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## Economic Growth, Reconstruction and Development in Southeast Europe: What Prospects after a Decade of Decline?

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# The wiiw Balkan Observatory

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*Rumen Dobrinsky*

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# The wiiw Balkan Observatory

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## *About*

Shortly after the end of the Kosovo war, the last of the Yugoslav dissolution wars, the Balkan Reconstruction Observatory was set up jointly by the Hellenic Observatory, the Centre for the Study of Global Governance, both institutes at the London School of Economics (LSE), and the Vienna Institute for International Economic Studies (wiiw). A brainstorming meeting on Reconstruction and Regional Co-operation in the Balkans was held in Vouliagmeni on 8-10 July 1999, covering the issues of security, democratisation, economic reconstruction and the role of civil society. It was attended by academics and policy makers from all the countries in the region, from a number of EU countries, from the European Commission, the USA and Russia. Based on ideas and discussions generated at this meeting, a policy paper on Balkan Reconstruction and European Integration was the product of a collaborative effort by the two LSE institutes and the wiiw. The paper was presented at a follow-up meeting on Reconstruction and Integration in Southeast Europe in Vienna on 12-13 November 1999, which focused on the economic aspects of the process of reconstruction in the Balkans. It is this policy paper that became the very first Working Paper of the wiiw Balkan Observatory Working Papers series. The Working Papers are published online at [www.balkan-observatory.net](http://www.balkan-observatory.net), the internet portal of the wiiw Balkan Observatory. It is a portal for research and communication in relation to economic developments in Southeast Europe maintained by the wiiw since 1999. Since 2000 it also serves as a forum for the Global Development Network Southeast Europe (GDN-SEE) project, which is based on an initiative by The World Bank with financial support from the Austrian Ministry of Finance and the Oesterreichische Nationalbank. The purpose of the GDN-SEE project is the creation of research networks throughout Southeast Europe in order to enhance the economic research capacity in Southeast Europe, to build new research capacities by mobilising young researchers, to promote knowledge transfer into the region, to facilitate networking between researchers within the region, and to assist in securing knowledge transfer from researchers to policy makers. The wiiw Balkan Observatory Working Papers series is one way to achieve these objectives.

**Economic Growth, Reconstruction and Development in Southeast Europe:  
What Prospects after a Decade of Decline?**

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The views expressed in this paper are the personal views of the author and not necessarily those of the organization he is affiliated with.

## 1. Introduction

The striking divergence in the patterns of economic performance among the countries undergoing a transition from plan to market has been a distinctive feature of the process of economic transformation throughout the past decade. However, the conceptual understanding of the systemic features of this transitional divergence has not been unequivocal. Initially – and following the prevailing mainstream transformation paradigm – when analyzing the characteristics of this divergence, considerable attention was focused on the aspects related to macroeconomic stabilization and price performance. Accordingly, the success in achieving price disinflation was usually taken as one of the basic criteria in placing a transition economy into the group of “fast” reformers; conversely, the failure to do so (perceived to be revealed by persistent macroeconomic instability and chronic high inflation) was considered as synonymous to the lack of progress in economic transformation. By this token, most of the Southeast European transition economies (SETE) fell into the latter category while the countries of Central Europe (CETE – the Central European transition economies) qualified as a rule as advanced reformers.<sup>1</sup>

While economic performance in these two regions was undoubtedly highly divergent during the course of transition, the difference in the growth patterns has recently surfaced as one of the main characteristics of this dividing line. Indeed, most SETEs (with the exceptions of Romania and Yugoslavia) have made considerable progress towards macroeconomic (in particular price) stability, especially during the last several years; however so far this has not been sufficient to set them on the path of healthy and sustained recovery. In fact, probably it would not be an exaggeration to claim that some SETEs have not yet departed from the phase of transformational depression.

However, the fact that all SETEs have displayed a low growth potential is not to be interpreted as a sign of homogeneity of this region. Although there are similar features in the economic performance of these countries, the underlying factors may be rather different across countries. Thus the series of wars leading to the continuing bloody disintegration of former SFR Yugoslavia has been by far the primary factor that has dominated both the

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<sup>1</sup> Throughout this paper “SETE” is defined as the group of countries including Albania, Bulgaria, Bosnia and Herzegovina, Croatia, Romania, The former Yugoslav Republic of Macedonia (FYROM) and Yugoslavia while the group defined as “CETE” comprises the Czech Republic, Hungary, Poland, Slovakia and Slovenia.

political and the economic life in many of the successor states. The nature of war-related economic damage or the economic losses due to maintaining a war economy are completely different from the damage resulting from economic crisis (however deep and persistent it can be). One feature though, which is indisputably common to this group of countries is the geography and history that they share. Somewhat misfortunately for all of them these common features are often being associated with the terms “Balkans” and “balkanisation” which probably emanate in a compressed the controversial (if not openly negative) attitude of the outside world (investors included).

Notwithstanding the differences and the country specificity, the regrettable fact is that during the past decade the SETEs have experienced an unprecedented degradation in incomes, standards of living and quality of life. Within a tiny historic period of several years – which, ironically was a period of “great expectations” of better life by the population – these countries have regressed backwards the equivalent of decades of economic development. This highly deplorable outcome – although not necessarily having occurred for the same reasons – has been a common feature for the whole Southeast European region.

## **2. Economic growth in Southeast Europe: a longer-term perspective**

Historically the south-eastern part of Europe has always been among the least developed regions in Europe. Located on the periphery of the continent, it remained largely underdeveloped until World War II. In turn, the process of industrialization that took place in over four decades of communist rule was not soundly based; investment decisions did not reflect comparative advantage and expected market returns but rather the arbitrary preferences of central planners. It is instructive though to take a look at longer-term developments in order to put the events of the past decade into perspective.

The long-term changes in per capita income levels of the SETEs relative to a control country or group of countries are probably most indicative of the changes in the relative economic standing of this group of countries (in terms of catching-up or falling behind). To illustrate this I have shown the changes in GDP per capita in some of the SETEs relative to the average of the 15 present EU-member states during the period 1950-2000 (figures 1 to 5). The data used for this exercise are taken from four different studies conducted at four different points in time: three studies undertaken by the UN ECE on the evaluation of comparative GDP levels involving the then centrally planned economies of Eastern Europe

(see ECE, 1993) and the results of the latest European Comparison Programme (ECE, 1999b) which has provided estimates of comparative GDP figures for most of the transition economies on the basis of PPPs for the year 1996. The results from the first three studies have been used to compute the relative per capita GDP figures shown on the figures for the period 1950-1985 (such estimates exist for each of the reference years in this period) while the ECP'96 data which exist in the form of a single point estimate have been extrapolated for the period 1985-2000 on the bases of the officially reported growth rates (projections are used for the last two years).<sup>2</sup>

Crude and tentative as such estimates may be, they are indicative of the major direction of the economic processes that were underway during these five decades. In fact, the SETEs have displayed quite similar long-term trajectories, featuring three distinct phases: starting from a relatively low starting positions, the SETEs experienced a period of relatively fast catching-up between 1955 and 1975 while the decade between 1975 and 1985 was in general featured by a status quo. However, during the latest phase (which started already in the 1980s and continues up-to-date) these countries have been rapidly falling behind, not only wiping away all of what had been achieved during the previous 3-4 decades but resulting in an unprecedented erosion of both the relative and the absolute income levels of the countries of this region. In turn, the CETEs in aggregate did not experience a catch-up during the 1950s-1970s; on the other hand during the transition they started to recover faster and since 1995 there has been some catch-up with western Europe.

The deep economic problems that the transition economies in south-eastern Europe have been facing since the start of their economic and political transformation are complex and interrelated. Facing serious locational disadvantages (being geographically remote from the most important west European markets), the regional economy had been additionally destabilized by the breakup of the former SFR Yugoslavia, and the ensuing conflicts in Croatia, Bosnia and Herzegovina, and Kosovo. The negative side effects of UN sanctions on Yugoslavia were particularly detrimental for many SETEs and in effect amounted to a strong external shock that added to an already severe transformational recession. Military conflicts,

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<sup>2</sup> A strong word of caution is needed as regards the accuracy of these estimates (especially those related to the past) as none of the methods that have been or are being used for computing comparable cross-country output and income levels can guarantee 100% reliable estimates. Thus the estimates shown on figures 1-5 (which are based on different methods for the two sub-periods) in some cases display striking discrepancies (such as for example in the case of Bulgaria – figure 2).

political unrest and general instability in the region have been a strong deterrent to FDI in the region; the countries of south-eastern Europe never became an attractive destination for FDI, unlike the not-so-distant central European transition economies. Regional trading links, never very strong, have been broken during a decade of military conflicts and economic sanctions, and there are now many barriers to their restoration, a factor which adds to the disincentives for significant FDI in the region.

In fact, the decade of the 1990s in south-east Europe has been one of sharp economic decline. Basically the SETEs have not managed to emerge from the transition depression and to embark on a path of sustained growth. The contrast in the trends of economic growth between SETE and CETE during the nineties is especially striking (table 1 and figures 6-8). The transformational recession in the central European economies lasted for some 3-4 years and after 1993 they began to recover (the Czech recession of 1998-99 can be regarded as belonging to a new cycle). The depth of the total output decline in these countries varied, but at the lowest point was roughly between 75 and 85 per cent of the pre-transition (1989) level. By 1999, GDP in most of these countries has regained its 1989 level, while in Poland it had already surpassed its pre-transition level in 1996 (figure 8). In contrast, the cumulative decline of GDP in the south-east European economies was much greater and in 1998 it was still considerably below the 1989 level (with the exception of Albania which had the lowest starting point anyway).

As a result of these developments, the income disparities vis-à-vis the rest of Europe have not only failed to narrow in the 1990s but have increased substantially. In terms of income levels, the economies in south-eastern Europe have always been lagging behind the rest of Europe but during the nineties they became still poorer both in relative and in absolute terms: as noted, the gap in per capita income relative to both the EU and CETE has increased considerably. The fact is that by 2000, the relative income position of SETE as a whole vis-à-vis the EU-15 will be considerably worse than it had been in 1950 (figure 5). A similar trend can be observed comparing the aggregate long-term performance of SETE with that of CETE: after narrowing considerably during the 1960s and 1970s, the gap widened in the 1990s and by 2000 the relative income disparity between SETE and CETE as a whole will be comparable over even larger than it had been in 1950.

Indeed, as a result of the widening of the income gap during the past decade, the difference in average GDP per head (on PPP basis) between SETE and CETE is comparable to that between CETE and the EU average. In other words, the SETEs have as much to do to



catch up with the current CETE average income level, as the CETEs have to do in order to catch up with the EU average. The time required for such a catching-up to occur is somewhat alarming: unless the current trends in economic performance are decisively broken, it will take decades, even on the more optimistic scenarios, for these poorest European countries to reach only the mediocre level of per capita income currently enjoyed by the more advanced CETEs.

It should be stressed that Yugoslavia occupies a special position in the context of the south-eastern region of Europe. Being one of the relatively large economies and strategically located on some of the main transport routes to western Europe, it is both an important market for neighbouring countries and an important transit country. However the Yugoslav economy has been in a parlous state for a long time. Following the second oil shock in 1979 the economy was virtually stagnant for most of the 1980s; it then suffered from the break-up of the former SFR of Yugoslavia, leading to the loss of markets, economies of scale, etc., and then from four years of conflict and international sanctions.

During the period 1989-1993 (when the break-up of the SFR Yugoslavia took place) GDP in the Federal Republic of Yugoslavia plunged by almost 60 per cent (figure 7). With the public finances in a chaotic state, in 1992-1993 there was a period of hyperinflation of a magnitude that was unprecedented in history. Although a period of modest recovery followed thereafter, the cumulative output decline in Yugoslavia was probably the largest among all the central and eastern European transition economies (with the possible exception of Bosnia and Herzegovina, for which no reliable data are available). Moreover, as a result of the enormous economic damage incurred during the Kosovo war, per capita income levels in Yugoslavia plunged further making it one of the poorest (in relative terms) countries in Europe.

The process of economic and political transformation that was under way, at varying rates and with varying degrees of success, in most of the other transition economies never got started in Yugoslavia. The persistence of military conflict and external economic sanctions were used by the authorities to justify the maintenance of a strong administrative grip over the economy which became even tighter during periods of open conflict. The long periods of conflict and external sanctions led to a vicious circle of reform stalemate and deteriorating economic performance and perpetuated a very specific economic regime in Yugoslavia, somewhat similar to an economy on a war-footing. Despite mimicking some reforms (such

as partial privatization), Yugoslavia has basically remained a non-starter in the process of economic and political transformation.

### **3. Economic self-destruction and the transformation growth trap**

The primary determinant of the dramatic falling behind of SETE (and, in general, to the growing income disparities during the transition) has been the drastic – and differentiated across countries – reduction of the growth potential of these transition economies caused in the first place by an absolute decline in the available and employable production factors. The knock-on effect of price and trade liberalization and the opening to global competition was equivalent to the erosion of a large share of the existing physical and human capital and hence in considerable losses in output generating capacity.<sup>3</sup> The growth potential of the different former centrally planned economies – which were seemingly similar and uniform in the past – turned out to be quite different during the transition period.

One of the tests which has verified the market quality of the physical and human capital in the individual transition economies and its capability to adjust to market conditions – often applied without safety cushions in this period – was the ability to produce output which is marketable on the competitive international markets. The dynamics of both industrial output and of exports in SETE and CETE during the past ten years (table 1) are quite indicative of the differences in the adjustment to the new market pressures. Thus while aggregate gross industrial output in SETE in 1999 was still less than half of its 1989 level, that in CETE had practically recovered from the transformational decline (in Hungary and Poland it was already exceeding the pre-transition level). The divergence in export performance has been even more pronounced: while the value of CETE aggregate exports (in dollar terms) has more than doubled during the last ten years, in 1999 SETE's aggregate dollar exports were still below their 1989 level.<sup>4</sup>

Similarly, the negative consequences for the labour markets have been much more severe in SETE than in CETE. This concerns not only the rates of unemployment which are

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<sup>3</sup> In addition, of course, the series of wars resulted in the actual physical destruction of large amounts of productive capital in the successor states of SRF Yugoslavia.

<sup>4</sup> The relative strong growth of Romania's exports during the 1990s reflects mostly the low base in 1989, following the decade of debt repayment enforced by the communist regime.

much higher in SETE than in CETE (the average unemployment rates in mid-1998 were 15.4% and 10.2%, respectively). Probably even more significant is the dynamics of employment during the transition: while between 1989 and 1998 total employment in CETE declined by 13.7%, that in SETE dropped by 25.8% (ECE, 1999a). This is to say that during the ten years of transition, the SETEs as a whole lost a quarter of the employed labour in the economy and altogether their labour force was reduced by some 15% (in contrast, the aggregate labour force in CETE only declined marginally).

In principle the change of the nature of economic agents is an essential element of the process of microeconomic transformation during the transition from plan to market. Moreover, in terms of the Schumpeter's entrepreneurial model of economic change, development is always a process of "creative destruction" led by innovative entrepreneurs who pave the way for new production techniques, products and markets while old and obsolete economic structures die away. However, the problem encountered by most SETE countries is that – in terms of the Schumpeterian model – during this first phase of transition there was too much destruction and too little creation.

One of the ironic outcomes of these changes has been a degeneration of the overall economic structure in the Southeast European region. Thus during the past decade there has been a tendency towards a regressive, reverse increase in the share of agriculture in GDP in some SETEs as compared to the pre-transition levels. Moreover, these countries had been still excessively agricultural anyway by the standards not only of industrialized countries but also in comparison with the CETEs (table 2).

The revealed dynamics of the output and exports in the transition economies reflects the outcome of two developments that constitute the essence of economic restructuring and reallocation of resources during the transition: the destruction of unviable physical and human capital and the generation of new, viable productive capacity. Taking their combined effect into consideration, one could argue that the start of a process of sustained recovery and growth in the transition countries was only possible due to the effect of one (or at the same time more than one) of the following occurrences:

- a significant share of the "old" productive (physical and human) capital was of sufficient quality to serve as an overall engine of the recovery (mostly through its reorientation to new markets), pulling to apparent solvency at least one part of the potentially viable firms, or

- this role was accomplished by new, greenfield investment and by the emerging *de novo* private sector, or
- old production facilities were restructured and rehabilitated to market efficiency through re-organization and new investment and became engines of recovery.

However, following the same logic, there is no absolute guarantee that one or more of the above will in fact take place. Consequently, one of the dangers – that became reality in some countries, in particular, in most SETEs – is that of falling into what could be called a “transformation growth trap”: embarking on a vicious circle of economic self-destruction and economic decline. This is an example of regressive changes during the transition when the accumulated negative outcomes may lead to destructive structural breaks, threshold or hysteresis effects.<sup>5</sup>

The transformational depression resulted, *inter alia*, from the fact that price and trade liberalization rendered many firms unviable (put differently, liberalization revealed the fact that many existing firms were unviable under market conditions). In particular, the restructuring of some firms was either inefficient for technological reasons (being more costly than an identical greenfield investment) or required considerable resources and time (that were not available). The problem was aggravated by the fact that the distinction between viable and unviable firms in a transitional environment has very often been obscure as it crucially depends on the overall state of the economy: while firms may appear insolvent during a prolonged depression, they may well look healthy in a period of robust recovery. This has been an additional deterrent to potential investors in potentially viable firms.

One of the greatest problems inherited from the past was related to the fate of genuinely loss-making firms, i.e., firms originating in the period of central planning, with technologically determined inefficiency and no further potential for x-efficiency gains in terms of increased profit/reduced loss (efficiency may possibly, but not necessarily, be improved only on the basis of new net investment in the enterprise). The inefficiency of such enterprises is embodied in their production technology: even after all possible x-efficiency gains are achieved, the enterprise continues to perform at a loss under market conditions.

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<sup>5</sup> The presence of non-linearities such as threshold effects and hysteresis has been studied in the development economics/“new growth” literature; see for example Murphy, Shleifer and Vishny (1989), Azariadis and Drazen (1990), Sachs (1997). Thus Azariadis and Drazen (1990) argue that a certain threshold of human capital is necessary for the emergence of positive externalities that give rise to increasing returns to scale (and, hence, higher growth and/or catching up). However, the type of hysteresis/threshold effects observed during the transition are of the reverse type, giving rise to negative externalities and amplifying the economic decline and the falling behind.

The only way to improve the productive efficiency of such an enterprise would be to upgrade its production technology which requires new investment. However, as noted above, the economic rationale of such upgrading may be dubious because the costs of upgrading may be higher than the costs of a greenfield investment in a new production site of the same capacity.

In addition to that, it has been argued that the presence of a large number of “bad” firms may have (and presumably did have) a contaminating effect for microeconomic behaviour as it is the “bad” firms that set the prevailing norms of behaviour. Under these circumstances, perverse incentives and practices may be contagious, affecting even otherwise healthy firms, and in the case of an endemic spread of such distortions, the overall efficiency of economic policy will be eroded, even if it is otherwise coherent and consistent.<sup>6</sup>

Hence a period of prolonged depression may give birth to something similar to a “critical mass effect”: the critically large number of genuinely unviable firms may not only pull the whole economy into the red but may cause more and more (potentially viable) firms also to become *de facto* unviable. The ensuing fundamental problem is that if the depression is not arrested at a relatively early phase by a counteracting process of self-sustained growth, it may start to feed on itself and may set in motion the above mentioned vicious circle of self-destruction of production factors and economic decline. The resulting knocking off of productive factors – or, put differently, the destruction of economic activity – may lead to further destruction of economic activity, both of which may be potentially viable in other circumstances.

Probably the gravest implication is that due to the combined effect of the above factors, a critical mass of unviable firms *de facto* annihilates the aggregate sources of growth for the economy. Thus the economy may fall into the transformational growth trap when it becomes incapable of growing on the basis of its own resources alone.

Apparently, two of the important distinctions among the former centrally planned economies – which in the course of time translated into distinctly different growth patterns during the transition – were: 1) the presence of a critical mass of unviable firms and 2) the existence/emergence or the lack/non-emergence of an engine of recovery and growth. Whether a country fell into the one or the other category depended on numerous factors, such as the inherited economic and institutional structures, the proximity to important markets (geographic and geopolitical factors), the course of policy pursued, to name just a few.

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<sup>6</sup> See Perotti (1994) and Dobrinsky (1998).

#### 4. The policy challenge of the transformation paradigm

The actual experience of policy reforms and transformation experience in Southeast Europe has been highly problematic. Indeed, some transition economies have been in a state of a “permanent crisis” since the very start of economic and political transformation. The decade long transition failures in some countries (as a matter of fact, not only in SETE but also among the CIS countries) have raised considerable doubts about the wisdom of the actual transformation paradigm that has been pursued in these countries during the last decade. The mainstream policy approach – heavily influenced by the “Washington Consensus” – presumed that sustainable macroeconomic stabilization could be easily and rapidly achieved through rapid liberalization and monetary austerity; it was supposed (at least implicitly) that this would then pave the way for high and sustained rates of economic growth, supported strongly by inflows of private capital from abroad. This paradigm embodied strong reliance on the automatic operation of the market mechanism in restructuring the economy, an assumption incorporated in the actual design of the transition programmes.

This model of transformation, however, has not proved to be very successful in the SETEs and the increasing number of transformation failures has shown that in many cases this paradigm did not perform in accordance with expectations. The reasons are much too complex to be spelled out here, but with respect to the SETEs they are probably related to factors such as: the locational disadvantage of the region, highly unfavourable starting conditions in terms of distorted economic structures (in some of the countries), and the lack of strong traditions in institutional development, the emergence of vicious “path dependence” in economic performance during the transition as well as the severe political constraints that policy makers were facing in this period (the fact that the endogeneity of the policy process may become a dominant factor during a period of severe structural adjustment). We shall try to briefly look into some of these factors.

The starting conditions (in terms of inherited economic structures and the legacy of resource misallocation) can in principle be presented in some form of a “distance” from the “normal” state in a mature market economy (or, equivalently, from the desired “end-point”).<sup>7</sup>

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<sup>7</sup> See, for example Daianu (1997).

Such a quantifiable measure (which is country-specific and which in general depends on the inherited distortions in the domestic allocation of resources and in relative prices) defines the magnitude of the required adjustment effort in the course of the transformation process. As adjustment is costly and painful, at a given level of admissible pain suffered by the population (at which social cohesion can still be maintained), the needed adjustment time basically depends on two main parameters: 1) the “distance” (the starting point) and 2) the available (locally or attracted from abroad) resources to perform the necessary adjustment.

Moreover, under these conditions, the rapid liberalization and opening of the economies (as implemented in some SETEs) turned out to be premature and detrimental as they were not prepared to cope with the external shocks. The scale and speed of the latter greatly exceeded the possible rate at which internal economic restructuring and the re-allocation of capital and labour could be achieved in these economies, and this resulted in an unwelcome rate of destruction of productive assets and much higher levels of unemployment than were necessary. In fact it could be argued that – in terms of the model of economic self-destruction outlined above – premature liberalization and opening up of the economies reduced the “viability threshold” (the set of conditions beyond which a firm became economically unviable) and likely amplified the “critical mass effect” which, arguably, could be avoided under a different set of policies and sequencing of the policy reforms.

The transition economies that are recorded to have made the most progress in the transformation process so far (such as the CETEs) are those that had to cover a smaller “distance” or/and were capable of attracting more external resources (in the first place FDI). On the other hand, severe transformation crises occurred in countries where both these conditions were the most unfavourable (for example Bulgaria and Romania). The fact is that having fallen into the transformation growth trap and having experienced ten years of economic self-destruction, some transition economies (including some SETEs) are incapable even of self-sustained economic performance and can only keep on functioning under continuous international assistance.

The issue of re-gaining economic viability and sustainability is intimately related to economic restructuring in the broader sense, that is, to the establishment of a sufficiently large number of viable businesses that would pull the whole economy to a viable performance path. The problem is that some transition economies may turn out to be unrestructurable on their own. Consider the case when the resumption of self-sustained growth requires that a “critical portion” of the economy be restructured and transformed into

a growth engine through massive new capital investment but the funds are not available domestically. Such an economy could regain economic sustainability only under the condition of a continuous inflow of external resources of significant scale (considerably larger than the current level of official assistance) but, arguably, international financial markets would hardly be willing to generate this type of funds, given bleak internal economic prospects. This outcome outlines the need for a differentiated approach by the international community towards the transformation process in individual transition economies (in particular, some of the SETEs).

In addition to that, it should be stressed that wide public support is crucial for the success of complex and painful reforms. This aspect of any reform process has been repeatedly emphasized in the recent policy reform literature (Rodrik, 1993). An important stream in this literature has studied the importance of political constraints for the success of policy reforms: it has been argued that political constraints may be a key factor in the reform process; severe political constraints may impede the successful implementation of a reform package even in the presence of political will to push it forward, and even if the latter increases long-term social welfare (Fernandez and Rodrik, 1991). One of the important findings in this literature concerns the endogeneity of the policy process: the policy process can be strongly affected by the actual outcome of the ongoing reform process.

It can be argued that, given the scale of the required adjustment effort which needs to be engineered through policy reforms in the course of economic transformation (to a high degree determined by the starting conditions) and the available resources at the disposal of the authorities, the endogeneity of the policy process by and large determines the plausible speed of restructuring. When the required adjustment is very large, the endogeneity of the policy process may become a dominant factor that determines the plausibility of the policy course and de facto sets upper limits to the possible speed of restructuring. If adjustment is pushed at a greater speed than the plausible one (in terms of social cohesion), policy is likely to generate perverse results and resistance to reforms.

In this context, public resistance to transformation reforms and the emergence of political structures that are strongly opposed to the policy of reforms in some SETEs is not solely based on ideological grounds as is often simplistically depicted. These reflect the emergence of large layers of society that are not only chronic losers in the transformation process but also see no chance of becoming winners under the ongoing course of reforms. These processes are at the same time the regrettable outcome of wrong policy prescriptions



and inadequate policy course undertaken in the first phase of economic transformation; had this first phase been more successful – and more successful in a greater number of countries – the political environment could have been much more reform-friendly in the transition economies in general and in each individual country taken separately.

## **5. What are the prospects?**

The economic prospects for the SETEs in the eve of the new millennium do not appear to be very bright. After a decade of economic decline these economies are exhausted and their growth potential is extremely limited. Even if one assumes that the phase of transformational recession is over (or at least is coming to an end), the generally meagre investment activity which has been observed in most of them during most of the past decade implies that robust recovery could hardly be expected in the short- to medium term. In particular, private foreign capital has been stubbornly reluctant to respond to the evidence of improving macroeconomic (especially price) stability in some of these countries.

As indicated by the experience of the more successful in the economic transformation CETEs, revitalizing the SETE economies (i.e. reconstruction and development) would require a major re-industrialization effort on the basis of efficient, modern manufacturing industries capable of competing on the highly competitive Western European markets. Modern European economies are unthinkable without the presence of a strong and efficient manufacturing sector and tangible participation in international trade. If the SETEs are aiming at becoming modern European economies, they should aim at establishing a strong, export-oriented manufacturing sector as the backbone of their economies. On the other hand, if the international community is serious about assisting the process of “economic regeneration” in these countries (the term used by Tony Blair during the Kosovo war), it should also aim to assist them in reaching this goal.

Against this goal is the widespread economic decay in the Southeast European region where the failure to lay out the necessary replacement investment during this period has resulted in the loss of productive assets that potentially could have been put to efficient use. The regrettable outcome is that a significant portion of the previously existing physical capital stock has dissipated, and while a large part of it apparently was unfit for restructuring, another (probably sizeable) part arguably constituted potentially viable production facilities. Hence, re-industrialization in this region by and large signifies greenfield investment in new

production capacities. Put differently, reconstruction and development in the Southeast European region is synonymous to new investment of a large scale. And since the resources needed for this type of development are lacking in the region, such a developmental strategy would only be feasible if foreign capital would flow to the SETEs.

As noted, at present there are no signs of this happening and a dramatic reversal could hardly be expected in the short- to medium term. The reasons for this are well known<sup>8</sup> but in general they are related to the classical investor's dichotomy "risk – expected return". Given the considerable political, economic and business risks associated with the Balkan region and the bleak economic prospects for most of the SETEs, the current levels of capital inflows (and for that matter, the low levels of domestic investment by local investors) reflect nothing but rational behaviour by the potential investors.

A reversal in investment would require a change in the relation "risk – expected return" that would make investment attractive to a considerably larger number of potential investors. Obviously this can be done by changing any side (preferably both) of the relation: either by reducing the perceived investors' risk or/and by offering more, and more attractive, opportunities for gainful investment.

I will not discuss here the issues related to the reduction of political risk which are quite specific but lie outside the scope of this paper. As regards the economic and business risk, the levers of control are in principle in the hands of the governments of these countries. In the final run, these risks are very much associated with the conduct of sound economic policy and the existence of efficient public governance. While, as noted, there has been notable progress in some SETEs in the conduct of macroeconomic policy, public governance remains a very weak point; moreover, in some countries it has lost credibility with the public at large.

Establishing sound practices of public governance requires efficient and transparent public administration and well functioning state institutions (guaranteeing, in particular, law and contract enforcement). This is an area where competent and qualified assistance by the international community (in the first place by the EU) would be most appreciated and where potential international investment in assistance could bring the highest and fastest returns in terms of amelioration of the business environment. One possible avenue of such aid could be created if the EU were to adopt a more active stance in providing a facility of "public

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<sup>8</sup> See, for example, Gligorov, Kaldor and Tsoukalis (1999).

governance assistance” to these countries, for example by offering the possibility to second experienced public administrators and civil servants (paid by the EU or by the EU-member states) to work “in the field” (in the various offices of the local public administration) to the SETEs that are willing and ready to accept this kind of assistance.

A permanent shift in the perceived returns expected by investors in the end means making the whole region more prosperous or, at least, creating justified expectations that this is going to happen within a reasonable time span. However, it should be plain clear that the dire straits of the Southeast European region and the immense scale of the needed reconstruction effort call for an innovative approach towards aid to the region, something over and above the forms of assistance conceived within the Stability Pact. It also calls for much more generous financial assistance, including non-debt financial assistance of various forms, envisaged for a sufficiently long time horizon. On the other hand, a credible EU commitment for long-term assistance would have a tremendous positive effect in building public support for transformation reforms and reducing the above mentioned political constraints that policy makers are facing in the SETEs at present.

It should be pointed out that helping SETE to become more prosperous in a shorter period of time is in the self-interest of Europe as a whole and, in particular, of the EU. Assistance aimed at this goal needs to be regarded plainly as an investment in the future economic and political security of the whole continent. The economic reasoning of this argument becomes very simple if the cost of providing such assistance is counted against the opportunity cost of not providing it: maintaining an impoverished, potentially explosive region at the outskirts of the continent will not only be a source of political instability but will also continue to inflict huge direct and indirect costs on the rest of Europe, in particular, the EU (such as the direct cost of crisis management and control or the indirect costs related to foregone opportunities for western businesses). Probably this is a message that the SETE politicians could convincingly convey to their EU counterparts while the latter would manage to sell to their constituencies.

In this regard, one of the possible avenues of assistance that would affect favourably both sides of the relation “risk – expected return” would be the creation of a regional investment fund dedicated to the reconstruction of SETE. This fund could serve various aspects of the investment process such as, for example:

- provision of investment insurance covering (partly) the perceived political and economic risk;

- supply of finance for regional project (such as infrastructure, energy, environment);
- supply of seed finance or participation with co-finance in investment projects (seed finance is something badly needed in the region);
- supply of infant industry finance and credit to SMEs, etc.

Naturally, the fund should operate as a business entity with proper market screening and assessment of prospective projects. At the same time it should be a not-for-profit enterprise, and the explicit postulate that it provides assistance and does not necessarily maximize profit should be included in its articles of incorporation (for example, by maintaining interest below the regional market rates or by accepting above average rate of failures of investment projects). Hence, this type of operation would require periodic replenishment of the fund during the period of its existence.

Creating a free trade area in the region (potentially overlapping with CEFTA and – eventually – partly with the EU, within the scope of the current and future association agreements) will also be in principle an attractive component of the new business environment for potential investors. However, a free trade area alone (moreover one among poor countries alone) is by far not a sufficient to generate the finance needed for the economic re-vitalization of the Southeast European region.

## **6. Conclusions**

The current state of deep economic distress in Southeast Europe is highly hazardous both for the countries of the region and for the whole of Europe. In some of these countries, the nearly ten years of economic decline has resulted in a painful reversal in the absolute level of the living standards, probably by several decades. Counter to the expectations of the population (and, arguably, counter to the ambitions of most politicians), so far economic and political transformation has not brought prosperity and catching up with the West; on the contrary, the gap in income levels at the turn of the century is even higher than it had been 50 years ago.

As indicated in this paper, transition revealed that the growth potential of the Southeast European transition economies is very low and the basic cause for this has been the actual loss of productive factors (physical and human capital and labour) in the course of economic transformation. One of the important factors – but by far not the only one – has been the large degree of resource misallocation (embodied in obsolete production facilities

and unviable firms) inherited from the past. However, the policy paradigm followed by some SETEs – which in some cases involved premature liberalization and opening up of the economies – also contributed negatively as the abrupt lifting of these barriers was equivalent to the sharp reduction of the viability threshold for the firms. In turn, while it was considered that the inherited level of skills of the labour force was relatively high, it turned out that some of the skills that had been employed in the past simply were not in demand in the new environment; consequently the labour force in many of these countries has shrunk considerably.

It is argued in the paper that the combined effect of these factors has been equivalent to the destruction of a large share of the productive factors – both capital and labour – in these countries: in the form of reduction of the labour force, exposure of the technological obsolescence of production facilities; decay due to the lack of replacement investment, and in some cases physical destruction of capital in the course of several wars. Moreover, it is argued that the prolonged transformational depression may have set in motion a vicious circle of economic decline and self-destruction of productive resources causing the economy to fall into a transformational growth trap when it becomes incapable of growing on the basis of its own resources alone.

In fact, while economic transformation used to be regarded as a process of re-allocation of resources aimed at their more efficient use, it turned out that in the course of transition a large share of the productive resources were wasted away: physical capital was by and large destroyed, and a great number of previously employed people left the labour force altogether. Consequently, the next phases of economic transformation in these countries – if made feasible by overcoming the current resource constraints – will rather consist of re-industrialization (development) than of re-allocation of resources (reconstruction).

The present economic situation in Southeast Europe is not only highly regrettable as regards the deepening impoverishment of the population in the region; since poverty is a nourishing environment for domestic and international tensions, the current state is at the same time also highly explosive and may be the source of serious threats to the economic and political security of the whole continent. The paper argues that it is in the self interest of Europe as a whole to help eradicate poverty from the periphery of the continent and thus eliminate the ensuing threats to the rest of Europe. In this regard the paper calls for innovative approaches and much more generous assistance by the international community for the economic regeneration of the Southeast European region.

The paper argues that in the course of transition of some countries (notably the SETEs) there were widespread (negative) hysteresis phenomena and (reverse) threshold effects. The resultant negative externalities led to the emergence of vicious circles (in particular, growth traps) and amplified the economic depression and the unprecedented falling behind experienced by some transition economies. While this has been a major developmental handicap for the SETEs during the first phases of transition, when put into perspective, this may also be considered as a source of hope for turnaround. Indeed, if these economies manage to engineer a reversal in this trend – admittedly on the basis of substantial external assistance – then possibly one could expect positive hysteresis/threshold effects and virtuous growth circles in their future economic development.

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## **Tables and charts**



**Table 1. GDP, industrial output and exports in the Central and Southeast European transition economies, 1989 – 1999.**

Country	GDP				Gross industrial output				Dollar exports			
	Average annual rates of growth (%)			GDP in 1999 (1989=100)	Average annual rates of growth (%)			Output in 1999 (1989=100)	Average annual rates of growth (%)			Exports in 1999 (1990=100)
	1991-95	1996-99	1991-99		1991-95	1996-99	1991-99		1991-95	1996-99	1991-99	
Albania	-2.1	3.8	0.5	93.9	-22.7	-1.4	-13.9	22.6	-2.6	5.5	0.9	108.2
Bulgaria	-2.6	-3.2	-2.9	70.0	-7.5	-7.1	-7.3	41.9	0.5	-8.2	-3.5	72.7
Croatia	-6.2	3.8	-1.9	78.1	-10.9	2.9	-5.0	55.7	2.9	-2.5	0.4	104.0
Romania	-2.1	-3.9	-2.9	72.4	-7.1	-7.1	-7.1	42.1	11.6	0.4	6.5	176.1
FYROM	-5.5	1.7	-2.4	72.4	-13.7	0.7	-7.5	44.2	1.6	-2.2	-0.1	98.8
Yugoslavia	-13.7	-3.3	-9.2	38.7	-15.7	-3.9	-10.6	32.1	-19.9	-0.5	-11.8	95.3
<b>SETE average</b>	<b>-4.2</b>	<b>-2.3</b>	<b>-3.4</b>	<b>68.4</b>	<b>-9.5</b>	<b>-2.2</b>	<b>-6.3</b>	<b>46.7</b>	<b>1.0</b>	<b>-2.5</b>	<b>-0.5</b>	<b>95.3</b>
Czech Republic	-1.1	0.4	-0.4	94.9	-5.4	1.0	-2.6	76.2	19.1	5.0	12.6	290.5
Hungary	-2.4	3.9	0.4	99.7	-2.5	8.7	2.3	111.4	6.2	17.5	11.1	257.6
Poland	2.2	5.4	3.6	121.8	4.4	6.3	5.2	119.7	9.8	3.2	6.8	181.5
Slovakia	-2.9	5.1	0.6	102.6	-5.1	2.8	-1.7	80.7	16.1	4.1	10.6	248.0
Slovenia	-0.6	3.9	1.4	103.9	-4.3	1.0	-2.0	74.8	15.1	1.6	8.9	214.9
<b>CETE average</b>	<b>0.0</b>	<b>4.0</b>	<b>1.7</b>	<b>108.9</b>	<b>-1.1</b>	<b>4.6</b>	<b>1.3</b>	<b>98.2</b>	<b>12.6</b>	<b>6.6</b>	<b>9.9</b>	<b>233.1</b>

Note: The 1999 growth rates used in this table are based on preliminary estimates.

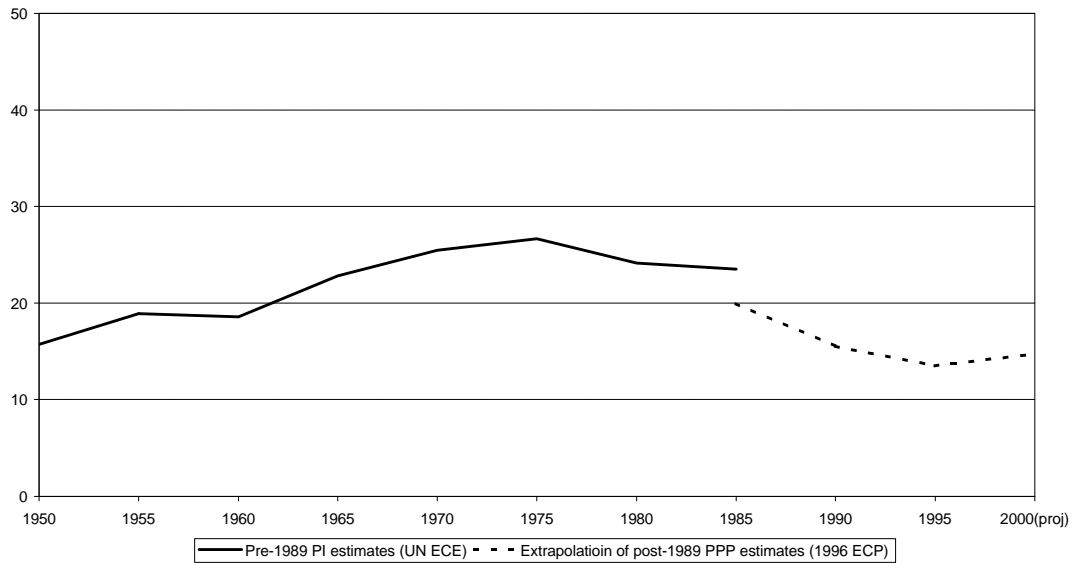
Source: UN ECE data base; author's calculations.

**Table 2. Composition of GDP (%) in the Central and Southeast European transition economies, 1990 – 1998**

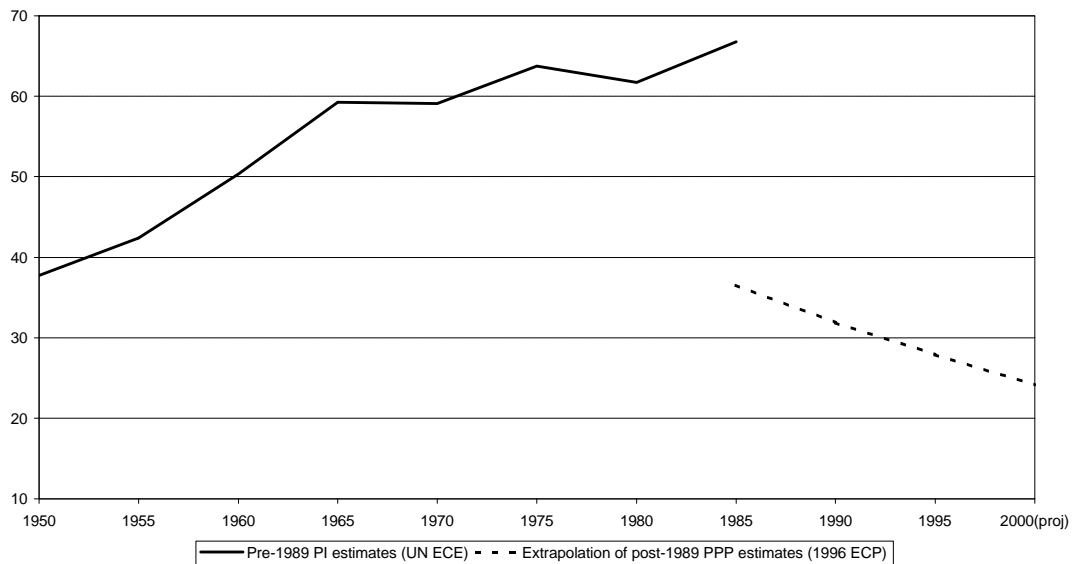
Country	Agriculture and forestry			Industry and construction			Services		
	1990-95	1996-98	1991-98	1990-95	1996-98	1991-98	1990-95	1996-98	1991-98
Albania	50.1	53.7	51.5	29.0	23.0	27.4	20.9	23.3	21.1
Bulgaria	13.5	14.6	16.0	38.3	31.9	35.2	48.2	53.5	48.8
Croatia	11.6	10.2	10.8	33.0	32.8	32.7	55.5	57.0	56.5
Romania	20.7	20.4	20.2	43.5	42.2	43.2	35.8	37.4	36.6
FYROM	11.3	12.8	11.8	34.8	28.9	32.9	54.0	58.3	55.3
<b>SETE average</b>	<b>18.7</b>	<b>19.1</b>	<b>18.9</b>	<b>40.3</b>	<b>38.0</b>	<b>39.4</b>	<b>41.0</b>	<b>42.9</b>	<b>41.7</b>
Czech Republic	5.5	4.6	5.2	45.8	41.0	44.4	48.7	54.3	50.5
Hungary	7.5	6.7	7.0	32.6	30.8	32.5	60.0	62.5	60.5
Poland	7.5	7.2	7.1	42.5	38.8	40.9	50.0	54.0	52.0
Slovakia	6.1	5.8	5.8	44.5	38.3	41.6	49.4	55.9	52.6
Slovenia	5.2	4.5	4.9	40.2	37.6	39.3	54.6	58.0	55.8
<b>CETE average</b>	<b>6.8</b>	<b>6.3</b>	<b>6.4</b>	<b>41.6</b>	<b>37.9</b>	<b>40.2</b>	<b>51.6</b>	<b>55.9</b>	<b>53.4</b>

Source: UN ECE data base; author's calculations.

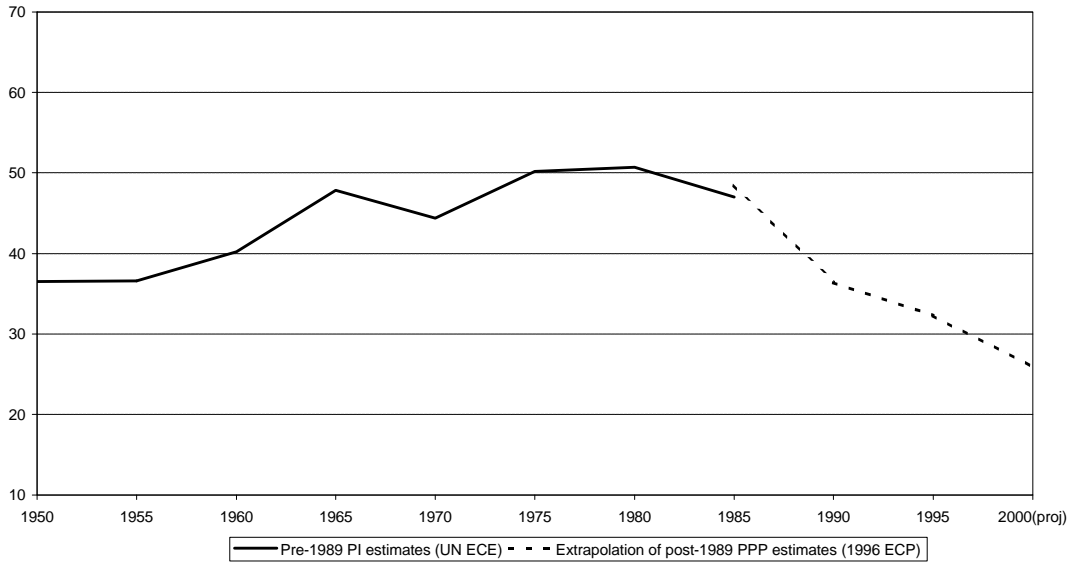
**Figure 1. Albania: per capita GDP relative to the EU average, 1950-2000**  
(EU-15 average=100)



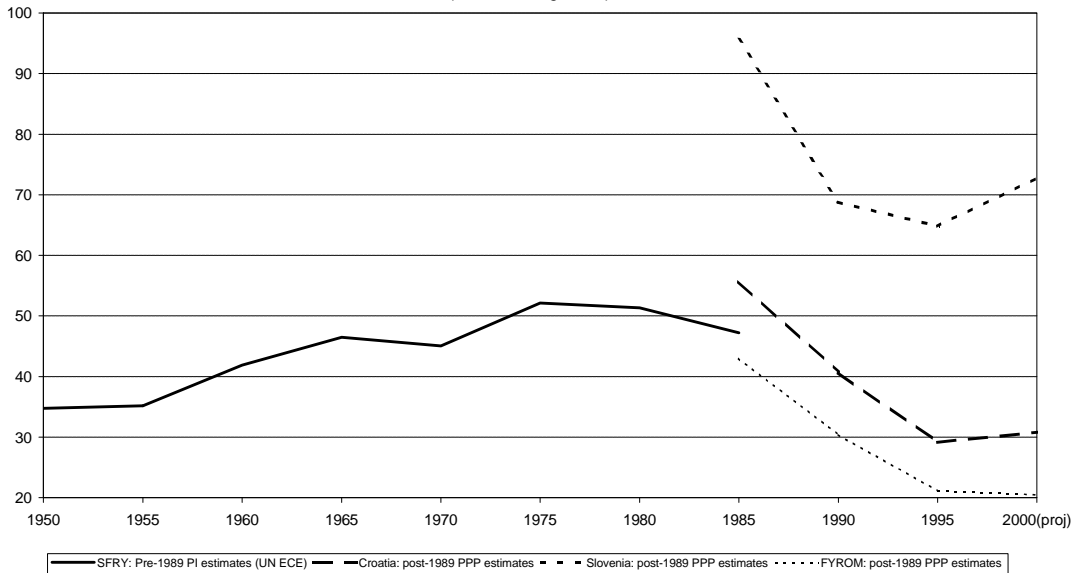
**Figure 2. Bulgaria: per capita GDP relative to the EU average, 1950-2000**  
(EU-15 average=100)



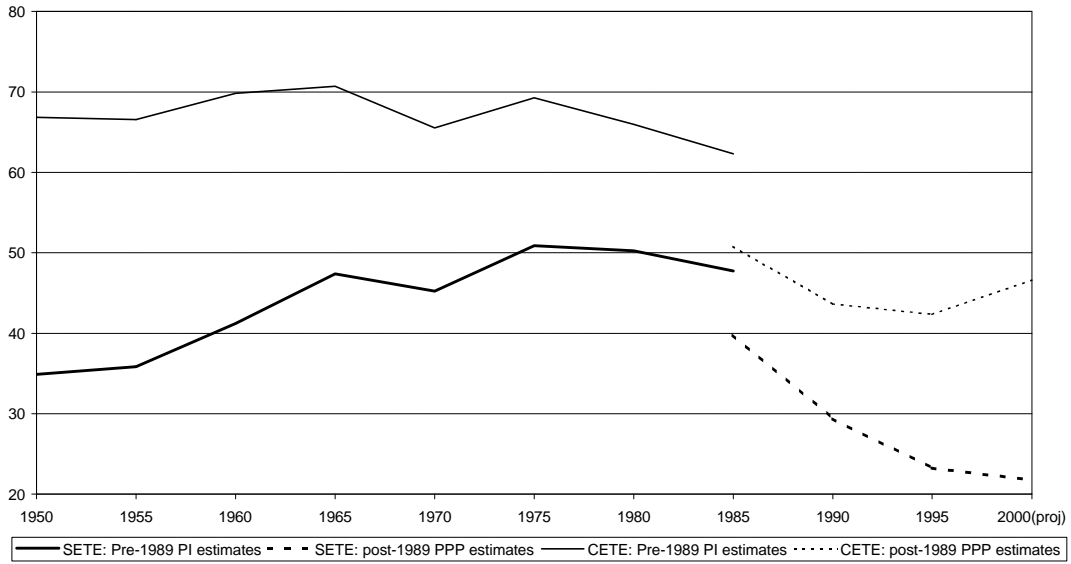
**Figure 3. Romania: per capita GDP relative to the EU average, 1950-2000**  
(EU-15 average=100)



**Figure 4. SFR Yugoslavia, Croatia, Slovenia and FYROM: per capita GDP relative to the EU average, 1950-2000**  
(EU-15 average=100)



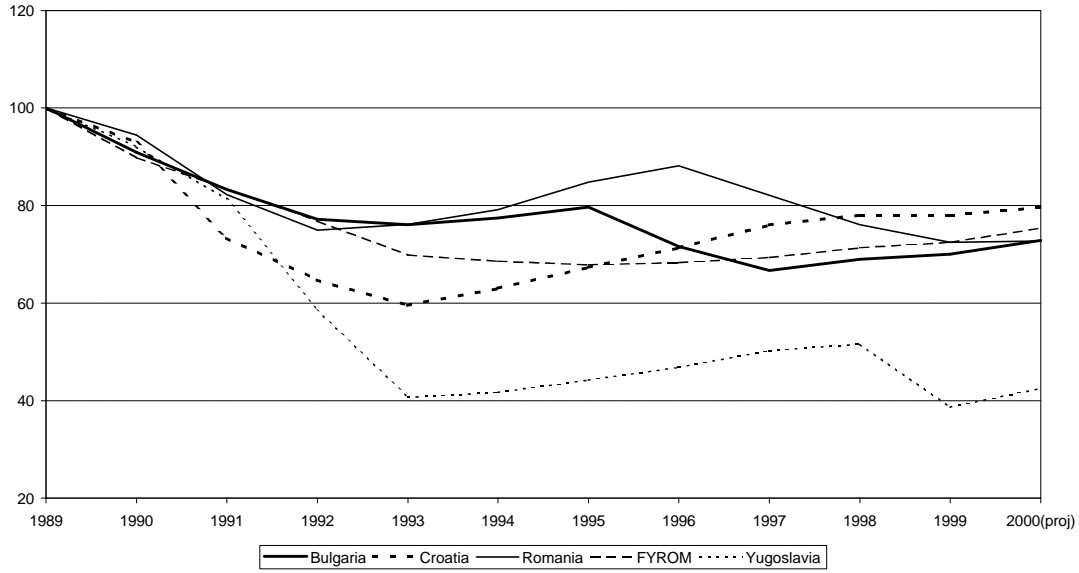
**Figure 5. Central and Southeast Europe: per capita GDP relative to the EU average, 1950-2000**  
*(EU-15 average=100)*



**Figure 6. Aggregate GDP in the Central and Southeast European transition economies, 1989-2000**  
*(Indices, 1989=100)*



**Figure 7. GDP in the Southeast European transition economies, 1989-2000**  
(Indices, 1989=100)



**Figure 8. GDP in the Central European transition economies, 1989-1998**  
(Indices, 1989=100)

