period of financial crisis.
Conclusion

First, banking sectors, which are the main and core part of financial sectors and the most important driving force in financial development of the SEE countries, are adversely affected by the crisis. The deterioration in financing conditions is expected to become more severe for countries with large current account deficits, and for those that showed signs of rapid credit growth prior to the intensification of the financial crisis.

Second, without question, current circumstances have revealed important weaknesses not only in crisis preparedness. Prevailing part of the literature on FDI in banking sectors pointed out the positive implications of FDI for the financial development of host countries only. The possibility of sudden reverse effects was completely excluded, both because of missing to postulate that a financial crisis can originate from the developed world, and because of perceptions based on the Asia crisis ten years ago.

Third, provided that the depth and duration of the global crisis are still unclear, one can expect that priority will be rather given to stabilization of the banking systems through government interventions than to their further development. In this environment there are sufficient arguments to expect that implementation of financial development goals will be disturbed and postponed for the period after overcoming the consequences of the financial crisis. Governance and structure of financial sectors will be a step to expect later.

Fourth, this brings us to the suggestion to broaden the characteristics of the FDI’ absorptive capacity as measured by financial development/financial reforms. Under financial globalization external negative effects originating from countries with highly developed financial systems could hurt or stop reform efforts thus may freeze financial development. In case this possibility is included into the characteristics, it could make the term more practice-oriented and could get in line with a better understanding of the nature and the risks of the current global financial system.

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ANTO DOMAZET*

TRADE AND GROWTH IN BOSNIA AND HERZEGOVINA – GROWING IMPORTANCE OF INTRA INDUSTRY TRADE

Introduction

On the integration road to global trade Bosnia and Herzegovina passed a few development stages. Promptly after the war the liberalization has consumed trade with neighbouring countries on grounds of bilateral free trade agreements. Stability Pact for South Eastern Europe (SP SEE) initiatives in 2001/2002 launched the process of trade liberalization in SEE region through bilateral agreements in which BH benefited the advantages of asymmetrical preferences. In December 2006 BH signed CEFTA Agreement that took effect in year 2007, which indicated transition to qualitatively new liberalization basis through multilateral preferences in trade. In June 2008 BH signed Stabilization and Association Agreement, thus designating a new era of liberalized trade with EU, after unilateral trade preferences EU for SEE countries in year 2001. Today BH is in a final stage of preparations for admittance to World Trade Organization (WTO). Trade liberalization was carried out in context of transitional reforms and building competitiveness of domestic production through founding of new and restructuring and privatization of inherited companies. Trade liberalization has exerted, from one point of view, a competitive pressure on domestic production, and on the other side it opened new markets for growing production capacities and contributed to enhanced interest for foreign direct investments. The effects of trade creating and routing towards the areas of its liberalization, and effects of returns to scale, specialization and growth of intra industry trade had different sector, regional and distribution according to size and proprietary profile of the company. The aim of this paper is to provide an empirical verification of thesis that BH foreign trade from 2002 to 2007 has been dominantly based on intra industry trade and that the basis of its development consists of existence of competitive advantages. More detailed aim of this paper is to research regional and sector specificities of such exchange.

1. Theoretical framework

Traditional comparative advantages theories in international trade start from the point where goods in trade are imported or exported, but they are never the subject of simultaneous import and export inside certain country. Comparative advantages suppose that production in one country can be performed with lower level of costs than the other country could do that. Based on Heckscher-Ohlin theorem countries with high quantity of cheap labour should produce labour intensive products and countries with capital availability should produce capital intensive products. This theory has never been approved in reality of economic life. This fact was the reason why, starting from sixties years of 20th century, searching for new theory of international trade has been intensified. (Fontagne, Freudenberg, 1997)

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When customs and other barriers in some trade area are eliminated, the additional incentive occurs so that the goods from the same production sector become simultaneously subjects of both import and export. It is a intra industry trade phenomena which is thereby more intensive as it concerns the products of higher level of differentiation in which countries don't have distinct competitive advantages or disadvantages (Caves ed al. 2002, pp. 137). Regional integrations create intra industry trade as one of the possible effects in using the opportunities for trade advancement (well known effect of integrations in creating trade). Intra industry trade occurs within the same economic or industrial sectors and is more intense in developed than underdeveloped countries. Intra industry trade as the greatest source of assets from liberalized trade occurs when countries are at a similar stage of economic growth (substantial human capital of cheap unqualified work) (1) and when the profits of returns to scale in production and wide assortment production are especially expressed (2) (Nafziger, 1997, pp. 498). In foreign trade exchange BH in relation to actual CEFTA all the limitations of underdeveloped production structure for generating industrial exchange are bespoken. What is most important, it takes a significant amount of time for the effects of liberalization on multilateral basis to show in practice through restructuring of the production. It confirms also the experience of the actual CEFTA in early nineties of the twentieth century, with additional circumstance that the profits for all the members of CEFTA integration depend in great deal on progress in integrations towards EU (Hadžiomeragić ed al., pp. 35). Intra industry trade leads to broader product spectrum that country simultaneously imports and exports within the foreign trade exchange whereat products differentiation, monopoly status of such products and returns to scale have such a huge role in generating trade and profits from trade (Krugman, 1983, pp.345). What matters here is returns to scale which disables that possibility that every country produce a full assortment of product for itself, and also the monopoly of the differentiated products. Relative importance of intra and inter industry trade depends on likeness of the countries that practice the exchange. If domestic and foreign country are alike in their relation of work and capital, than there will be less inter and more intra industry trade, bases on returns to scale (Krugman, Obstfeld, 2000, pp. 137). Overview of differentiated products is important because it relates to question whether some production is homogenous or heterogeneous. Heterogeneous product includes many differentiated products which cannot all be produced in one country efficiently, so they will be provided through intra industry trade (Caves, Franklin, Jones, 2002, str. 137). The reasons for intra industry trade are as follows: products differentiation, transport expenses and geographical location, dynamics of returns to scale, level of production aggregation, differences in income distribution in the country (Field, 1998, str. 195).

Empirical research IIT show its growth and importance for total exchange, in developed and underdeveloped countries in transition alike. From 1990 to 1999 IIT in Italy has, expressed in GL index, risen from 47,9 to 51,4. The biggest part of its IIT Italy carries out with high income countries (73,1%), with middle income countries (21,5%) and low income countries (5,4%), (Reganati, Pittiglio, 2005., pp. 4). Ten countries candidates for EU, that were accepted in EU in year 2004., have enhanced their share of IIT from 1993 to 2001 from 16,1 to 27,0. Among them the leading position had Czech Republic (GL index IIT growth from 34,2 to 49,2, respectively), Hungary (GL index growth from 28,2 to 36,8, respectively), Slovenia (GL index growth from 27,0 to 35,2, respectively), Poland (GL index growth from 18,5 to 32,5, respectively). The lowest level of IIT had Latvia (GL index growth from 3,3 to 8,7, respectively), Estonia (GL index growth from 3,5 to 27,0, respectively) and Lithuania (GL index growth from 5,3 to 11,2, respectively), Bulgaria and Romania, as countries that
were accepted in EU in year 2007, had in that period IIT in the middle of the observed countries. Bulgaria enhanced its GL index from 13.8 to 17.8, and Romania from 10.0 to 21.7 respectively (Caetano, Galeggo, 2006., pp. 22).

In Bosnia and Herzegovina deeper researches about intra industry trade have not been conducted. However, undoubtedly every research about IIT in BH should be put in context of three important factors of development. First of them is associated with the macroeconomic reforms and openness of BH towards the foreign environment, which connected the possibilities of economic growth of the country only to competitiveness and efficiency of the foreign goods and capital transactions. The other factor is associated to liberalization of the foreign trade and capital flows on regional level (bilateral agreements about free trade in SEE and new CEFTA), European level (European Union) and global level (WTO). The third factor refers to supply side aspects of export to BH, which in period before year 2002 were dominantly based on resource oriented development strategy with production which trade was based on competitive advantages, that is low production costs. Period from 2002 to 2007 has been marked by transition to a development stage based on investments, with efficiency of the production as main competitiveness driver. However, for a larger spread of export to markets of the actual CEFTA and EU much more efficient export strategies and reforms for strengthening of the export competitiveness are needed (Domazet, 2006, pp. 95-106).

2. Dynamics and basic structural changes in BH foreign trade

Basic macroeconomic indicators for BH in period from 2002 to 2007 show a stable GDP growth, monetary stability based on currency board regime, growth of foreign transactions and existence of high deficit and high unemployment (see Table 1).

<table>
<thead>
<tr>
<th>Table 1</th>
</tr>
</thead>
<tbody>
<tr>
<td>Basic macroeconomic data for BH 2002 – 2007</td>
</tr>
<tr>
<td>mil KM</td>
</tr>
<tr>
<td>Year</td>
</tr>
<tr>
<td>1. GDP (current prices)</td>
</tr>
<tr>
<td>- real GDP growth (%)</td>
</tr>
<tr>
<td>- GDP pc in EUR</td>
</tr>
<tr>
<td>- GDP pc in $ PPP*</td>
</tr>
<tr>
<td>2. Export</td>
</tr>
<tr>
<td>3. Import</td>
</tr>
<tr>
<td>4. TOTAL (E+I)</td>
</tr>
<tr>
<td>5. Trade goods deficit</td>
</tr>
<tr>
<td>7. FDI – stock</td>
</tr>
<tr>
<td>8. Foreign debt</td>
</tr>
<tr>
<td>9. Inflation</td>
</tr>
<tr>
<td>10. General government revenue (% of GDP)</td>
</tr>
<tr>
<td>- overall balance of general government (% of GDP)</td>
</tr>
<tr>
<td>10. Unemployment rate</td>
</tr>
<tr>
<td>11. Openess (E+I/GDPx100)</td>
</tr>
</tbody>
</table>

The results in foreign trade growth confirm the effects of trade creating caused by liberalization of trade in SEE region and approved export preferences for goods in SEE countries by EU in year 2000. Faster foreign trade growth in relation to BDP resulted in growth of BH level of openness from 79% to 94.7%, which puts BH among countries most opened to global market influences. The openness enabled dynamic export growth, but its level, of 28.4% share in BDP for year 2007 still is among the lowest in the region.

Foreign trade activities gave a negative contribution to GDP movement because of the relatively low export rate. Negative effects dominated in period from 2002 to 2005, while in the period from 2006 to 2007 record positive contributions because of the rapid export dynamics.

### Table 2

**Foreign trade contribution to the economic growth in BH**

<table>
<thead>
<tr>
<th>Year</th>
<th>GDP (current prices) (y)</th>
<th>Export (x)</th>
<th>Import (m)</th>
<th>Export contribution to GDP growth (%)</th>
<th>Import contribution to GDP growth (%)</th>
<th>Foreign trade contribution to GDP growth (%)</th>
<th>Annual growth of GDP (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2002</td>
<td>12,829</td>
<td>2,089</td>
<td>8,048</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>2003</td>
<td>14,505</td>
<td>2,323</td>
<td>8,319</td>
<td>1.56</td>
<td>-2.34</td>
<td>-1.78</td>
<td>13.30</td>
</tr>
<tr>
<td>2004</td>
<td>15,786</td>
<td>2,819</td>
<td>9,306</td>
<td>3.45</td>
<td>-6.90</td>
<td>-3.45</td>
<td>8.96</td>
</tr>
<tr>
<td>2005</td>
<td>16,928</td>
<td>3,783</td>
<td>11,179</td>
<td>6.33</td>
<td>-11.39</td>
<td>-5.06</td>
<td>6.96</td>
</tr>
<tr>
<td>2006</td>
<td>19,121</td>
<td>5,164</td>
<td>11,389</td>
<td>8.28</td>
<td>-1.78</td>
<td>6.50</td>
<td>13.01</td>
</tr>
<tr>
<td>2007</td>
<td>20,950</td>
<td>5,937</td>
<td>13,899</td>
<td>3.66</td>
<td>-2.62</td>
<td>1.04</td>
<td>13.09</td>
</tr>
</tbody>
</table>

Source: as for table 2.

The structure of BH foreign trade in relations to basic market affiliations shows effect of export deflection towards the CEFTA and EU free trade areas (see Table 3). From 82.4% in year 2002 that export markets have increased its share to 92.8% in year 2007 in total BH export. The effect of import deflection is negative, because CEFTA and EU share in total BH import has dropped from 90.0% in year 2002 to 82.4%. It is about high energy dependence on Russia and growth of export from China and Turkey. Turkey is not included in CEFTA countries, although BH has a bilateral free trade agreement with it.

### Table 3

**The structure of foreign trade of BH 2002 – 2007**

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Export</td>
<td>Import</td>
<td>Deficit</td>
</tr>
<tr>
<td>1. CEFTA</td>
<td>346.9</td>
<td>1,125.2</td>
<td>778.3</td>
</tr>
<tr>
<td>os2. EU</td>
<td>448.5</td>
<td>2,042.0</td>
<td>1,548.5</td>
</tr>
<tr>
<td>3. Other countries</td>
<td>170.1</td>
<td>357.1</td>
<td>181.2</td>
</tr>
<tr>
<td>TOTAL</td>
<td>965.5</td>
<td>3,518.5</td>
<td>2,553.0</td>
</tr>
</tbody>
</table>

Source: BH Foreign Trade Chamber (for trade data), BH Statistical Agency (for all other data)

122 Export and import contributions to GDP growth are calculated as follows (Grgic, 1989, p. 135 in Sokcicvic, 2008, p. 182): Export contribution: \[(Xt - Xt-1) / Yt-1\] x 100; Import contribution: \[(M1 - Mt-1) / Yt-1\] x 100
In observed period, as can be seen from the graphics in figure 1., the most stable market share had the actual CEFTA affiliation countries, both in export share (35,9% in year 2002. and 36,6% in year 2007.) and import share in BH (32,0% in year 2002. and 35,4% in year 2007.) It confirms existence of very mild trade deflection effect which was expected from bilateral free trade agreements. However, such trade liberalization has defended regional trade from higher trade deflection effects toward European Union market. It is especially important for BH that has the highest level of SEE market orientation among all the countries in the region.

The largest changes in market structure of BH foreign trade records EU market. BH export to that market is accompanied by share growth from 46,5% in year 2002. to 56,2% in year 2007., while the import share decreased from 56,0% in year 2002. to 49,9% in year 2007. The growth of EU export share is a result of changes in restructuring domestic companies whose production is traditionally and permanently oriented towards the EU market.

Other markets have a significant share of 14,7% in BH import in year 2007., against 10,0% in year 2002., while their export share is reduced to 7,2% in year 2007. from 17,6% in year 2002. The high import share of these countries comes from the export of natural gas from Russian Federation, whose prices are constantly growing, and also dynamic growth of import from Turkey, with whom BH otherwise retains bilateral free trade agreement, and growth of import from China and developing trade relations with the countries that assured export preferences for BH through free trade export (USA, Switzerland, Norway, Canada and other countries).

The permanent mark of BH foreign trade for observed period is high trade deficit which amounted 42,9% for year 2002., and 37,2% BDP for year 2007. Structural dynamics of BH foreign trade deficit records growth of deficit share in trade with the countries of actual CEFTA (from 30,6% in year 2002., to 34,5% in year 2007.), decrease of deficit share in trade with EU (from 62,3% in year 2002., to 44,8% in year 2007.), and high growth of deficit in trade with other countries (from 9,9% in year 2002., to high 20,7% in year 2007.)
3. Methodology of research

Research of IIT in Bosnia and Herzegovina is conducted primarily on aggregation country level. Disaggregation is conducted in two dimensions. First, market dimension relates to main market affiliations, that is the actual CEFTA affiliation, EU and other countries. Second, production dimension relates to IIT research by production sectors which are classified by statistic double-digit SITC classification which comprehends twenty of the leading BH production sectors according to export rate in year 2007. Data source is presented by foreign trade exchange data base from Foreign Trade Chamber of Bosnia and Herzegovina. Namely, Agency for statistics of Bosnia and Herzegovina publishes full data for BH foreign trade from year 2005., so the research for period from 2002. to 2007 was not possible by using their data.

Although the regional trade in period from 2002 to 2007 was conducted through bilateral free trade agreements, in this paper we will use the term trade within the actual CEFTA affiliation for that trade\textsuperscript{123}. As opposed to the actual CEFTA in this paper will be used a term the new CEFTA in context of the future role of CEFTA in development of foreign trade and IIT in BH.

In research of IIT we use the Grubel-Lloyd Index (GLI) which appears in two forms (Grubel, Lloyd, 1971, pp. 494-517).

The first form is aggregated GL Index, which is calculated as follows:

\[
GL = 1 - \frac{x - m}{x + m}
\]

whereat:
\(x = \text{export value,}\)
\(m = \text{import value of the country in specified time period}\)

The other form is GL\textsubscript{i} Index by industries and is calculated as follows:

\[
GL_i = 1 - \frac{\sum_{t=1}^{T} X_t - \sum_{t=1}^{T} M_i}{\sum_{t=1}^{T} X_t + \sum_{t=1}^{T} M_i} \times 100
\]

whereat:
\(GL_i = \text{value of the Grubel-Lloyd Index for industry sector } i ,\)
\(X = \text{export value for industry } i ,\)
\(M = \text{import value of industry } i\)

GL Index ranges from 0 to 100. Higher index value indicates a higher level of specialization in IIT. Specialization demands broadening of the diversification area within certain industries, and simultaneously ensures returns to scale, as a source of competitiveness in IIT.

\textsuperscript{123} CEFTA (Central Europe Free Trade Agreement) had until the expansion of EU in 2004, comprised of Poland, Czech Republic, Slovakia, Hungary, Bulgaria, Romania and Croatia. From November 2007, when Preamble of the CEFTA Agreement Amendment of and Accession to the Central European Free Trade Agreement took effect, it is composed of eight countries: Croatia, Bosnia and Herzegovina, Serbia, Montenegro, FYR Macedonia, UNMIK Kosovo, Albania and Moldova.
Increase of GL Index is possible by decreasing the numerator in above mentioned formula. It is achieved by decreasing the differences between export and import within a single industry, by decreasing both deficit and surplus. Interpretation of GL Index is that it shows the share of intra industry trade in total trade of certain industry.

4. IIT in Bosnia and Herzegovina foreign trade

As we said in methodology, IIT research is focused on market and production dimensions of Bosnia and Herzegovina foreign trade.

4.1. Market dimension of IIT in Bosnia and Herzegovina foreign trade

Intra industry trade has in period from 2002 to 2007 become a dominant form of BH foreign trade. Intra industry trade shows significant variations on level of basic market affiliations which BH conducts foreign trade with.

Data from Table 4 show that IIT expressed with the GL Index in BH foreign trade record in period from 2002 to 2007 a bounce from 43,07 in year 2002 to 61,71 in year 2007, which confirmed intra industry trade as dominant form of trade. Foundation of such changes is entering into development stage based on efficiency and investments as driver developments. Such development encourages competitiveness of existing and enables diversification of new productions and products which BH is able to provide on international market. At the same time, the effect of export substitution should be taken under consideration, because IIT growth on BH example means decreasing relation of the trade deficit towards the total range of foreign trade, which is also contributed by import substitution. Each of above mentioned affiliation has its IIT specifics, on affiliation level, and also on certain countries level. It shows that in IIT determinants act on affiliation level and certain countries level as well.

That is why the differences can be spotted in IIT of certain countries as related to affiliation, and also the affiliations show certain specifics in relation to IIT in BH foreign trade. Trade with the actual CEFTA affiliation has become dominantly intra industry trade. Growth of GL Index from 47,07 in year 2002 to 63,10 in year 2007 confirms that in the observed five year period has come to a high range of convergence in BH foreign trade with the actual CEFTA, and primarily because of the great structural changes in trade with Croatia and Serbia.

BH trade with EU countries is also transformed into intra industry trade, and it reached GL Index of 66,88 in year 2007. The largest effect in the rising of the production-market convergence in BH trade with EU gave the countries that are traditional foreign trade partners of BH: Germany, Slovenia, Italy and Austria. It showed that the trade with the countries of low geocultural distance leads to growth of intra industry trade and its transformation into dominant form of foreign trade. Besides above mentioned, there are many other countries that BH had a decade long trade backseat with, but that now started a more intense trade with BH based on intra industry trade, such as Hungary, Slovakia, Poland, Romania and Bulgaria.
Table 4

GL Indexes of BH intra industry trade with main foreign trade affiliations and partners

<table>
<thead>
<tr>
<th></th>
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<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>CEFTA</td>
<td>47.07</td>
<td>63.10</td>
<td>133.9</td>
<td>EU</td>
<td>36.02</td>
<td>66.88</td>
<td>185.7</td>
</tr>
<tr>
<td>- Croatia</td>
<td>30.9</td>
<td>53.7</td>
<td>173.8</td>
<td>- Germany</td>
<td>52.2</td>
<td>70.8</td>
<td>135.6</td>
</tr>
<tr>
<td>- Serbia</td>
<td>80.5</td>
<td>66.8</td>
<td>83.0</td>
<td>- Slovenia</td>
<td>25.6</td>
<td>61.9</td>
<td>241.8</td>
</tr>
<tr>
<td>- Montenegro</td>
<td>-</td>
<td>45.1</td>
<td>-</td>
<td>- Italia</td>
<td>53.7</td>
<td>82.1</td>
<td>152.9</td>
</tr>
<tr>
<td>- Macedonia</td>
<td>66.8</td>
<td>59.0</td>
<td>88.3</td>
<td>- Austria</td>
<td>26.5</td>
<td>59.1</td>
<td>223.0</td>
</tr>
<tr>
<td>- Albania</td>
<td>75.7</td>
<td>60.3</td>
<td>79.7</td>
<td>- Hungary</td>
<td>5.9</td>
<td>62.5</td>
<td>1.059.3</td>
</tr>
<tr>
<td>- Moldova</td>
<td>62.0</td>
<td>81.4</td>
<td>131.2</td>
<td>- Czech Republic</td>
<td>10.6</td>
<td>36.6</td>
<td>289.6</td>
</tr>
<tr>
<td>- UNMIK Kosovo</td>
<td>40.4</td>
<td></td>
<td></td>
<td>- United Kingdom</td>
<td>74.6</td>
<td>18.2</td>
<td>24.4</td>
</tr>
<tr>
<td>OTHER COUNTRIES</td>
<td>65.25</td>
<td>36.04</td>
<td>55.3</td>
<td>- France</td>
<td>69.2</td>
<td>87.3</td>
<td>126.2</td>
</tr>
<tr>
<td>- USA</td>
<td>25.2</td>
<td>94.2</td>
<td>271.1</td>
<td>- Netherlands</td>
<td>18.2</td>
<td>56.9</td>
<td>312.6</td>
</tr>
<tr>
<td>- Switzerland</td>
<td>82.8</td>
<td>33.5</td>
<td>40.5</td>
<td>- Slovakia</td>
<td>18.8</td>
<td>52.9</td>
<td>281.4</td>
</tr>
<tr>
<td>- India</td>
<td>19.4</td>
<td>76.7</td>
<td>395.4</td>
<td>- Poland</td>
<td>8.9</td>
<td>89.0</td>
<td>1.000.0</td>
</tr>
<tr>
<td>- Ukraine</td>
<td>48.2</td>
<td>19.5</td>
<td>40.5</td>
<td>- Romania</td>
<td>3.1</td>
<td>88.1</td>
<td>-</td>
</tr>
<tr>
<td>- Russian Federation</td>
<td>1.1</td>
<td>9.6</td>
<td>872.8</td>
<td>- Spain</td>
<td>21.3</td>
<td>72.2</td>
<td>587.0</td>
</tr>
<tr>
<td>- China</td>
<td>7.7</td>
<td>0.6</td>
<td>7.8</td>
<td>- Bulgaria</td>
<td>13.2</td>
<td>79.5</td>
<td>602.3</td>
</tr>
<tr>
<td>- Turkey</td>
<td>21.2</td>
<td>23.1</td>
<td>109.0</td>
<td>TOTAL BH</td>
<td>43.07</td>
<td>61.71</td>
<td>143.3</td>
</tr>
</tbody>
</table>

Source: calculations based on data base of BH Foreign Trade Chamber for 2002 and 2007.

Only BH trade with other countries has been transformed into inter industry trade with GL Index of 36.04, even though at start of the observed period in 2002, it was dominantly intra industry trade with GL Index of 65.25. Dominant influence on such negative movement had trade with several countries, with which BH record huge deficit in absolute and relative indicators (Switzerland, Turkey, China and Russian Federation). Trade with this country affiliation grows into trade based on competitive advantages, with typical example of unilateral trade with China, as base for cheap outsourcing for BH and Russian Federation as source of supply for natural gas.

4.2. Production dimension of IIT

Changing the focus of the research to certain industries gives the results which fully show the specifics of intra industry trade of BH. Production approach to IIT research gives a more detailed picture of the trade, because the essence of IIT is shown through the trade of products of the same industry. Factors that cause IIT phenomena from production point of view are diversification of production structure, monopolistic status of the product, protected by brands and returns to scale, which promotes specialization, because in some country's industry it is now opportune to produce all sorts of products from possible assortment of certain industry. Producing aspect of IIT is directly relying on microeconomic efficiency of companies from countries that make the trade. Abandoning purely the criteria for competitive advantages as basis for trade, enables the growth within the given environment of domestic...
competitiveness base of the competitive advantages in producing the products of the same industries.

4.2.1. Intra industry trade in certain BH industries

For deeper analysis of IIT by industries, twenty leading industries are extracted based on their place in BH export in year 2007, whose IIT indicators are shown in Table 6. They comprehend 87,0% of the export and 60,0% of the import for BH in year 2007., which means that they represent a relevant background for IIT research.

Twenty of the leading industries according to export rate in BH are observed as aggregate proportion record IIT stage above BH IIT level. GL Index of IIT for that industries in year 2007 amounts 74,6 and is by 24,5% larger from the same index for the year 2002, which amounted 59,9%. It additionally confirms earlier conclusions that the BH foreign trade growth was generated mostly from intra industry trade.

Among observed 20 leading export industries intra industry trade is dominantly present in 14 industries in the year 2007, unlike year 200, when only seven of the observed industries had such IIT status. Those are industries that upgraded their technological level and made diversification of production, and also raised competitiveness and increased the export (SITC marks 25, 28, 41, 48, 61, 62, 64, 68, 72, 73, 74, 76, 84 and 94). In many industries those are initial but important steps, because the IIT level is still low because of the underdevelopment of the elements on which it is based. For example, even though the share of raw aluminium in export industry with SITC mark 76 in year 2007. has decreased to 79,8% from 90,8% in year 2002., it is still a high share which indicates the need to grow the aluminium processing with higher added value and possibilities for employment.

Table 5

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<tbody>
<tr>
<td></td>
<td></td>
<td>Export</td>
<td>Import</td>
<td>GLI</td>
<td>Export</td>
<td>Import</td>
</tr>
<tr>
<td>25</td>
<td>Salt, brimstone; land; stone, plaster; whitewash and cement</td>
<td>6,9</td>
<td>61,4</td>
<td>20,3</td>
<td>30,7</td>
<td>61,7</td>
</tr>
<tr>
<td>26</td>
<td>Mineral, scum and leach</td>
<td>6,7</td>
<td>0,2</td>
<td>6,3</td>
<td>64,4</td>
<td>0,5</td>
</tr>
<tr>
<td>27</td>
<td>Mineral fuel, mineral oil and their sub products</td>
<td>76,9</td>
<td>324,8</td>
<td>38,3</td>
<td>241,7</td>
<td>982,3</td>
</tr>
<tr>
<td>28</td>
<td>Non organic chemical products; organic and nonorganic compounds</td>
<td>1,2</td>
<td>17,8</td>
<td>13,0</td>
<td>110,2</td>
<td>108,1</td>
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<tr>
<td>39</td>
<td>Plastic mass and their products</td>
<td>10,7</td>
<td>126,4</td>
<td>15,6</td>
<td>67,6</td>
<td>275,3</td>
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<tr>
<td>41</td>
<td>Pelt and fell</td>
<td>29,3</td>
<td>11,5</td>
<td>56,3</td>
<td>52,2</td>
<td>107,5</td>
</tr>
<tr>
<td>44</td>
<td>Wood and its products</td>
<td>192,2</td>
<td>39,7</td>
<td>34,3</td>
<td>268,1</td>
<td>88,4</td>
</tr>
<tr>
<td>48</td>
<td>Paper and carton; paper and cellulose products</td>
<td>12,5</td>
<td>85,4</td>
<td>25,6</td>
<td>52,5</td>
<td>131,9</td>
</tr>
<tr>
<td>61</td>
<td>Clothes and kit for clothes, crochet or braided</td>
<td>5,2</td>
<td>24,7</td>
<td>34,7</td>
<td>27,2</td>
<td>52,5</td>
</tr>
<tr>
<td>62</td>
<td>Clothes and kit for clothes, excluding crochet or braided</td>
<td>30,9</td>
<td>43,7</td>
<td>82,8</td>
<td>98,5</td>
<td>74,5</td>
</tr>
<tr>
<td>64</td>
<td>Footwear and its parts</td>
<td>26,5</td>
<td>44,1</td>
<td>75,1</td>
<td>178,3</td>
<td>106,0</td>
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Table 5 (continue)

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<tbody>
<tr>
<td>68</td>
<td>Products of stone, whitewash, cement, concrete and asbestos</td>
<td>4.6</td>
<td>32.2</td>
<td>25.0</td>
<td>26.2</td>
<td>40.7</td>
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<tr>
<td>72</td>
<td>Iron and steel</td>
<td>35.3</td>
<td>82.0</td>
<td>60.2</td>
<td>195.7</td>
<td>39.1</td>
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<tr>
<td>73</td>
<td>Steel products</td>
<td>28.5</td>
<td>87.1</td>
<td>49.3</td>
<td>235.8</td>
<td>199.9</td>
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<tr>
<td>74</td>
<td>Copper and products of copper</td>
<td>7.6</td>
<td>12.7</td>
<td>75.0</td>
<td>36.7</td>
<td>49.0</td>
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<tr>
<td>76</td>
<td>Aluminium and products of aluminium</td>
<td>163.5</td>
<td>33.5</td>
<td>34.1</td>
<td>326.4</td>
<td>114.6</td>
</tr>
<tr>
<td>84</td>
<td>Nuclear reactors, boilers, engine</td>
<td>57.6</td>
<td>360.8</td>
<td>27.5</td>
<td>325.9</td>
<td>782.1</td>
</tr>
<tr>
<td>85</td>
<td>Electrics engine and equipment</td>
<td>22.2</td>
<td>249.1</td>
<td>16.4</td>
<td>81.0</td>
<td>392.6</td>
</tr>
<tr>
<td>87</td>
<td>Vehicle, excluding trains</td>
<td>32.8</td>
<td>210.3</td>
<td>27.0</td>
<td>56.7</td>
<td>455.8</td>
</tr>
<tr>
<td>94</td>
<td>Furniture, bedclothes, mattress, pillow</td>
<td>73.1</td>
<td>79.3</td>
<td>95.9</td>
<td>229.4</td>
<td>118.9</td>
</tr>
<tr>
<td></td>
<td>Total of top 20 export sectors</td>
<td>824.4</td>
<td>1,926.7</td>
<td>59.9</td>
<td>2,705.2</td>
<td>4,181.4</td>
</tr>
<tr>
<td></td>
<td>Total B&amp;H</td>
<td>965.8</td>
<td>3,521.1</td>
<td>43.07</td>
<td>3,108.7</td>
<td>6,966.4</td>
</tr>
<tr>
<td></td>
<td>Share of top 20 in B&amp;H (%)</td>
<td>85.4</td>
<td>54.7</td>
<td>139.0</td>
<td>87.0</td>
<td>60.0</td>
</tr>
</tbody>
</table>

Source: calculation by the author based on data base of BH FTC about BH foreign trade for 2002 and 2007.

In dynamics of IIT development an increase of GL Index can be seen in sixteen out of twenty observed industries. IIT growth is shown in relative export growth in relation to import, decrease of the difference between the export and import, and in growth of total range of foreign trade (SITC marks 25, 28, 39, 41, 61, 62, 68, 72, 73, 74, 84, 85). However, in some industries an extraordinary growth of export causes decrease of IIT mostly because of the faster increase in surplus of traded goods, than the growth of total trade range. By mathematical relation, such movement decreases GL Index, from that point at which deficit outgrows to surplus of trade in goods of a certain industry. Interpretation of the GL Index decrease in such cases depends on the nature of the industry. That is why decrease of GL Index in industry with SITC mark 26 – minerals, scum and leach can be explained with growth of inter industry trade based on competitive advantages, while decrease of GL Index for SITC marks 64 – footwear and 94 – furniture should be treated as growth of IIT based on competitive advantages.

In sector structure of IIT it is possible to aggregate the data of IIT on level of production-market unities, such as metal sector, wood sector, agro sector, energy sector, clothing and footwear sector. Such aggregating is especially useful for overseeing the effects of vertical intra industry trade. For example, the metal sector of BH (industries with SITC marks 26, 72, 73, 74, 76, 84, 85) accomplished export in year 2007 in the amount of 829,4 mil Euro (in the year 2002. Export amounted 321,4 mil. Euro) and import of 1,077,3 mil Euro (in the year 2002. the import range was 825,4 mil Euros). Its GL Index of 87,0 in the year 2007 (GL Index in the year 2002. was 56,1) shows that it is a sector with extraordinary high IIT intensity which is based on development of new competitive advantages within diversification of the production.

5. Conclusions

The results of the research show that the key driver of the BH trade growth is intra industry trade. Unlike the condition in year 2002, when 53% of share in total trade was dominated by inter industry trade, in year 2007 intra industry trade becomes dominant with share in total
trade of 67.01%. These results show that the fundamentals of competitiveness for foreign trade are ever growing sustainable competitive advantages, and that the importance of comparative advantages is decreasing.

Of course, BH will have the need to sustain and develop comparative advantages in industries which are based on natural resources, such as electricity, aluminium, steel, industries with mass usage of unqualified or semi-qualified work and similar. However, these comparative advantages should be developed and transformed into competitive advantages. Since, problem with comparative advantages is that they can be lost quickly, and they are not sustainable in long terms, if they are not advanced in such a way to outgrow to sustainable competitive advantages.

Intra industry trade reflects a growing base of new competitive advantages for BH, and also enables positive impulses for further making of competitive advantages based on larger investment flow (especially in FDI form), technology and know-how, and better knowledge of CEFTA and EU market needs, and larger convergence of production and marketing towards the needs of that market. Industrial and trade policies in BH should be improving the framework for making these competitive advantages, especially bearing in mind three key determinant. First, it is a sense that BH place in global market is not set only by products in which BH has comparative advantages. It has possibilities to compete also in other sectors based on availability of new technologies for standard products, based on strategic partnership and foreign direct investments and other arrangements. Second, IIT provides opportunities for specialization and production according to laws of returns to scale, which are not only determined by quantity of production output anymore, but also the economy in domain of marketing, research, logistics and other factors that bring out the competitive advantages of BH as business location. Third, the possibilities of ensuring resources needed for upgrade of BH competitiveness exist also outside the domestic competitiveness base, whereat regional and EU integration allow the competitiveness base to be built on so called concept double diamond of competitive advantages.

References

NETWORK BUILDING – EXPERIENCE OF EUROPEAN REGIONS

PRZEMYSŁAW WOZNIAK*

EXPERIENCE OF CASE WITH BUILDING NETWORKS

Introduction of CASE

Center for Social and Economic Research CASE from Warsaw, Poland is an independent non-profit institute founded on the idea that research-based policy-making is vital to the economic welfare of societies. Ever since its establishment in Warsaw in 1991 its scholars and researchers have assisted policy-makers during the earlier years of transition in post-communist countries in the CEE and Former Soviet Union. Throughout the decade of the nineties thematic priorities have changed and the challenges inherent in the EU accession process became the centre of CASE’s activity towards the end of the decade. Currently CASE carries out policy-oriented research and development assistance projects, specializing in questions of European integration, post-communist transition, and the global economy.

CASE mission has always been to provide objective economic analysis and to promote constructive solutions to the challenges of transition, reform, integration and development in order to improve the socio-economic well-being of societies. We therefore attempt to disseminate economic knowledge and research results, advise governments, international organizations and the NGO sector, inform and encourage public debate through conferences, seminars, academic internships, and study visits and support the growth and independence of the NGO sector in post-communist countries.

After nearly two decades of its existence CASE identity has evolved in numerous directions: part – international network with affiliates and collaborators spread across the world, part – think-tank with significant research, educational and advocacy activities taking place in Warsaw and in the other cities where CASE organizations are based and finally part development/economic consultancy – seeking to compete successfully for and to implement international research and aid contracts.

CASE multidimensional structure of networks

The institute began building its networks from the early years of its existence in the early nineties. Building networks was a priority from the beginning and a natural consequence of many CASE’s activities. They now lie at the core of its institutional and scientific development. There are at least four dimensions along which CASE built and expanded them.

* Przemyslaw Wozniak, Director, Center for Social and Economic Research-Centre, Poland
First, CASE has created a network of the so-called daughter foundations in the area of FSU in which it was particularly active in the beginning: Ukraine, Moldova, Russia, Transcaucasia, Kyrgyzstan and Belarus. Secondly, in the course of its development and activities expansion CASE became a member of various external research institute networks such as ENEPRI, EUROFRAME, FEMISE, ARETT or ERAWATCH. Thirdly, CASE has also worked on increasing the number and intensifying the cooperation with its network of experts which currently numbers some 1000 people in various countries worldwide. Finally, CASE researchers are encouraged to bring in their own scientific networks which are often key in building research teams for various projects, broadening thematic areas and expanding new funding opportunities.

**CASE Network of daughter organizations**

CASE is a founder or co-founder of a regional network of think tanks in Eastern Europe and CIS countries. It comprises CASE and 6 others institutes:

- CASE Kyrgyzstan (based in Bishkek, created in 1998)
- CASE Moldova (based in Chisinau, created in 2003)
- CASE Transcaucasia (based in Tbilissi, created in 2000)
- CASE Ukraine (based in Kiev, created in 1999)
- CASE Belarus (based in Warsaw, created in 2007)
- IPM Research Centre (Minsk-based and created in 1999)
- IET (Institute for the Economy in transition, based in Moscow, created in 1991)

All institutes are independent from CASE but as a group they represent our continued efforts to increase the range and quality of economic information available to decision-makers and the public across the post-communist world, as well as to foster vibrant civil sectors in these societies. CASE cooperates regularly with its daughter organisations, mainly through joint projects (most notably research grants of Polish Ministry of Foreign Affairs, or regional studies funded by the WB, UN or EC) and publications: CASE Network Studies & Analyses (since 1993) and CASE Network Reports (since 2002).

**CASE External Networks**

CASE is an institutional member of six external networks:

ENEPRI – The European Network of Economic Policy Research Institutes brings together 24 leading national economic policy research institutes from most of the EU-27 countries. The goals of the network are to foster the international diffusion of existing research, coordinate research plans, conduct joint-research and increase public awareness of the European dimension of national economic policy issues. ENEPRI is one of the primary avenues through which CASE participates since its membership in 2002 in pan-European research projects focused on health and social policy issues. In 2007, our researchers worked alongside ENEPRI partners in the AHEAD and AIM projects. ENEPRI is coordinated by the Brussels-based Centre for European Policy Studies (CEPS).
EUROFRAME-EFN: EUROPEAN FORECASTING NETWORK (EFN) brings together ten of the most respected economic forecasting and research institutes in Europe to produce twice-yearly reports on the euro area for the European Commission's Directorate General of Economic and Financial Affairs. The reports include economic forecasts, policy monitoring and coverage of special policy topics. CASE joined EUROFRAME-EFN in late 2007 after contributing to specific EUROFRAME-EFN projects from 2005 onward. The network is coordinated by the Economic and Social Research Institute (ESRI) in Dublin.

FEMISE – FORUM Euro-Méditerranéen des Instituts Économiques is a Euro-Mediterranean network which brings together more than 70 independent economic institutes from across the European Union and Middle East and North African regions to conduct socio-economic analysis of the Euro-Mediterranean Partnership. CASE joined FEMISE in October 2006 and began to actively participate in FEMISE activities in 2007. FEMISE is coordinated by the Institute for the Mediterranean in Marseille and the Economic Research Forum in Cairo.

ERAWATCH is a European web-based service that supports evidence-based policy making in Europe and contributes to the realization of the European Research Area (ERA). The ERA aims to create a more coherent science and technology environment across the European Union through improved coordination of existing and future member states' national scientific and technology capacities. The overarching objective of this network covering 43 countries is to provide knowledge and a better understanding of national and regional research systems and of the environment in which they operate. CASE is an associate member of ERAWATCH. The network is a joint initiative of the European Commission's Directorates-General for Research and Joint Research Centre – Institute for Prospective Technological Studies (IPTS) in Seville, Spain, in collaboration with CORDIS.

ARETT – The Association of Russian Economic Think Thanks was created in 2002 in Moscow to bring together scientific and research institutes and not-profit organizations, as well as teams of researchers studying economic policy. CASE joined ARETT in the fall of 2004 as an observer.

PASOS – The Policy Association for an Open Society supports the development and strengthens the outreach and impact of its 31member policy centres and five Associate Members. Since its establishment in 2003 in Prague, members provide policy advice to the European and Central Asian decision-makers and international organisations on issues as diverse as human rights, economic development, legal reform, management of governmental reforms, social policy, education, health, religion, international co-operation, small enterprise development, public participation and public sector management. CASE joined in 2007.

In 2007, we continued to support the Association of Polish Non-Governmental Organizations known as 'Grupa Zagranica'. This is a group of 40 Polish organizations which are united by the international scope of their work and by their aim to educate and inform Europeans about the needs of people living in developing countries. Grupa Zagranica in turn gave us valuable support in developing the concept behind the Fostering Global Responsibility project that we launched in the beginning of 2008 and that focuses on increasing understanding of the European Union's international development agenda in the new member states.
**CASE Network of researchers**

This is probably our biggest asset – CASE network of researchers from many countries in nearly all continents. There are the experts who have taken part in one of hundreds of our projects in any capacity – as team leaders, coordinators, consultants or administrative staff. They may have worked in advisory, research or technical assistance projects, and have different backgrounds and experience (academics, consultants, former IMF/WB economists, etc.). The size of the network (currently around 1000) expands with time as more projects means longer experts list. Recently more and more experts found out about CASE and contact us directly.

With such a large community of cooperating researchers maintaining good contacts and staying in touch is vital. We make sure that we communicate project involvement opportunities either through e-mail lists or individual targeted e-mails. Several e-mail lists are used – INTERNAL, EKSPERCI, EXPERTS – depending on the location, interests of experts or their proximity to CASE. Researchers also receive the minutes from the weekly application team meeting with most up-to-date information on project opportunities.

**CASE Informal networks**

Every cooperating researcher has his/her own network and very often shares it with CASE. These networks are based on common research projects or sometimes even private contacts made during conferences, workshops, study tours, various courses and trainings. The efficiency of this source of networking at CASE is hard to measure precisely but undoubtedly has been very valuable for its development over the years. It has also resulted in establishing good connections with a number of worldwide befriended institutions (mostly in Europe and the FSU).

**Final Comments**

As can be seen from the above review networks are of crucial importance for CASE. In fact CASE as an institution has a purely network structure – so talking about CASE is equivalent to talking about its various networks. CASE network of researchers and institutions contribute to its growing research output and advisory activities and are the primary source of endogenous growth. This growth occurs through experts and befriended institutions taking new project initiatives and working independently or cooperating on common project applications. They are also a potentially very good source of information about new funding opportunities – independent of CASE’s own application team who investigates such opportunities on a regular basis.

However, building and expanding networks has not been an easy task. This especially concerns the first two networks – CASE daughter organisations and external networks. In the case of the former, it has often been difficult to maintain their financial viability as well as ensure the necessary portfolio of projects. In case of the latter – external networks – joining them was impossible for CASE for a number of years due to the insufficient track record and/or too small a size of the institute and inadequate administrative capacity. Being a
member in a network can also be costly (due to official charges or costs of maintaining official contacts) which has to be taken into account while doing the cost-benefit analysis. On a broader level the network structure may be challenging due to high turnover of cooperating experts, inherent asymmetry of information and problems with retaining highly qualified staff.

Overall CASE’s experience with building networks has been very positive. We strongly believe in the efficiency of such structures especially in the area of economic and social research, policy advice and various kinds of technical assistance. Our networks provide us with a much larger quantity of experts to be potentially used in our activities than any NGO-type institution could effort to employ. We can therefore afford to better match needed skills and competences with the requirements of various tasks and projects. We believe that in a globalised world this is indeed the best way to go in order to provide high quality research and expertise. On the downside we can mention that one of the biggest problems may be the asymmetry of information inevitable in contacts with a 1000+ community of researchers. However, continued cooperation and involvement of new experts in new initiatives as well as improved instruments for investigating experts qualifications gradually diminishes the severity of this problem. Our experience has taught us that the commitment to quality and high standards in our research output is the best way to attract top scholars and practitioners.