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**Research Report**

## Development cooperation and stability in South-Eastern Europe: a Herculean or a Sisyphean task?

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## Development Cooperation and Stability in South-Eastern Europe: a Herculean or a Sisyphean Task?

*Development cooperation will play an important role in the stabilization of South-Eastern Europe. Under the "Stability Pact for South-Eastern Europe" German development cooperation faces the major challenge of contributing to the EU's emerging common foreign and security policy (CFSP) - both bilaterally and through political representation in multilateral institutions.*

- *In view of the large number of participants in the Stability Pact efficient donor coordination is needed. To this end, new institutions have quickly been created, although their powers are not yet entirely clear. Coordination will work only if the interest of all participants in the Stability Pact's success outweighs particularist interests. For the coordination of German development cooperation it will be crucially important (i) to reconcile the differing interests of German actors and (ii) to ensure integration into a coherent reconstruction strategy coordinated by the EU and the World Bank.*
- *The short-term objectives of development cooperation are emergency assistance, the restoration of basic infrastructure, the provision of balance-of-payments support, and budgetary aid. Given the recipients', and especially Kosovo's, limited borrowing capacity, such aid should take the form of non-refundable grants. For procurement preference should be given to local supplies and services in order to strengthen self-help capacities and stimulate the development of local economic potential.*
- *The medium-term objective of development cooperation is sustainable, self-perpetuating development in the region. The foundations for this have to be laid through democratization, the development of the administration and legal system, and the strengthening of the education system. Kosovo's development prospects are limited. This makes it all the more important for reconstruction to stimulate the regional economy. German industry's commercial interests should be subordinated to this objective. Concentration on a few, internationally agreed areas would increase the efficiency of German development cooperation.*
- *The gravest problem for aid to South-Eastern Europe will be the poor absorptive capacity, i.e. an inadequate environment for the appropriate use of funds. It is essential that aid commitments are geared not to calculated needs but to the actual spending opportunities created by reforms. Politically motivated pressure to disburse funds should be avoided because it would encourage corruption and mismanagement and reflect badly on the Stability Pact. An innovation would be country funds into which the donors each year paid resources that would not necessarily have to be spent in the financial year concerned, but could be saved for a future use (accumulating country funds). This would give the recipient countries an incentive to create an environment in which these resources can be put to good use.*
- *In the long term the countries of South-Eastern Europe should have the prospect of acceding to the EU. Early accession, however, is not a realistic option for stabilization. It would hamper the development of competitive enterprises in the region and harm the EU's currently high standing in South-Eastern Europe. The aim should be rather to make gradual integration possible by means of tailored stabilization and association agreements and to formulate the conditions for EU membership in more practical terms and so give South-Eastern Europe clear and reliable signs of what is needed.*

### Stability for South-Eastern Europe and the role of development cooperation

Reconstruction and development are the keys to the lasting stabilization of South-Eastern Europe. Development cooperation will have an important role to play in this. The World Bank believes the international community faces a "Herculean task", while the head of the UN Civil Administration in Kosovo, Tom Koenigs, fears it will be a "Sisyphean task". The difficulties are mainly due to Kosovo's political status still being unclear and also to the large number of international actors and institutions wanting to make their contribution to stabilization.

On 30 July 1999 the Sarajevo summit reaffirmed the **Stability Pact for South-Eastern Europe**, which had been concluded on 10 June on the initiative of the European Union - and especially German foreign policy

(see the box below). The intention underlying this initiative is that the Union's CFSP should play the leading role in reconstruction in South-Eastern Europe, a role it was unable to play in bringing peace to Kosovo or to Bosnia and Herzegovina.

The Stability Pact aims "at *strengthening countries in South Eastern Europe in their efforts to foster peace, democracy, respect for human rights and economic prosperity, in order to achieve stability in the whole region*" (Article 9).

The most important institution of the Stability Pact is the South-Eastern Europe Regional Table chaired by Special Coordinator Bodo Hombach (with its seat in Brussels). The Regional Table oversees three Working Tables for (i) security questions, (ii) democratization and human rights and (iii) economic reconstruction, economic development and cooperation.

Moreover, a **joint EU-World Bank coordination mechanism** was adopted for South-Eastern Europe at the G7's spring meeting with the international financial institutions (IFIs). Coordination is achieved through a joint office in Brussels and at meetings of a High-Level Steering Group (G7 finance ministers and IFIs).

**Reconstruction in Kosovo** occurs under the aegis of the

#### Participants in the Stability Pact:

- the EU Member States, the European Commission and the European Council,
- the countries of South-Eastern Europe, with the exception of Yugoslavia, viz. Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Romania, Slovenia, Macedonia and Hungary,
- the USA, Japan and Canada,
- the Russian Federation,
- Turkey,
- the Organization for Security and Cooperation in Europe (OSCE),
- the UN and its relief agency for refugees (UNHCR),
- NATO and the Western European Union (WEU),
- IMF, World Bank, European Bank for Reconstruction and Development (EBRD), and European Investment Bank (EIB),
- OECD,
- various initiatives for cooperation and integration in South-Eastern Europe.

UN Mission (UNMIK) headed by Bernard Kouchner. It covers the four civil areas of (i) development of the administration (lead agency: UN), (ii) return of refugees (UNHCR), (iii) democratic development (OSCE) and (iv) economic reconstruction (EU).

The EU has dispatched a Task Force (TAFKO) to Kosovo. Its functions will later be taken over by the new **European Agency for Reconstruction** (which will have its seat in Thessaloniki and its operating unit in Prishtina). The European Bank for Reconstruction and Development (EBRD) and the European Investment Bank (EIB) are preparing for an extensive commitment to South-Eastern Europe.

The Federal Republic of Germany is planning to appoint a representative for Kosovo. Its Ministry for Economic Cooperation and Development (BMZ) has set up a Working Group on the Reconstruction of South-Eastern Europe (AWS) consisting of representatives of the German development bank Kreditanstalt für Wiederaufbau (KfW), the German Agency for Technical Cooperation (GTZ) and the German Finance Company for Investments in Developing Countries (DEG). The Working Group has an office in Prizren (GORED), where a German Foreign Office coordination staff unit for reconstruction in Kosovo also operates.

Given the large number of institutions involved, **donor coordination** will work only if the interest of all participants in seeing the whole Stability Pact succeed outweighs any particularist interests.

The coordination of German development cooperation must ensure two things in particular: (i) a balance of the individual interests of the government departments and implementing organizations involved, a lesson learnt from the TRANSFORM programme for central and

Eastern Europe, and (ii) the integration of the German development cooperation contribution into a coherent reconstruction strategy agreed at the upper levels of coordination.

#### Direct and indirect war damage in the countries of South-Eastern Europe

The countries of South-Eastern Europe (see the box on page 3) have been affected by the war to different degrees. A distinction can be made between countries that have suffered direct war damage (mainly the Serbian part of Yugoslavia and Kosovo) and the neighbouring countries, which have suffered indirectly (Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Macedonia and Romania).

**Direct war damage** is largely confined to Yugoslavia. NATO bombed communications, energy supply and industrial facilities. In Kosovo damage to infrastructure was accompanied by the extensive destruction of rural and urban life support systems (farms, housing) due to ethnic cleansing. Some of the area is mined.

**Indirect war damage** takes the following forms:

- Costs for refugees: Albania, Macedonia and Bosnia and Herzegovina were and remain the main recipient countries for Kosovar refugees, many of whom have returned to Kosovo by now.
- Slump in trade, tourism and transport: Bosnia and Herzegovina and Macedonia have lost most of their Yugoslav export market. Croatia's reviving tourist industry has again suffered. Romania and Bulgaria have been forced to use new, more costly transit routes for their foreign trade.
- Loss of confidence by foreign investors: The renewed instability in South-Eastern Europe has frightened off foreign direct investors and increased the risk premiums for the region's financing instruments in the international capital markets.
- Suspension of structural reforms: Owing to the financial burdens, some governments in South-Eastern Europe are likely to have difficulty pressing ahead with the reform measures that are needed.

Indirect damage is expected to result in losses of growth in Yugoslavia's neighbours, with Bosnia and Herzegovina and Macedonia hardest hit, followed by Bulgaria and Croatia.

#### Short-term objectives: alleviating the consequences of war and restoring the basic infrastructure

In the next few months the international community must address four priority areas:

- care of refugees and returnees;
- restoration of local basic infrastructure (housing, municipal services and utilities, agriculture);
- development of administrative structures;
- alleviation of the indirect consequences of war with balance-of-payments and budgetary aid.

Whenever possible, these measures should take the form of **non-refundable grants** so as not to increase the recipient countries' debt burden.

For procurement preference should be given to **local supplies and services**. This will strengthen self-help capacities and stimulate the development of local economic potential.

### Medium-term objectives: transformation and sustainable development

The medium-term goal is **sustainable, self-perpetuating development** in South-Eastern Europe through the reconstruction of the industrial infrastructure and economic transformation. It does not differ fundamentally from the objectives pursued with the donor programmes in support of transformation that have been in operation since the early 1990s.

Economic success will be possible only if the following requirements are also satisfied:

- democratization with a view to replacing corruption with transparent and equal opportunities for everyone and promoting the integration of society;
- an efficient administration that is willing to reform and creates a business-friendly environment including a simple, transparent tax system;
- an efficient legal system that protects property rights and so makes foreign direct investment attractive;
- a modern education system that teaches the skills needed in an industrial and service economy.

Of particular interest are **prospects for the development of Kosovo**, which was the poorest part of Yugoslavia even before the war. Much of the population was engaged in small-scale and subsistence farming. The energy sector (brown coal production and hydroelectricity, largely for supply to other parts of the country) and the mining of non-ferrous metals in the northern part of the country have given rise to some "industrial islands", which do not, however, offer much scope for development. With the political issues unsettled, the potential for direct investment will remain limited for the time being. Kosovo's borrowing capacity must therefore be rated extremely low.

It is therefore all the more important for the medium-term strategy to be so formulated that it has **employment and income effects in the region**. In Bosnia and Herzegovina the reconstruction work financed by donors has become the country's main engine of growth - although it has yet to generate any self-sustaining growth. As with emergency aid, local supplies and services should be preferred to turn-key supplies from the donor countries so as to encourage the local economy.

Conflicts with German industry's interest in supplying goods and services may occur in this area. Development cooperation must give clear **priority to the foreign policy objective** of stabilizing regional development. It would be at its most efficient if it participated in the sectoral programmes coordinated at EU/World Bank level. **Concentration** on a few focal areas is advisable in this context.

### Financing needs and absorptive capacity

There is as yet no final assessment of the resources that will be needed for reconstruction in South-Eastern Europe. So far the **total reconstruction aid requirement** has been estimated at US\$ 30 to 100bn over a 10-year period.

In May 1999 the IMF calculated the following provisional financing needs for Kosovo's six most affected neighbours (Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Macedonia and Romania):

- US\$ 400 to 760m in humanitarian assistance;
- US\$ 1.1 to 1.7bn in balance-of-payments aid;
- US\$ 530 to 750m in budgetary aid.

The figures being mentioned for Kosovo are around US\$ 3.5 to 5bn, which would have to be raised primarily

### Unequal development in South-Eastern Europe

[EBRD reform ranking of countries in transition; per capita income in 1998]

**Hungary** [Rank 1; US\$ 4,727] and **Slovenia** [Rank 6, US\$ 9,826] are the most advanced countries in the region and are negotiating with the EU on their accession.

**Bulgaria** [Rank 12; US\$ 1,700] and **Romania** [Rank 16; US\$ 1,697] have not achieved this objective because of shortcomings in their economic reforms and will probably be candidates for the subsequent enlargement of the EU.

**Croatia** [Rank 9; US\$ 4,477] and **Macedonia** [Rank 13; US\$ 1,663 (1997)] have advanced only slightly further than Bulgaria and Romania.

**Albania** [Rank 19; US\$ 952] is the poorest country in the region; after a period in which it was in danger of disintegrating, it has achieved no more than makeshift consolidation.

**Bosnia and Herzegovina** [Rank 23; US\$ 972] can be called a "state" only as defined by the criteria of international law. In fact, the international administration forms no more than a tether around the Serbian and Muslim-Croat parts of the country, which continue to drift apart.

**Yugoslavia** [not included; US\$ 1,240] has lost the former republics of Slovenia, Croatia and Bosnia and Herzegovina. It isolated itself politically and economically at international level by resorting to ethnic "cleansing", first during the wars with Croatia and Bosnia and Herzegovina, then in Kosovo. It will remain excluded from reconstruction aid for the foreseeable future. The Republic of Montenegro is pressing for a more independent role.

**Kosovo** is even poorer than Albania. Its future status in the Yugoslav federation is unclear. At present the most important sovereign functions are being performed by an interim UN administration (UNMIK) and an international military security presence (KFOR).

by bilateral donors and the EU. Kosovo cannot be allocated any IMF or World Bank credits for the time being because Yugoslavia is no longer a member of these institutions. The World Bank, however, has paid US\$ 60m in grants from its net profit into a **trust fund** for the next 18 months. The fund is intended to cover the wages and salaries of the employees of Kosovo's administration and public services.

The first international donor conference on 28 July 1999 pledged aid of initially US\$ 2.2bn for Kosovo. The largest shares of this will be provided by the US (US\$ 557m) and the EU (US\$ 534m). The EU has announced its willingness to provide Euro 500m for the next four years.

Some donors are now correcting their estimates of financing needs downwards. The outgoing EU Commissioner for economic and financial policy has said that the destruction in Kosovo is probably less than assumed. The EBRD points out that **rapid reconstruction is hardly possible** because of the lack of partners and industrial structures.

Even if these statements conceal a desire to save, the main **dilemma for reconstruction aid** remains the same: aid to Eastern Europe in the past has been successful only where there has been a local willingness and appropriate institutional capacities to undertake reforms. Currently, Romania, for example, is having

problems meeting the conditions attached to the IMF and World Bank credits it was allocated before the reconstruction programme. Although additional lending commitments may bridge any bottlenecks that emerge in the short term, they are no substitute for reform efforts by the countries of South-Eastern Europe themselves.

Bosnia and Herzegovina makes it particularly clear that the capacity for absorbing aid in a chaotic political environment is limited. It is therefore essential that aid commitments be geared not to calculated needs but to actual spending opportunities created by reforms and that this view be put forward in public.

It is at all events important that donors should **avoid any politically motivated pressure to disburse resources**. Headlines about rapid, but inadequately monitored aid to South-Eastern Europe encouraging corruption and rent-seeking would do irreparable damage to the Stability Pact.

An innovation would be country funds into which the donors each year paid resources that would not necessarily have to be spent in the financial year concerned, but could be saved for a future use (**accumulating country funds**). This would give the recipient countries an incentive to create an environment in which these resources can be put to good use.

### **Prospects for the South-Eastward enlargement of the EU**

In recent weeks there has been a growing debate about the promotion of stability in South-Eastern Europe by accelerating accession to the EU. The hope associated with this is that the EU's stability will spread to the region.

Politicians committed to reforms will undoubtedly find local support in a clear and reliable **prospect of EU membership** for their countries. Precipitate accession, however, will benefit neither the countries of South-Eastern Europe nor the EU. None of the countries of South-Eastern Europe yet satisfies the five Copenhagen criteria for accession:

- (i) democracy and the rule of law;
- (ii) market economy;
- (iii) competitiveness in the internal European market;
- (iv) adoption of the *acquis communautaire* and agreement with the goals of political union and economic and monetary union;
- (v) the EU's capacity to absorb new members while maintaining the momentum of EU integration.

Some countries of South-Eastern Europe and Kosovo still have shortcomings as regards the democracy and rule of law criterion, and the question is whether early EU membership would lead to positive adjustment in these countries or to a relaxation of EU standards. It

makes sense, however, to expand development cooperation programmes under which legislation in South-Eastern Europe is already being aligned with EU law.

The main problems are the market economy and competitiveness. An early entry into the internal EU market would give these economies a violent shock and so jeopardize the hoped-for revival of the regional economy. The EU had good reason not to include Bulgaria and Romania among the candidates in the first round of accession negotiations. Conditions have since only slightly improved.

In the short term all that matters is to show what conditions countries of South-Eastern Europe have to satisfy in the interests of both sides if they are to accede to the EU. Speculation about early accession awakens in these countries expectations that are based not on a sober analysis of costs and benefits but on rather vague hopes of prosperity. As early accession would entail substantial adjustment costs, the EU could hardly help but see its standing decline in South-Eastern Europe - especially as there are no funds for generous transfer payments.

Reviving the regional linkages would be wise, given the proximity of the markets and similar quality standards, and might be promoted by the EU's development cooperation programmes. As at the time of the Soviet Union's collapse, however, it is not economic considerations but political factors geared to division rather than regional integration that now determine what action is to be taken in the region. However, the countries of South-Eastern Europe are already gearing their trade closely to the EU.

The realistic prospect is therefore one of enabling the gradual convergence of individual sectors by means of tailor-made stability and association agreements. Non-reciprocal trade concessions would then have to be granted for a transitional period. The EU agricultural markets in particular would have to be opened quickly to small regional economies such as Kosovo. Conversely, regional agriculture in South-Eastern Europe should be protected in the near future.

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#### **Additional readings**

**World Bank / European Commission** (1999): *Economic Reconstruction and Development in South East Europe* (regularly updated information available at <http://www.seerecon.org>)

**Wittkowsky, A.** (1999): *Transition, Governance, and Aid – The Dilemma of Western Assistance to Slowly Transforming Countries*, GDI, Berlin (forthcoming)