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## South-East Europe: Economic performance, perspectives and policy challenges

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**South-East Europe:  
Economic Performance,  
Perspectives, and Policy  
Challenges**

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# South-East Europe: Economic Performance, Perspectives and Policy Challenges

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# I. Introduction

The past decade has witnessed sweeping changes east of what once was the *iron curtain*. For most countries in Central and Eastern Europe, these changes have yielded the emergence of viable democracies and market economies and culminated in their membership in NATO and, soon, in the European Union. With few exceptions, the economic and political changes in South East Europe have so far had much less positive results. Only Slovenia and Cyprus are included in the upcoming enlargement of the EU in 2004. Bulgaria and Romania can hope for attaining EU membership by the end of this decade. Turkey's status as an EU candidate country has been officially recognized, but no date has been set for its accession. The remaining countries of the region, Albania, Bosnia and Herzegovina, Croatia, FYR Macedonia, and Serbia and Montenegro are today even less integrated into the network of European economic and political integration. Thus, South East Europe remains a region in search of its economic orientation and geography.

In this study, we present an overview of the economic and social developments in the region in recent years. We focus on a comparative perspective, and we use Greece as a benchmark for the region throughout this study. In section II, we report the basic economic and social facts and trends. In section III, we turn to the quality of institutions in South East European countries. Section IV looks at recent macro economic developments. In Section V we discuss recent trade and foreign direct investment patterns and performance.

Our analysis identifies the following four main areas where policies should be pushed further to promote competitiveness, economic growth and stability in South East Europe:

*Openness to trade and foreign direct investment.* Given the small size of regional markets, sustained growth depends on trade expansion primarily with the EU and the rest of the world. Attracting foreign investment is key to modernize the production sector. The region should focus on improving its production structure to increase its export capacities in more growth-promising industries. Liberalizing international capital flows will contribute to the improvement of national financial systems.

*Regional cooperation.* Countries in the region should coordinate their development policies to avoid wasteful competition for foreign investment.

*Strengthen governance.* Good public institutions are key factors to secure sustainable growth and attract FDI. Strengthening democracy, improving government effectiveness and the quality of market regulations and competitive environments, and controlling corruption have positive pay-offs in terms of growth and attracting FDI.

*EU leadership.* As in the case of the current EU accession countries, the prospect of future EU membership can play a decisive role in overcoming internal resistance to reform and facilitating institutional improvements. The EU should realize its responsibility for providing such a perspective and exerting leadership in the region, which otherwise could remain a weak and unstable part of Europe for too long.

## II. Economic Conditions and Perspectives: Disparities and Catch - up Prospects

South East Europe is a very diverse region. Consider Table 1. Cyprus will soon be one of the smallest countries in the EU, while Turkey's population exceeds those of France and Italy. Romania is twice the size of Greece in terms of population size, while Bulgaria and Serbia and Montenegro are roughly of the same size as Greece. The remaining states have populations between two and four million people, comparable in size to Ireland. Over the past decade, population dynamics were very diverse, too. Turkey's and Cyprus's populations grew at strong rates of 1.5 – 1.7 percent annually. In stark contrast, Bulgaria, Bosnia and Herzegovina, Albania, and Romania have suffered population losses over the past decade, partly due to emigration. Population densities are lowest in Bulgaria and Croatia, and highest in Albania and Serbia and Montenegro.

Table 1 indicates that Turkey has the largest GDP in the region, almost USD 200 billions. The Greek economy amounts to 56 percent of that. All other countries in the region are much smaller than these two. In 2000, Albania and FYR Macedonia were of almost equal economic size, reaching less than 3.5 percent of the Greek economy. Croatia and Slovenia were both of about 16 percent of the Greek economy, Romania of about one third. These relations are quite different, however, when we look at per-capita GDPs. To improve comparability, we use per-capita GDPs calculated in US dollars at purchasing power parity rates rather than market exchange rates. Table 1 shows that, in terms of this basic indicator, Slovenia and Greece have the highest standards of living in the region, with per-capita GDPs of almost 18000 dollars annually. Slovenia with 17788 dollars, exceeds the Greek level of 17653 dollars. At the other end of the scale, Bosnia and Herzegovina is the poorest country in the region, reaching no more than 2715 dollars, or 15 percent of the Greek level. Turkey's per capita GDP reaches no more than 34 percent of per-capita GDP in Greece.

Table 1 also reports the shares of agriculture and industry in GDP. Albania is still a largely agricultural country, with almost half of its output produced in this sector. Romania, Bulgaria, Bosnia and Herzegovina, and Turkey are more comparable on this account, with shares of agriculture between 12 and 15 percent. Slovenia and Cyprus, in contrast, have only 2.7 and 5.0 percent of GDP produced in this sector, much less than Greece. Serbia and Montenegro have the largest share of industry in GDP. There is a middle group of countries, led by Romania and Croatia, with shares of industry ranging between 31 and 37 percent, while Cyprus has only 20 percent of GDP originating in industry.

Table 2 adds further development indicators to this picture. The low shares of urban in total populations in Albania, Bosnia and Herzegovina, and Serbia and Montenegro underscore the importance of the agricultural sector in these countries. Life expectancy remains low except in Greece, Cyprus and Slovenia. Adult literacy is quite high, the only exceptions being Albania and Turkey, where it reaches only 85%. However, school enrolment is low in several countries. Only Greece and Slovenia have enrolment rates above 80 percent; Turkey has the lowest rate with merely 62 percent, while the other countries reach enrolment rates around 70 percent. Despite the relatively high literacy rates, the

enrolment rates indicate a rather poor level of education in most countries of the region. A low level of education of the workforce thus remains an obstacle to sustained growth.

Finally, this table also reports the human development index published by the UN Development Program (UNDP), a summary statistic of human development including economic, social, health, and environmental conditions.<sup>1</sup> Greece, Cyprus, and Slovenia have practically the same scores on this index; as a result, they rank numbers 24, 26, and 29 respectively on a world-wide scale. At the lower end of the spectrum, Albania has the lowest index value and ranks number 92 worldwide. Turkey is the next lowest on this measure, ranking number 85 worldwide. Again, the table underscores the diversity of economic development conditions in the region, reaching from middle-income countries such as Greece, Cyprus, and Slovenia, to low-income countries like Albania and Turkey.

Explaining the differences in levels of economic development gives a hint at the economic policies countries in the region should pursue for sustained growth. A first suggestion might be that economic development hinges on moving factors of production from agriculture to industry. As it turns out, the correlation between the share of agriculture in GDP and per-capita income in the region is indeed strongly negative, as expected; see Chart 1.<sup>2</sup> Yet, the correlation between the share of industry in GDP and per-capita GDP is also negative.. This probably indicates the legacy of outdated industrial structures in many countries in the region, which we also find reflected in the trade structure of several countries, as will be discussed below. **Thus, expanding industry *per se* is not a promising strategy for the region, what matters as much is to develop a more modern and internationally competitive industrial sector.** At the same time, we find that there is a significant positive correlation between the levels of per-capita GDP and the share of the remaining sectors (services, construction, etc) in GDP. This again hints at the importance of developing more modern production structures to achieve higher levels of economic welfare.

Table 2 reports the EBRD indicators of infrastructure reform for the South East European countries.<sup>3</sup> The high scores for Bulgaria, Romania, and Slovenia clearly reflect the results of a decade of pre-accession assistance from the EU. These countries have reached infrastructure endowments that are not far from EU levels and quality. Croatia equals Bulgaria, although it is not among the candidates for EU membership. The other countries are marked by much lower infrastructure quality, which can be an impediment to economic development and trade in particular. **Low levels of infrastructure quality thus contribute to the low level of economic development in most countries in the region. This indicates a need for significant public sector investments in these countries in future years.**

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<sup>1</sup> HDI scores are between 0 and 1. According to UNDP (2002), South East Asia and the Pacific Region have scores of 0.69, and Latin America and the Caribbean have scores of 0.76.

<sup>2</sup> In this and the following charts, the  $R^2$  gives the statistical coefficient of determination of the trend line shown in the graphs. As the squared correlation coefficient, it indicates the strength of the correlation.

<sup>3</sup> These data are not available for Turkey, Cyprus, nor Greece. Higher values indicate better infrastructure development, the maximum score is 4+, a value assigned to a fully functioning market economy.

Openness to the international economy is another important factor in explaining the differences in economic development in the region. Chart 2 makes the point by plotting the share of exports in GDP together with the level of per-capita GDP. Bulgaria is a bit exceptional in this graph given its very large export share and its yet less advanced level of economic development. Nevertheless, the graph illustrates the importance of an outward-orientation to achieve economic improvement for the countries of the region. Below, we show that the predominant trade orientation of the regional economies is towards the EU. A noteworthy corollary of this is that the region never developed much of an internal market in the past 50 years, although several of the countries belonged to the same state. The reason for this is that domestic demand was not sufficiently large for sustained growth. Today, the implication is that a regional development strategy must be one based on trade with the rest of Europe rather than developing a regional market of its own. Given the small size of most of the economies, counting on the regional market development for growth prospects bears the risk of detrimental competition of national development policies. One example for this would be the duplication of infrastructure projects. Another example is that countries might engage in tax competition – or competition in tax relieves – trying to attract the same international investors to build new production facilities. Such competition is useful to the extent that it promotes public sector discipline and effectiveness, but it can be economically wasteful. If potential investors from abroad have bargaining power over governments in the region, they can demand that infrastructure supporting their investments be put in place as part of the bidding process. This can lead to excess infrastructure investment at the regional level, since only one country wins the bid for the investor. Similarly, competition can induce a race to the bottom in the taxation of international investors. To promote efficiency and avoid waste of public resources, a balance ought to be struck between these two opposing forces. One way to achieve this – practiced, for example, by the states bordering the Great Lakes in the US – is to establish a common development council for the region, through which governments exchange information about their dealing with foreign investors and arrange cooperation in specific infrastructure and development projects to coordinate and avoid costly duplication. If, as in the case of the Great Lakes, such cooperation is strictly voluntary in the sense that no government can be forced by others to invest resources in common projects, the risk of wasteful public investments is minimized.

Greater economic openness and international integration can also contribute to mitigating ethnic tensions in the region. To reduce and eliminate the risk of ethnic conflicts, countries in South East Europe need unambiguous prospects for economic and political integration in European and trans-Atlantic institutions conditioned on respecting human rights including those of ethnic minorities. This integration policy has worked well in the cases of two EU accession countries, Estonia and Latvia, where ethnic discrimination and tensions were high at the beginning of the last decade.

Tensions resulting from ethnic divisions can impede democratic and economic development in the region, for example, if ethnic discrimination in the labor markets keeps countries from making full use of their labor forces. But it is important to recognize that this is not necessarily the case. Latvia, Lithuania, and Estonia, three of the countries with the most positive transition experiences in the past decade are characterized by very strong ethnic divisions that were regarded as potentially damaging

for their development in the early 1990s. All three are today front-running EU acceding countries. One of the most important lessons that can be learned by the South East European countries from the Baltic experiences is probably that a determined political and economic orientation towards Western Europe can be helpful in mitigating conflicts from ethnic divisions. Overcoming problems with ethnic discrimination in the labor market and other social institutions was an explicit condition for these countries to be considered as serious applicants for EU membership. At the same time, this suggests a role for the EU in attaining peaceful development in the region by providing assistance and, perhaps most importantly, a perspective for the countries' economic and political future

### **III. Institutional Development and Economic Performance**

In recent years, economists and policy makers have increasingly recognized the importance of good government institutions, *governance* for short, for strong and sustainable economic development. Governance determines the conditions under which economic transactions evolve, business contracts are made, and commitments to invest capital are entered into. Institutions determine the “rules of the game” for economic actors and for political actors dividing solutions to economic and social conflicts. Good institutions reduce economic uncertainty, increase the predictability of the outcomes of economic choices such as saving and investment, and generally increase efficiency. In doing so, good institutions can increase the willingness of businesses and workers to accept structural reforms instead of defending their positions and privileges inherited from the past. Strong political participation and accountability assure that government provides the services that the citizens need. Government effectiveness and good quality regulation increase the transparency of markets and improve and intensify competition in the economy. Keeping a check on corruption assures greater transparency of policy choices and a more level playing field for all competitors. Kaufmann et al. (2002) present an extensive database that allows international comparisons in this regard. They look at governance in six dimensions, voice and accountability, political stability, government effectiveness, regulatory quality, rule of law, and control of corruption.<sup>4</sup> The data are based on surveys and polls conducted in 1997-98 and in 2000-01. Governance indicators are defined for values between -2.5 and 2.5, higher values indicate better institutions. Table 3 reports these data for the South-East European countries. Here, too, Cyprus, Greece, and Slovenia are the leading countries. They stand out for relatively strong democratic institutions, relatively high political stability, effective government and good quality of regulations. Slovenia and Cyprus both reach considerably higher scores even than Greece in terms of rule of law and corruption control. In the remaining countries, lack of government effectiveness, low quality of economic regulations, weak rule of law and high levels of corruption indicate a situation of poor governance, that renders business conditions unfavorable and works against the emergence of a

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<sup>4</sup> Voice and accountability refers to the ability of citizens to participate in the selection of their governments. Political stability indicates perceptions of the likelihood that a government will be overthrown by unconstitutional means. Government effectiveness refers to the perceptions of the quality of the bureaucracy and public service provision, while regulatory quality measures the quality of regulatory policies in terms of market friendliness and regulatory burden. Rule of law indicates the extent to which agents have confidence in the rules of society and control of corruption measures the perception of how prevalent corruption is in society. See Kaufmann et al (2002).



market economy. Democratic institutions have improved over the past five years, but remain weak compared with advanced economies. Between 1997/98 and 2000/01, political stability has improved in Albania, Bosnia and Herzegovina, Serbia and Montenegro, and Turkey, but weakened in Croatia, Bulgaria, and Romania. In the latter three countries, political stability has improved since 2001.<sup>5</sup> Apart from the leading group, all countries in the region still face the need for strong efforts to build the institutional foundations of modern economies and societies. The importance of developing better institutions of governance in the South East European region is illustrated by linking the development and the institutional data from the countries. In chart 3, we show the correlation between the level of economic development, measured in terms of per capita GDP, and institutional quality in terms of the measure for voice and accountability. The correlation is strongly positive, showing that better institutions are typically paired with higher per-capita incomes. As noted above, the simple correlation can be interpreted in both directions. Still, the experience of the institutional improvements in the EU candidate countries and their economic performance during the 1990s suggest that it is likely that developing good institutions improves economic performance, and this conclusion is supported by much of the recent research in the area.<sup>6</sup> Charts 4 and 5 corroborate that view. Here, we show the correlation between the average growth rate of real GDP during 1997 – 2001 together with two important aspects of institutional development, i.e., the quality of regulatory regimes and the effectiveness of corruption control. Since Albania and Bosnia and Herzegovina had exceptionally high growth rates in some of these years due to the post-war recoveries, we do not include these two.<sup>7</sup> The figures show strong positive associations of economic growth and institutional quality in the region.

This indicates that efforts to improve the quality of the public sector including legislation and administration is another important element of a sustainable economic development strategy for South East Europe. Here, it is important to point to a potential role for the EU. The political acceptability of institutional reform is likely to be greater when those who give up significant powers can expect to be compensated and rewarded, be it by greater political support in other areas, be it by greater overall economic success of the country. In both aspects, a realistic perspective for achieving closer links with, and, ultimately, membership in the EU could be an important stimulus for institutional reforms in the region. Clearly, the region's interest in obtaining such a perspective must be balanced by the EU's legitimate interest in avoiding economic turmoil that could result from admitting economies which are not yet mature for full membership. But the experience of the 1990s suggests that the process and speed of maturing depends itself on the expectation that membership can be attained. Setting clear targets and procedures for achieving membership, and involving the countries in visible forms of dialogue with the EU in the same way as the EU did for the current candidates is indispensable to speed up institutional and economic improvements in the region.

Table 4 reports a number of indicators of the development of financial institutions in the region. Monetization of the economy, measured in terms of the ratio of broad money to GDP is still very low,

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<sup>5</sup> See the assessments in the country reports by the European Commission (2002, 2003a).

<sup>6</sup> See IMF, World Economic Outlook 2003 for a survey.

<sup>7</sup> The correlations vanish when these two are included.

Cyprus being the only exception. Serbia and Montenegro, FYR Macedonia, Romania and Turkey show particularly low levels of monetization, with the ratio of broad money to GDP 17, 19, 24 and 25 percent, respectively. To compare, the average ratio for the euro area is 70 percent. The low value indicates that banking institutions remain severely underdeveloped. In many countries, the government still owns significant parts of the banking system indicating a lack of competition in this sector. At the same time, banking systems are plagued with large shares of non-performing loans. This is a problem especially in FYR Macedonia and Serbia and Montenegro, but also in Croatia and Turkey. The EBRD index of financial banking reform reaches satisfactory values only in Slovenia, Croatia, and Bulgaria. It remains particularly low in Serbia and Montenegro. A significant result of the weakness of the banking sectors is the low level of financial intermediation, indicated by the low ratios of credit to the private sector. It indicates that the lack of access to financial resources is an important impediment to the development of the private sector. The corresponding number for the euro area is 110 percent. Similarly, non-banking financial institutions remain weak. Where such data exist, the stock market capitalization points to the fact that equity markets are small. Apart from Croatia, the EBRD index of non-bank financial institutions is generally low in the region.

Apart from Turkey, the South - East European economies are likely to be too small to develop efficient financial institutions and markets on their own. Access to and supply of foreign capital is a viable alternative to improve the economy's provision with financial resources. Following the example of several EU accession countries in recent years, governments in the region should consider allowing foreign financial institutions to enter their domestic markets by buying domestic banks and their subsidiaries. This can help increase the efficiency of financial intermediation by bringing in know-how. At the same time, it gives domestic institutions greater financial stability. For foreign banks, entering markets in this way can be attractive as it saves the costs of building up customer relations especially on the depositor side. Obviously, opening up the financial system to international participation requires the removal of capital controls and the introduction of modern, market friendly financial regulation. Foreign investors have contributed positively to intensifying competition and improving efficiency in the financial sector in Central European countries where they own more than two thirds of the banking system ( Caviglia, Krause, and Thimann; Ickes, von Hagen, and Traistaru, 2002).

## **IV. Macroeconomic Stability: Successes and Risks**

Macro economic performance has been very disparate in the region in recent years, as some countries struggled through post-war periods and others like Turkey suffered currency crises. Table 5 gives an overview. A striking impression from that table is that the region today falls into two groups, one, for which successful macro economic stabilization could become an asset in attracting foreign investment in the future, and one which still suffers from more severe macro economic instability.

As shown in Table 5, seven of the 10 South East European countries achieved single-digit average inflation rates in the period from 1999 – 2001, four of them had inflation rates below five percent on average. This group contains Albania, Bosnia and Herzegovina, Croatia, FYR Macedonia, Bulgaria, Slovenia, and Cyprus. Note that Slovenia, though most advanced in terms of EU membership, had the

highest average inflation rate in this group. Inflation picked up somewhat in Albania during 2002, but remained stable or came down in the other countries of this group. These data indicate a strong commitment to monetary stability in these countries.

The other group of countries, consisting of Romania, Serbia and Montenegro, and Turkey, shows the effects of large macro economic imbalances during this period. Between 1997 and 2001, average inflation was 42 percent, 61 percent and 58 percent annually, respectively. All three countries achieved significant stabilization by 2002, but inflation remain well in the double-digits. Thus, stabilization remains a principal policy concern in these countries.

The commitment to macro economic stability seems to have had some positive pay-off in terms of stable and healthy economic growth. During the period 1997-2001, Albania and Bosnia and Herzegovina had the highest real growth rate, 6.5 percent annual average, which may be upward biased by the effects of a post-war recovery. Slovenia, Albania, Cyprus, and Croatia had the strongest growth performance among the other countries, 4.5, 4.4, 4.2, and 3.4 percent annual averages respectively. In contrast, the more unstable countries, Romania, Serbia and Montenegro, and Turkey, had much lower average growth during this period. Chart 6 makes the point. It shows the strong, negative relationship between the average rate of inflation (1999-2001) and the average real growth rate (1997-2001).

Table 5 also indicates that **the region's growth performance was quite robust in 2002, despite the economic slowdown in the world economy.** Bosnia and Herzegovina, FYR Macedonia, and Slovenia experienced somewhat lower real growth in 2002 compared to the average of the preceding five years, but Turkey and Romania improved considerably.

Successful macro economic stability has largely been achieved by stabilizing exchange rates. Official exchange rate regimes vary across countries in the region. Albania, Croatia, Serbia and Montenegro, Romania, and Slovenia apply managed floats, FYR Macedonia has a fixed exchange rate tied to the euro, Bosnia and Herzegovina and Bulgaria both maintain currency boards with the euro as anchor currency. As indicated in Table 6, however, exchange rate variability has been very low among the countries that achieved high degrees of macro economic stability, even if their official exchange rate regimes admit more flexibility. Average rates of change in euro exchange rates were very small in this group, as were the standard deviations of exchange rates. This is in line with the common perception that the exchange rate is the best nominal anchor for small, open economies. Note, however, Bulgaria and Slovenia, both countries with very stable exchange rates had among the highest inflation rates in that group. For fast-growing Slovenia in particular, this might be prima facie evidence of the *Balassa Samuelson effect* that predicts higher CPI inflation for countries pegging their exchange rates while enjoying faster productivity growth in their tradables industries than for the country whose currency they peg to. The policy implication is that the macro economic goals of low inflation and high productivity growth can be conflicting under fixed-exchange regimes. This could become a relevant point in a future choice of monetary strategy for joining the euro area. Since countries joining the euro area must not have inflation rates that are too high compared to the euro, they could be forced to give

up the fixed exchange rate to hold inflation down.<sup>8</sup> Alternatively, they might move to full-blown currency boards with the euro, to preserve the improve of the fixed exchange rate.

Adopting currency boards with the euro is an attractive option, for the small countries in the region at least, for another consideration. Above, we have pointed out that the countries should consider opening their banking systems to foreign banks to improve their economies' access to credit. Such a move would require liberalizing international capital flows, which in turn, endangers the sustainability of pegged exchange rate systems. When fixed exchange rates come under speculative attacks, capital controls are often the only defense the central banks have left to avoid currency crises. Since exposure of traditional managed floats to speculative attacks is particularly large, moving to a currency board can be a viable strategy to reduce the risk of currency crises. Of course, moving to a currency board forces a country to virtually give up its monetary policy autonomy. But the value of such autonomy is small for small open economies, anyway, since domestic monetary policy has little control over domestic output and prices (Begg et al., 2003). Thus, currency boards should be attractive arrangements for those countries in the region which do not already practice them today, as they combine greater macro economic stability with the opportunity to attract foreign banks and capital.

A number of risks to macro economic stability lurk behind this broader picture. One is the persistent and high level of unemployment in the region (see Table 5). Official unemployment rates are extremely high Bosnia and Herzegovina, Bulgaria, FYR Macedonia, and Serbia and Montenegro. But even where official rates are lower, the employment index, which compares employment in 2001 to employment in 1989 and, thus, illustrates the extent of job destruction in the transition process, shows that employment is generally low in the region. In fact, Cyprus is the only country that enjoyed significant job creation over the last decade. Employment growth was low even in Greece and Turkey, which are not transition economies. **Creating new jobs must be a priority of economic policies in these countries in particular. Political pressures might arise otherwise that turn governments to using inflationary policies in efforts to overcome the problem.**

A second risk to macro economic stability arises from the external sector in some countries. Table 6 shows that several countries in the region experienced very sizeable current account deficits recently. Albania, Bosnia and Herzegovina, FYR Macedonia, and Serbia and Montenegro received very sizeable remittances from emigrant workers and significant amounts of international financial aid in recent years, which offset part of these deficits. In 2000, **some of the economies in South East Europe show a large aid dependence.** Thus, Albania received international assistance amounting to 8.5 percent of GDP, FYR Macedonia 7.6 percent of GDP, Serbia and Montenegro 13.4 percent of GDP, and Bosnia and Herzegovina 17.6 percent of GDP. But these sources of financing are not sustainable in the long run. Turkey, Bulgaria, and Serbia and Montenegro have very heavy burdens of external debt, making their external performance more precarious.

A third risk factor comes from the lack of fiscal discipline in some countries, see Table 7. Turkey stands out for its huge fiscal deficit in 2001 and the years before, and its high public debt. Both add to

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<sup>8</sup> See Begg et al. (2003) for a discussion.

the macro economic instability of the country. Though much smaller, large fiscal deficits are also a reason for concern in Albania, Croatia, and Serbia and Montenegro. In the first two of these, the problem has been going on for some time, as indicated by the averages for 1999-2001 shown in Table 7. Public debt burdens seem rather large already in Albania, Croatia, and Serbia and Montenegro, indicating that there is not much room left for allowing deficits to persist. Achieving greater fiscal discipline is a principal policy requirement in these countries. The experience from other countries suggests that improving fiscal institutions, i.e. the rules of budget making and administration, and increasing fiscal transparency is one important approach to achieve this goal (von Hagen and Harden, 1995; Gleich, 2002).

Public services including welfare systems are not yet developed according to modern standards in these countries. Public spending on education and health is generally low, amounting to no more and often much less than six percent of GDP in the region. Only Croatia (9.5 percent of GDP) and Slovenia (6.7 percent of GDP) had higher health expenditures in 2001. Education and social reforms that are necessary to promote the development of sustainable market economies will put additional pressures on future budgets and force governments to cut spending elsewhere to avoid expansions of public spending to unsustainable levels. During the 1990s, the ratio of government spending to GDP has converged to rates around 40 percent in most EU accession states (von Hagen and Gleich, 2001). **Taking this rate as a benchmark suggests that there is considerable room for reducing expenditures in Bosnia Herzegovina, Croatia, and Serbia and Montenegro, which would help assuring macro economic stability and free public resources for the required spending adjustments. Other countries will have to rely more on finding additional and new sources of tax revenues both to secure fiscal stability and to finance new demands on the public sector.**

## V. Trade and Foreign Direct Investment Performance

The recent improvement of the economic climate in the region following the stabilization and reform process has contributed to the expansion of trade and foreign direct investment although it has been uneven across countries. In most South East European countries export growth has been the main engine for GDP growth in recent years. Chart 7 shows the positive correlation between export growth and real GDP growth.

### *Trade Liberalization*

South East European countries have generally liberal and open trade systems (see Table 8). Nine of these countries are members of the WTO while Bosnia and Herzegovina and Serbia and Montenegro have requested WTO membership in 1999 and 2001 respectively. All countries have preferential trade agreements with the European Union (EU) and a network of intra-regional bilateral free trade agreements. Cyprus and Turkey have had custom unions with the EU since 1973 and 1996 respectively. Bulgaria, Romania, and Slovenia have gradually liberalized their trade with the EU via

the Europe Agreements<sup>9</sup>. Cyprus and Slovenia are to become EU members in 2004 and Bulgaria and Romania are expected to join the EU in 2007. Croatia applied formally for EU membership in February 2003. The five countries of the Western Balkans group<sup>10</sup> have been benefiting from duty free access to EU market for almost all goods (with particular conditions for certain textile and agricultural products) via a set of autonomous trade measures (ATMs) granted unilaterally by the EU in September 2000<sup>11</sup>. Furthermore, the EU has signed Stabilization and Association Agreements (SAA) with FYR Macedonia and Croatia providing for progressive reciprocal free trade of goods. SAA negotiations have started with Albania at the beginning of 2003 and are under examination in the cases of Bosnia and Herzegovina and Serbia and Montenegro.

Intra-regional trade liberalization and trade cooperation have been facilitated through regional free trade agreements such as CEFTA (Central European Free Trade Agreement)<sup>12</sup> and bilateral free trade agreements concluded in the framework of the Stability Pact<sup>13</sup>. Bulgaria, Croatia, Romania and Slovenia are members of CEFTA. A network of 21 bilateral free trade agreements have been negotiated as part of the Trade Initiative of the Stability Pact<sup>14</sup> amongst Albania, Bosnia and Herzegovina, Bulgaria, Croatia, FYR Macedonia, Romania, Serbia and Montenegro<sup>15</sup>. A free trade area in South East Europe is planned to be fully in force starting with July 2003. Yet, the experience with CEFTA, and the existing trade and specialization patterns suggest that its potential in generating intra-regional trade will be limited given the small size of the regional market and very similar comparative advantages, as will be shown below. One important implication of the progressive trade liberalization is that it will diminish the governments' customs revenues. This loss will require compensation through the widening of the tax base and the development of new taxes.

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<sup>9</sup> The Europe Agreements established a framework for bilateral political dialog and economic co-operation between Central and Eastern European countries and the European Union. They include measures for the progressive trade liberalization with industrial products. Protocols on rules of origin provide for a diagonal cumulation of origin on industrial products between the EU, the EFTA countries, the CEECs and Turkey. Protocols on reciprocal tariff concessions on agricultural products entered into force on 1 July 2000 with all CEECs except Poland with whom it entered into force on 1 January 2001 (World Trade Organisation, European Union Trade Policy Review 2002).

<sup>10</sup> Albania, Bosnia and Herzegovina, Croatia, Former Yugoslav Republic of Macedonia, Serbia and Montenegro. Since 1999 Kosovo is under the special mandate of the UN Mission in Kosovo (UNMIK), based on the UN Security Council Resolution 1244.

<sup>11</sup> Applicable until 31 December 2005 based on Council Regulation No.2007/2000 (European Commission, 2003a)

<sup>12</sup> CEFTA was initially signed by Czechoslovakia, Hungary, and Poland on 21 December 1992. Slovenia, Romania, Bulgaria, and Croatia subsequently joined.

<sup>13</sup> The Stability Pact was launched in June 1999 by an EU initiative. It is a political declaration of commitment and a framework agreement on international co-operation to develop a long term strategy for stability and growth in South East Europe. Information about the activities of the Stability Pact can be found at <http://www.stabilitypact.org>

<sup>14</sup> the basis for these free trade agreements is the Memorandum on Trade Liberalization and Facilitation signed on 27 June 2001 in the framework of the Stability Pact

<sup>15</sup> 10 agreements are in force and 11 agreements are in the process of ratification. Moldova has associated itself to the Pact with an extended timetable

### *Trade Performance*

Overall, the region accounts for a small share of world total trade. In 2001, the region's exports of goods represented 1.2 percent and imports 2.0 percent of the world totals respectively. The largest trading countries in the region are Turkey, Romania, Slovenia and Greece. These four countries in 2001 accounted for 79 percent of the region's total exports (see Chart 8).

The EU is the main destination of exports from South East European countries (see Chart 9.) In 2001, the share of exports to the EU in total exports was above two thirds in Albania, Serbia and Montenegro, Romania, Bosnia and Herzegovina, and Slovenia. The share of exports to the other countries in the region was relatively high, 44 percent, in FYR Macedonia and around one quarter in Bosnia and Herzegovina, Greece, Serbia and Montenegro, and Croatia. Intra – regional exports accounted for smaller shares in the total exports of the remaining countries. The dependence on the EU markets for exports could negatively affect the prospects for export growth should the EU continue to grow slowly. **To keep exports growing, South East European countries must rely on improving competitiveness or regional diversification.**

The EU is also the main origin of imports with the exceptions of Cyprus and Turkey where the share of imports from the rest of the world is higher (see Chart 10). **Intra-regional imports account for a small share in the total imports of South East European countries.** Only three countries, Bosnia and Herzegovina, FYR Macedonia, and Serbia and Montenegro have imports from the other countries in the region above one quarter.

Labor-intensive products make up the largest part of exports for all countries with the exception of Slovenia (Chart 11). Slovenia and Croatia have relatively high shares of capital intensive product exports. Capital intensive and labor intensive products represent the bulk of imports in South East European countries with capital intensive products more than one third of imports. This trade structure reflects inter-industry specialization patterns typical for developing countries in their exchanges with more advanced economies. The examples of Slovenia and Croatia suggest that switching to more advanced specialization structures requires product quality upgrading in technologically more advanced branches<sup>16</sup>.

The comparative advantages of countries in South East Europe are to a large extent overlapping (see Table 9). The same three sectors ranked by the revealed comparative advantage index (RCA)<sup>17</sup> appear among the five highest ranked sectors in eight out of the eleven countries: *Leather products* (all countries, except Slovenia, Turkey, Greece); *Clothing* (in all countries, except, Bosnia and Herzegovina, Serbia and Montenegro, Slovenia); and *Basic manufactures* (in all countries, except Croatia, Cyprus, Slovenia). *Chemicals* are among the five sectors with the highest RCA in six countries (Croatia, Serbia and Montenegro, Bulgaria, Cyprus, Slovenia, Greece), as well as *Wood products* (in all five countries of the Western Balkans). Another three sectors from the labour intensive

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<sup>16</sup> see Landesmann and Stehrer (2002) for a more detailed discussion on the potential for switching to more advanced specialization patterns in catching –up economies

<sup>17</sup> The revealed comparative advantage is calculated as the ratio of the product group share in national exports to its share in the world exports.

category are present in four countries: *Miscellaneous manufacturing* (Albania, Bosnia and Herzegovina, Cyprus, and Slovenia), *Textiles* (Bosnia and Herzegovina, FYR Macedonia, Turkey and Greece), and *Processed food* (FYR Macedonia, Serbia and Montenegro, Cyprus, Greece). Capital intensive products are among the five sectors with the highest RCA only in a few countries: *Non-electronic machinery* (Slovenia, Bulgaria, and Romania), *IT & Consumer electronics* (Romania and Turkey), *Transport equipment* (Croatia, and Turkey), *Electronic components* (Slovenia).

This analysis indicates that the South East European countries compete in the same external markets and do so with developing countries having similar comparative advantages. Given the low growth potential of those external markets due to low income elasticities of demand in the export markets, **development strategies should focus on better production structures and differentiated products.**

### *Foreign Direct Investment*

FDI inflows in South East Europe in 2001 represented 1.3 percent of the world's inward FDI. The UNCTAD FDI performance index<sup>18</sup> and Inward FDI Potential Index<sup>19</sup> (Table 11), suggest that Bulgaria and Croatia are performing best in terms of their FDI performance while Slovenia, Cyprus, and Greece are the best placed in terms of inward FDI potential. **In recent years, FDI inflows were stimulated by privatization, so they could slow down if economic reforms do not continue.** Per capita FDI inflows were particularly high in Croatia, FYR Macedonia, Slovenia, and Cyprus, and were comparable with the size of per capita FDI inflows in two advanced transition economies, Hungary and Poland. Greece and Bulgaria performed better than the regional average while Albania, Turkey, Romania, Bosnia and Herzegovina, and Serbia and Montenegro fell below the region's average (Chart 12). FDI inflows were also positively related to the inward FDI stocks in 2001 (see Chart 13) suggesting that initial conditions and previous performance matter for future FDI inflows. This result implies a successful "demonstration effect" of first movers in attracting subsequent investors in the region.

The macro economic importance of FDI for the region is underscored by the fact that FDI inflows are positively correlated with export growth, see Chart 14. Countries with high levels of FDI inflows are those with relatively high per-capita exports, while low per-capita exports come with low FDI inflows. **This suggests that foreign investors are particularly attracted by opportunities to produce export goods in South East Europe,** i.e. to use the relative production cost advantages of the region. Given the importance of export growth for real GDP growth in the region, this means that attracting FDI is an important element of a strategy for sustained growth.

Foreign investors entering a country to produce export goods are likely to take the institutional quality of the host country as a particularly important factor in their decisions. As indicated above, institutional

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<sup>18</sup> The inward FDI performance index is calculated as the ratio of a country's share in global FDI flows to its share in global GDP (UNCTAD World Investment Report, 2002)

<sup>19</sup> The inward FDI potential index is an unweighted average of the scores of eight normalized economic and social variables including: the rate of growth of GDP; per capita GDP; share of exports in GDP; telephone lines per 1,000 inhabitants; commercial energy use per capita; share of R&D expenditures in gross national income; share of tertiary students in the population; country risk (UNCTAD World Investment Report, 2002)



quality determines the quality of the business environment and reduces the uncertainty of economic choices. This makes the institutional quality of the host country an important element in the competition for foreign direct investment. Charts 15-17 corroborate this reasoning. Here, we use three institutional indexes from Table 3: voice and accountability, regulatory quality, and corruption control. FDI stocks show strong positive correlations with all three. This again points to the importance of improving the institutional environment of the South East European countries to support and promote their economic development. An example of improved institutional quality and superior economic performance is Estonia which has achieved a regulatory quality similar to more advanced economies such as Denmark and Germany and has been recently successful in attracting foreign investment and achieving high growth rates.

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## Annex: Tables and Graphs

**Table 1: Basic Economic Indicators**

|                           | Population<br>(mill., 2001) | Average Population<br>Growth (%)<br>1991-2000 | Population Density<br>(persons per sq.km) | GDP<br>(mill. USD)<br>2000 | GDP<br>Per capita<br>(USD at PPP<br>rates)<br>2001 | Shares in GDP (% , 2001) |                    |                    |
|---------------------------|-----------------------------|---|---|----------------------------|--|--------------------------|--------------------|--------------------|
|                           |                             |   |   |                            |  | Agriculture              | Industry           | Others             |
| Albania                   | 3.4                         | - 0.6   | 120                                       | 3752                       | 3720   | 49.1                     | 27.3               | 23.6               |
| Bosnia and<br>Herzegovina | 4.1                         | - 0,1   | 79  | 4394                       | 2715   | 14.8 <sup>a)</sup>       | 30.6 <sup>a)</sup> | 54.6 <sup>a)</sup> |
| Bulgaria                  | 8.1                         | - 0.9   | 73  | 11995                      | 5607   | 13.7                     | 28.4               | 57.9               |
| Croatia                   | 4.4                         | 0.3   | 77  | 19031                      | 7854   | 8.3                      | 32.3               | 59.5               |
| Cyprus                    | 0.8                         | 1.5   | 82  | 8698                       | 11543  | 5.0                      | 20.0               | 75.0               |
| FYR Macedonia             | 2.0                         | 0.6   | 79  | 3579                       | 4913   | 10.9 <sup>b)</sup>       | 31.2 <sup>b)</sup> | 58.0 <sup>b)</sup> |
| Serbia and<br>Montenegro  | 10.6                        | 0.4   | 104                                       | 8449                       | 3532   | 25.1                     | 38.2               | 36.7               |
| Romania                   | 22.4                        | - 0.4   | 94  | 36719                      | 6973   | 12.4                     | 37.1               | 50.6               |
| Slovenia                  | 2.0                         | 0.4   | 98  | 18129                      | 17788  | 2.7                      | 27.4               | 59.1               |
| Turkey                    | 66.2                        | 1.7   | 85  | 199937                     | 6021   | 15.2                     | 26.6               | 58.3               |
| Greece                    | 10.6                        | 0.4   | 80  | 112646                     | 17653  | 7.9 <sup>b)</sup>        | 23.6 <sup>b)</sup> | 68.5 <sup>b)</sup> |

Notes: a) 1998; b) 1999

Source: World Bank, World Development Indicators (2002); EBRD (2002, 2003); UN Economic Commission for Europe (2002)

**Table 2: Development Indices (2002)**

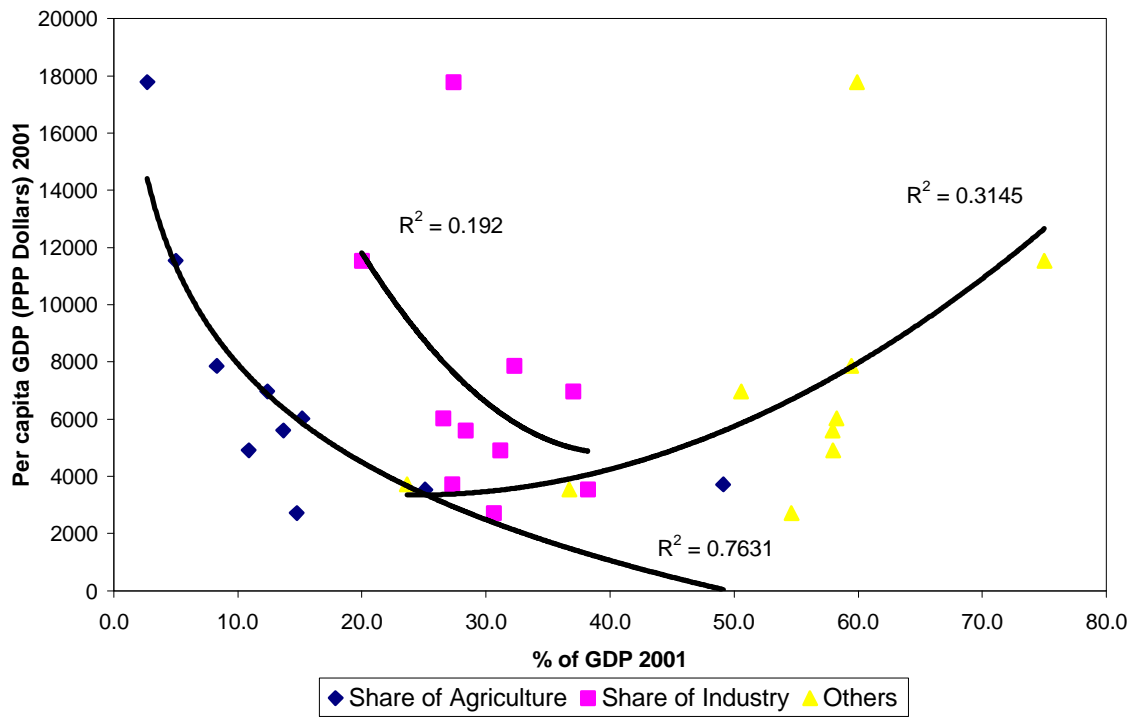
|                        | Urban Population (% of total) | Life Expectancy at Birth | Adult Literacy (%) <sup>a)</sup> | School Enrolment (%) <sup>b)</sup> | Human Development Index | EBRD Indicator of Infrastructure Reform |
|------------------------|-------------------------------|--------------------------|----------------------------------|------------------------------------|-------------------------|---|
| Albania                | 42.9                          | 74.0                     | 84.7                             | 71.0                               | 0.73                    | 2.0                                     |
| Bosnia and Herzegovina | 43.4                          | 74.0                     | n.a.                             | n.a.                               | n.a.                    | 2.0                                     |
| Bulgaria               | 67.5                          | 71.6                     | 98.4                             | 72.0                               | 0.78                    | 2.7                                     |
| Croatia                | 58.1                          | 73.3                     | 98.3                             | 68.0                               | 0.81                    | 2.7                                     |
| Cyprus                 | 69.9                          | 77.9                     | 97.1                             | 68.0                               | 0.88                    | n.a.                                    |
| FYR Macedonia          | 59.5                          | 72.8                     | 94.0                             | 70.0                               | 0.77                    | 2.0                                     |
| Serbia and Montenegro  | 51.7                          | 72.5                     | n.a.                             | n.a.                               | n.a.                    | 2.0                                     |
| Romania                | 55.3                          | 69.9                     | 98.1                             | 69.0                               | 0.78                    | 3.0                                     |
| Slovenia               | 49.2                          | 75.3                     | 99.6                             | 83.0                               | 0.88                    | 3.0                                     |
| Turkey                 | 65.8                          | 69.8                     | 85.1                             | 62.0                               | 0.74                    | n.a.                                    |
| Greece                 | 60.6                          | 78.2                     | 97.2                             | 81.0                               | 0.89                    | n.a.                                    |

**Notes:** a) percent of population age 15 and above

b) Combined gross primary, secondary, and tertiary enrolment (1999)

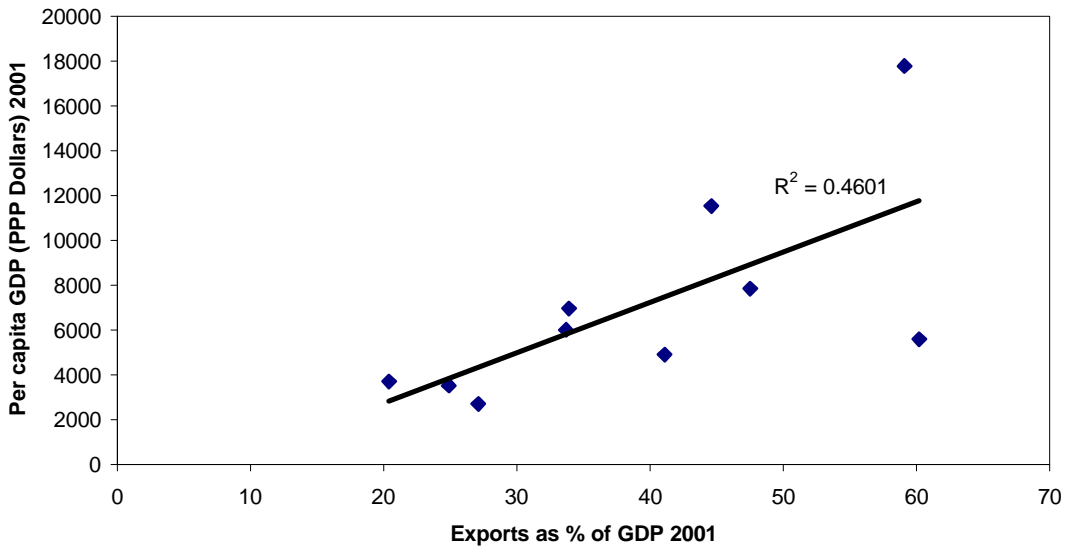
Source: EBRD (2001, 2002); World Bank; UNDP Human Development Report (2002)

**Chart 1: Economic Structure and Per-capita GDP in South-East Europe**



Sources: World Bank, World Development Indicators (2002); EBRD (2002, 2003); UN Economic Commission for Europe (2002)

**Chart 2: Economic Openness and Per-capita GDP in South-East Europe**



Sources: World Bank, World Development Indicators (2002); EBRD (2002, 2003); UN Economic Commission for Europe(2002)

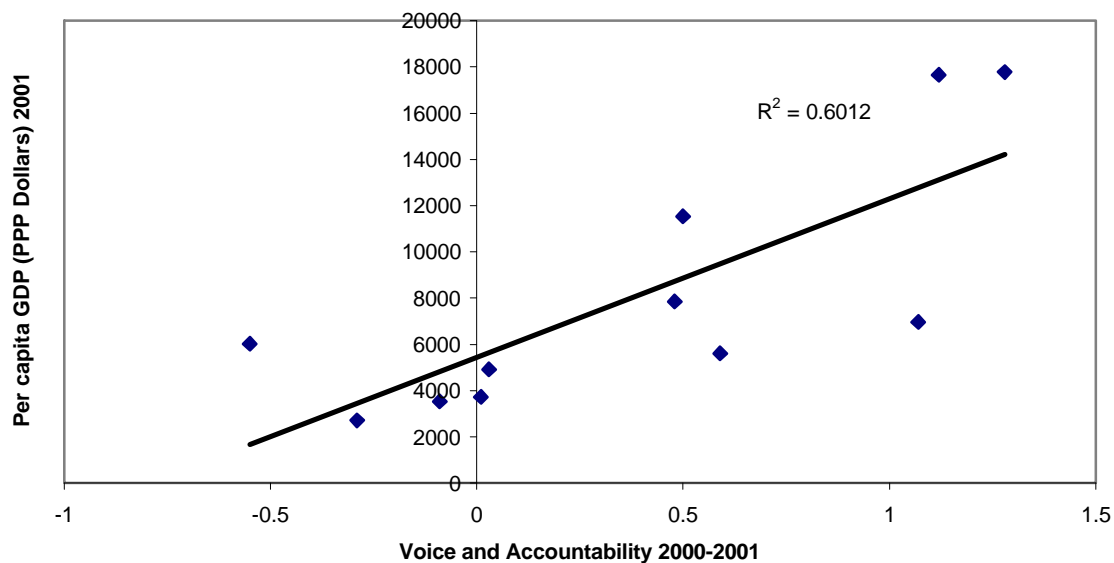
**Table 3: Institutional Indicators**

|                        | Voice, accountability |         | Political stability |         | Government effectiveness |         | Regulatory quality |         | Rule of Law |         | Corruption |         |
|------------------------|-----------------------|---------|---------------------|---------|--------------------------|---------|--------------------|---------|-------------|---------|------------|---------|
|                        | 2000/01               | 1999/98 | 2000/01             | 1997/98 | 2000/01                  | 1997/98 | 2000/01            | 1997/98 | 2000/01     | 1997/98 | 2000/01    | 1997/98 |
| Albania                | 0.01                  | - 0.13  | - 0.60              | - 1.00  | - 0.89                   | - 0.65  | - 0.21             | - 0.70  | - 0.71      | - 0.92  | - 0.60     | - 0.99  |
| Bosnia and Herzegovina | - 0.29                | - 1.00  | - 0.01              | - 1.16  | - 0.92                   | - 1.11  | - 1.18             | - 1.26  | - 0.75      | - 1.11  | - 0.49     | - 0.35  |
| Bulgaria               | 0.59                  | 0.47    | 0.37                | 0.43    | - 0.26                   | - 0.81  | 0.16               | 0.52    | 0.02        | - 0.15  | - 0.16     | - 0.56  |
| Croatia                | 0.48                  | - 0.23  | 0.18                | 0.41    | 0.10                     | 0.15    | 0.20               | 0.24    | 0.29        | 0.15    | 0.02       | - 0.46  |
| Cyprus                 | 1.28                  | 1.11    | 0.48                | 0.38    | 0.91                     | 1.04    | 0.83               | 0.84    | 0.96        | 0.93    | 1.24       | 1.81    |
| FYR Macedonia          | 0.03                  | 0.09    | - 1.45              | - 0.4   | - 0.63                   | - 0.58  | - 0.23             | - 0.31  | - 0.33      | - 0.26  | - 0.51     | - 0.52  |
| Serbia and Montenegro  | - 0.09                | - 0.71  | - 0.48              | - 1.42  | - 0.97                   | - 0.95  | - 0.70             | - 1.54  | - 0.94      | - 0.81  | - 1.04     | - 0.99  |
| Romania                | 0.50                  | 0.29    | - 0.08              | 0.02    | - 0.54                   | - 0.57  | - 0.28             | 0.20    | - 0.02      | - 0.09  | - 0.51     | - 0.46  |
| Slovenia               | 1.07                  | 1.03    | 0.87                | 1.09    | 0.70                     | 0.57    | 0.52               | 0.53    | 0.89        | 0.83    | 1.09       | 1.02    |
| Turkey                 | - 0.55                | - 0.88  | - 0.75              | - 0.94  | - 0.15                   | - 0.41  | 0.04               | 0.59    | - 0.16      | - 0.01  | - 0.48     | - 0.35  |
| Greece                 | 1.12                  | 1.05    | 0.79                | 0.21    | 0.65                     | 0.56    | 0.71               | 0.60    | 0.62        | 0.50    | 0.73       | 0.82    |

Source: Kaufmann et al. (2002); Fraser Institute (2002)

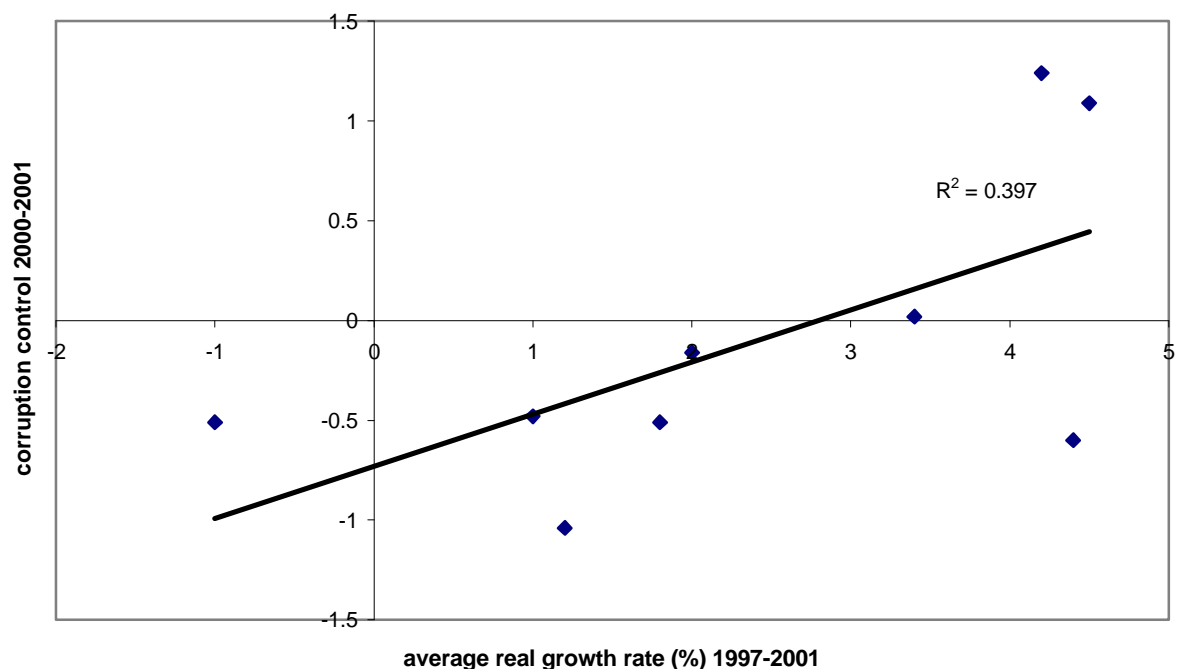


**Chart 3: Voice and Accountability and Per-capita GDP in South- East Europe**



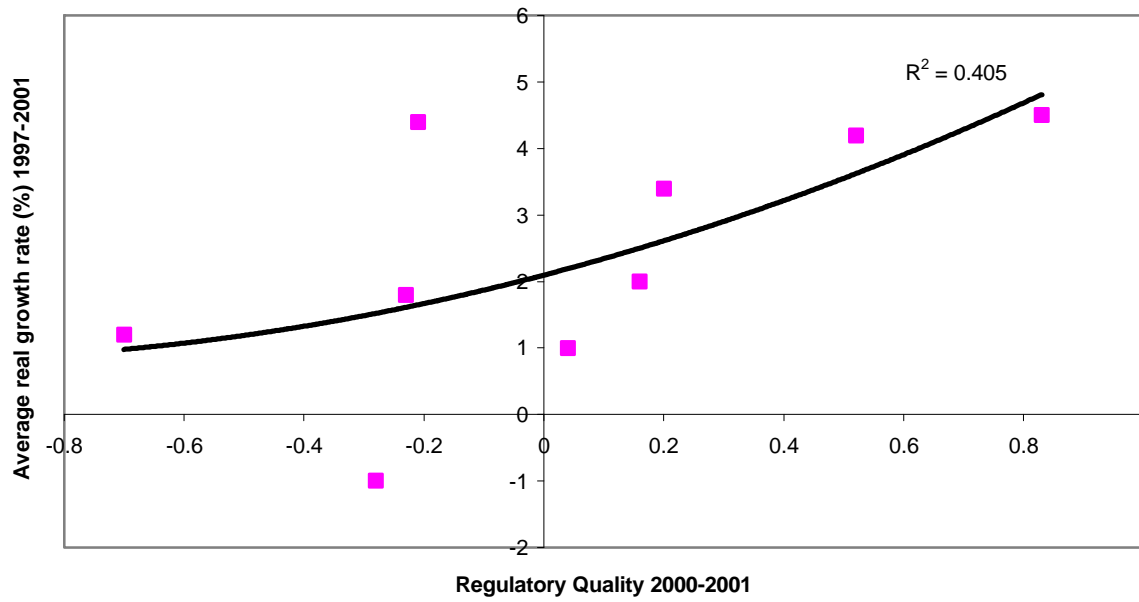
Sources: World Bank, World Development Indicators (2002); EBRD (2002, 2003); UN Economic Commission for Europe (2002); Kaufmann et al. (2002); Fraser Institute (2002)

**Chart 4: Corruption Control and Average Annual Real Growth in South-East Europe**



Sources: Kaufmann et al. (2002); Fraser Institute (2002); European Commission (2002, 2003); IMF, World Economic Outlook (2003); EBRD (2002, 2003); UN Economic Commission for Europe (2002); authors' calculations

**Chart 5: Regulatory Quality and Average Annual real Growth in South-East Europe**



Sources: Kaufmann et al. (2002); Fraser Institute (2002); European Commission (2002, 2003); IMF, World Economic Outlook (2003); EBRD (2002); UN Economic Commission for Europe (2002); authors' calculations

**Table 4: Monetary and Financial Sector Indicators, 2001**

|                           | Broad money<br>(M2 end-year)<br>% of GDP | Domestic credit to<br>private sector<br>% of GDP | Share of majority<br>state-owned banks<br>in total bank assets<br>(%) | Stock market<br>capitalisation<br>% of GDP | Non-performing<br>bank loans<br>% of total loans | EBRD<br>Index of<br>banking<br>sector<br>reform | EBRD index<br>of non-<br>banking<br>financial<br>institutions |
|---------------------------|--|--|---|--|--|---|---|
| Albania                   | 62.1                                     | 4.0  | 59.2  | n.a.                                       | 6.9  | 2.3   | 2.0   |
| Bosnia and<br>Herzegovina | 47.0                                     | 2.2  | 8.9   | n.a.                                       | 7.0  | 2.3   | 1.0   |
| Bulgaria                  | 40.9                                     | 14.6   | 19.9  | 3.7  | 7.9  | 3.0   | 2.0   |
| Croatia                   | 76.9                                     | 24.5   | 3.8   | 15.4                                       | 13.7   | 3.7   | 3.0   |
| Cyprus                    | 125.2                                    | 125.0  | 4.2   | n.a.                                       | 9.4  |   |   |
| FYR Macedonia             | 19.0                                     | 12.5   | 1.3   | 0.4  | 24.7   | 3.0   | 1.7   |
| Serbia and<br>Montenegro  | 16.9                                     | 6.0  | 68.0  | ..   | 24.4   | 1.0   | 1.0   |
| Romania                   | 24.0                                     | 8.0  | 45.4  | 6.0  | 3.4  | 2.7   | 2.0   |
| Slovenia                  | 63.0                                     | 40.4   | 48.4  | 15.3                                       | 9.2  | 3.3   | 2.7   |
| Turkey                    | 25.0                                     | 16.9   | 31.6  |  | 12.9   |   |   |
| Greece                    | 73.1 <sup>a),b)</sup>                    | 38.4 <sup>b)</sup>                               | n.a.  | n.a.                                       | n.a.   | n.a.  | n.a.  |

Note: a) M3; b) 2000

Source: EBRD (2002); UN Economic Commission for Europe (2002); European Commission (2002); IMF (2002); authors' calculations

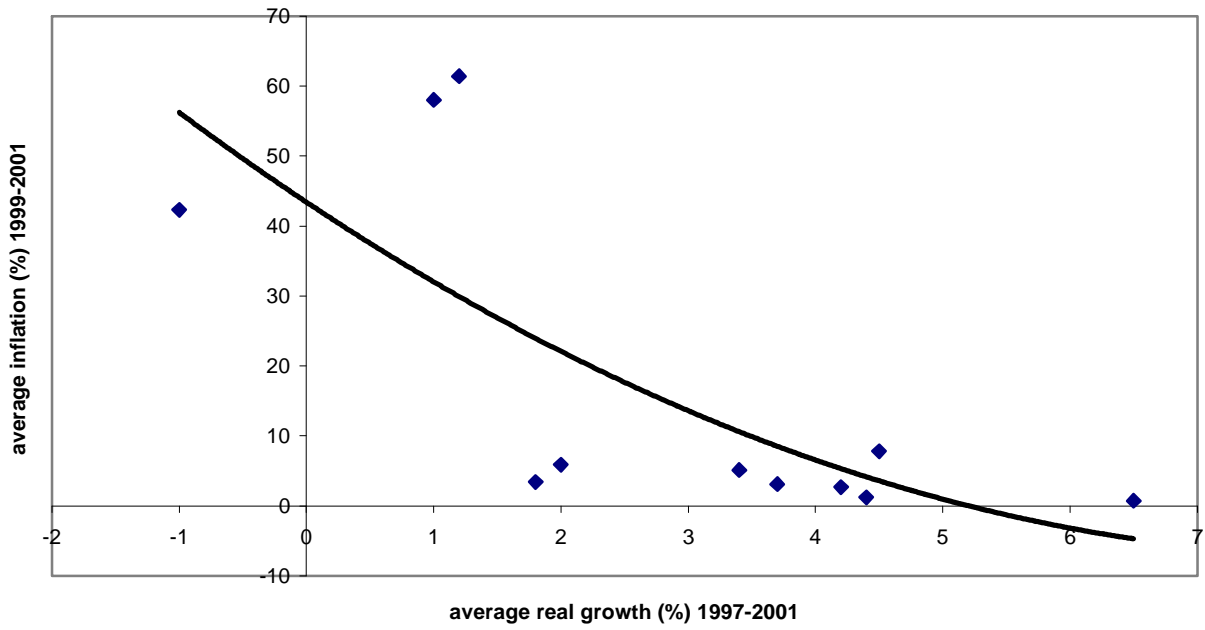
**Table 5: Macroeconomic Performance**

|                           | CPI Inflation<br>(%, 2002) | Average CPI Inflation,<br>1999-2001<br>(%) | Real GDP Growth<br>(%, 2002) | Average Real<br>GDP<br>Growth Rate<br>(1997-2001) | Unemployment<br>Rate<br>(%, 2002) | Total<br>Employment<br>(1989 =<br>100, 2001) |
|---------------------------|----------------------------|--|------------------------------|---|-----------------------------------|--|
| Albania                   | 5.4                        | 1.2  | 4.7                          | 4.4   | 14.6                              | 80.3   |
| Bosnia and<br>Herzegovina | 0.0                        | 0.7  | 3.8                          | 6.5   | 40.4                              | 74.2   |
| Bulgaria                  | 5.9                        | 5.9  | 4.5                          | 2.0   | 19.5                              | 37.9   |
| Croatia                   | 2.4                        | 5.1  | 5.2                          | 3.4   | 15.8                              | 67.4   |
| Cyprus                    | 2.8                        | 2.7  | 2.0                          | 4.2   | 4.0                               | 114.5  |
| FYR Macedonia             | 2.4                        | 3.4  | 0.0                          | 1.8   | 30.5                              | 60.3   |
| Serbia and<br>Montenegro  | 21.4                       | 61.4                                       | 4.0                          | 1.2   | 27.5                              | 80.2   |
| Romania                   | 22.5                       | 42.3                                       | 4.9                          | - 1.0   | 8.6                               | 78.8 <sup>a)</sup>                           |
| Slovenia                  | 7.5                        | 7.8  | 2.9                          | 4.5   | 5.9                               | 83.9   |
| Turkey                    | 54.4                       | 58.0                                       | 6.7                          | 1.0   | 8.5                               | 108.7  |
| Greece                    | 3.9                        | 3.1  | 4.0                          | 3.7   | 10.5                              | 106.9  |

**Note:** a) 2000

Source: European Commission (2002,2003a); IMF, World Economic Outlook (2003); EBRD (2002), UN Economic Commission for Europe (2002); authors' calculations

**Chart 6: Average Annual Inflation and Real Growth in South-East Europe**



Sources: European Commission (2002, 2003); IMF, World Economic Outlook (2003); EBRD (2002); UN Economic Commission for Europe (2002); authors' calculations

**Table 6: External Stability**

|                        | Average Change in Euro Exchange Rate <sup>a)</sup><br>(Annual Rate 1998 – 2002)<br>% | Standard Deviation of Euro Exchange Rate <sup>b)</sup><br>(%, 1997 – 2002) | Current Account Balance<br>(% of GDP, 2001) |
|------------------------|--|--|---|
| Albania                | - 4.8  | 12.8   | - 6.3                                       |
| Bosnia and Herzegovina | - 2.4  | 4.6  | - 22.3                                      |
| Bulgaria               | 0.7  | 1.4  | - 6.2                                       |
| Croatia                | 1.2  | 3.3  | - 3.1                                       |
| Cyprus                 | - 0.2  |  | - 4.3                                       |
| FYR Macedonia          | 1.0  | 3.0  | - 10.6                                      |
| Serbia and Montenegro  | 56.8   | 83.4   | - 5.5                                       |
| Romania                | 30.9   | 48.4   | - 5.9                                       |
| Slovenia               | 4.6  | 8.9  | - 0.4                                       |
| Turkey                 | 52.7   | 73.4   | 2.3   |
|                        |  |  |   |
| Greece                 | - 0.4  | 4.4  | - 4.0 <sup>a)</sup>                         |

Note: a) 1999, b) based on annual average rates

Source: European Commission (2002, 2003a); EBRD (2003); IMF, World Economic Outlook (2003); author's calculations

**Table 7: Fiscal Indicators**

|                        | General Government Balance (% of GDP) 2002 | General Government Balance (% of GDP) Average 1999 – 2001 | General Government Debt (% of GDP) 2002 | General Government Expenditure (% of GDP) 2002 |
|------------------------|--|---|---|--|
| Albania                | - 7.5                                      | - 9.7   | 64.4                                    | 31.0   |
| Bosnia and Herzegovina | - 4.1                                      | - 8.3   | 46.8 <sup>a)</sup>                      | 56.0   |
| Bulgaria               | - 0.8                                      | - 0.3   | 54.5                                    | 38.9   |
| Croatia                | - 6.2                                      | - 6.7   | 57.5                                    | 51.5   |
| Cyprus                 | - 3.5                                      | - 3.2   | 54.6 <sup>c)</sup>                      | 38.2 <sup>d)</sup>                             |
| FYR Macedonia          | - 3.5                                      | - 1.1   | 37.4 <sup>a)</sup>                      | 37.8   |
| Serbia and Montenegro  | - 5.7                                      | - 1.1 <sup>b)</sup>                                       | 77.0 <sup>a)</sup>                      | 48.7   |
| Romania                | - 2.7                                      | - 3.6   | 29.8                                    | 33.6   |
| Slovenia               | - 2.9                                      | - 1.1   | 29.0                                    | 43.5   |
| Turkey                 | - 28.4 <sup>c)</sup>                       | - 17.7  | 102.5 <sup>c)</sup>                     | 43.2 <sup>d)</sup>                             |
| Greece                 | - 1.3                                      | - 1.6   | 105.8                                   | 47.7   |

Note: a) external debt b) 200-2001 c) 2001 d) Central Government, 2001

Source: EBRD (2003); European Commission (2003a); European Commission (2002), IMF (2003a)

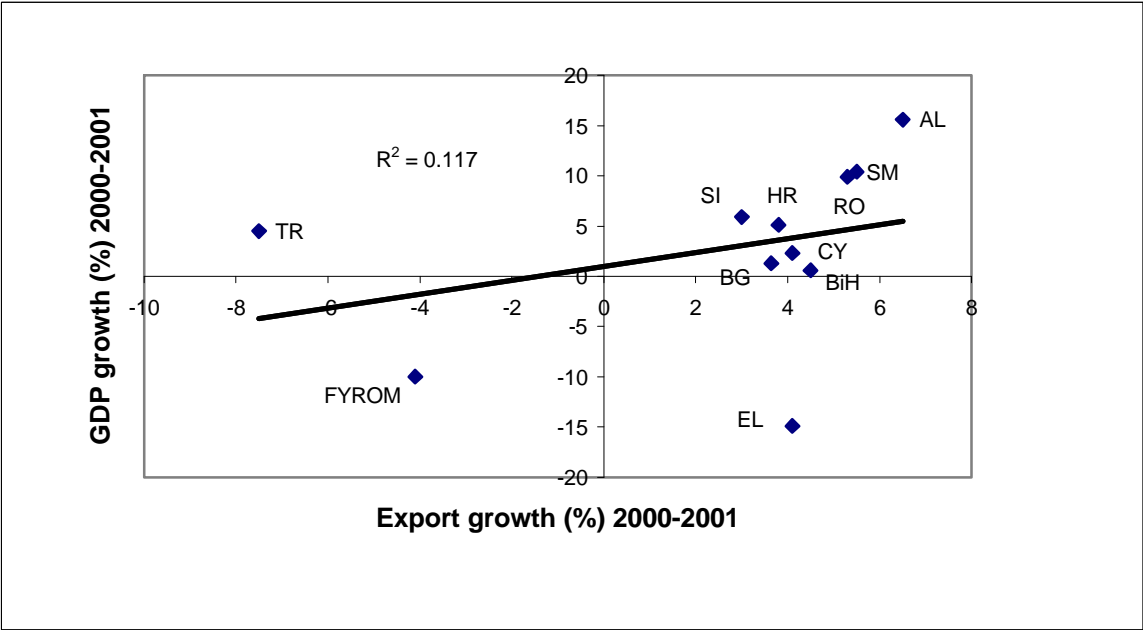
**Table 8: Free Trade Agreements in South - East Europe, as of January 2003**

|                        | WTO accession and Status | EU relations  | Free Trade Agreements(FTAs)  |
|------------------------|--------------------------|---|--|
| Albania                | 2000                     | ATMs September 2000<br>SAA negotiations started 2003  | FTAs under the Stability Pact  |
| Bosnia and Herzegovina | accession requested 1999 | ATMs 1997 and September 2000<br>Road Map for SAA  | FTAs under the Stability Pact  |
| Croatia                | 2000                     | ATMs September 2000<br>SAA signed October 2001<br>Interim agreement in force 2002<br>Applied for EU membership in February 2003 | CEFTA, 1 January 2003, FTA with EFTA<br>FTAs under the Stability Pact<br>FTA with Slovenia   |
| FYR Macedonia          | 2003                     | ATMs September 2000<br>SAA, signed April 2001<br>Interim agreement in force June 2001   | FTAs under the Stability Pact<br>FTAs with Turkey, Ukraine, EFTA   |
| Serbia and Montenegro  | accession requested 2001 | ATMs September 2000<br>Working groups of experts to assess the progress on reforms aiming at proposing a SAA                    | FTAs under the Stability Pact<br>FTAs with Hungary, Slovenia, Russia   |
| Bulgaria               | 1996                     | Europe Agreement, 31 December 1993<br>EU accession expected 2007  | CEFTA, 1 January 1999, FTA with EFTA<br>FTAs under the Stability Pact<br>FTAs with Turkey  |
| Cyprus                 | 1963                     | Association Agreement (CU, 1 June 1973)<br>EU accession Treaty signed April 2003  |  |
| Romania                | 1971                     | Europe Agreement, 1 May 1993<br>EU Accession expected 2007  | CEFTA, 1 July 1997, FTA with EFTA<br>FTAs under the Stability Pact<br>FTAs with Moldova, Turkey  |
| Slovenia               | 1994                     | Europe Agreement, 1 January 1997<br>EU accession Treaty signed April 2003   | CEFTA, 1 January 1996, FTA with EFTA<br>FTAs with Serbia and Montenegro, Turkey<br>Estonia, Latvia, Lithuania, Israel, Croatia             |
| Turkey                 | 1951                     | Association Agreement (CU, 1 January 1996)  | FTAs with EFTA, Israel, Romania, Hungary, Estonia, Czech Rep., Slovak Rep., Bulgaria, Poland, Slovenia, Latvia, FYR Macedonia<br>Lithuania |
| Greece                 | 1950                     | EU accession 1 January 1981<br>EMU member, 1 January 2002   |  |

ATMs: Autonomous Trade Measures; CU: Customs Union; FTA: Free Trade Agreement; SAA: Stabilisation and Association Agreement;  
CEFTA: Central European Free Trade Agreement  
Source: World Trade Organization data bases, [www.wto.org](http://www.wto.org), European Commission (2003)



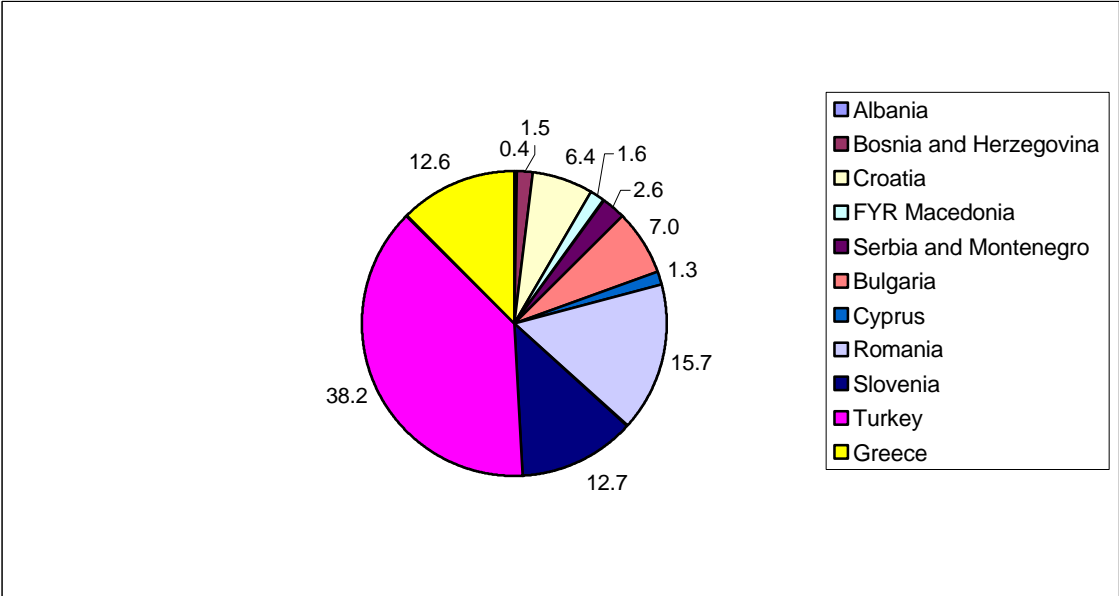
**Chart 7: Exports and GDP Growth in South - East Europe**



Source: Authors' calculations based on data from UNCTAD Handbook of Statistics (2002); EBRD (2003); IMF The World Economic Outlook Database (2003)

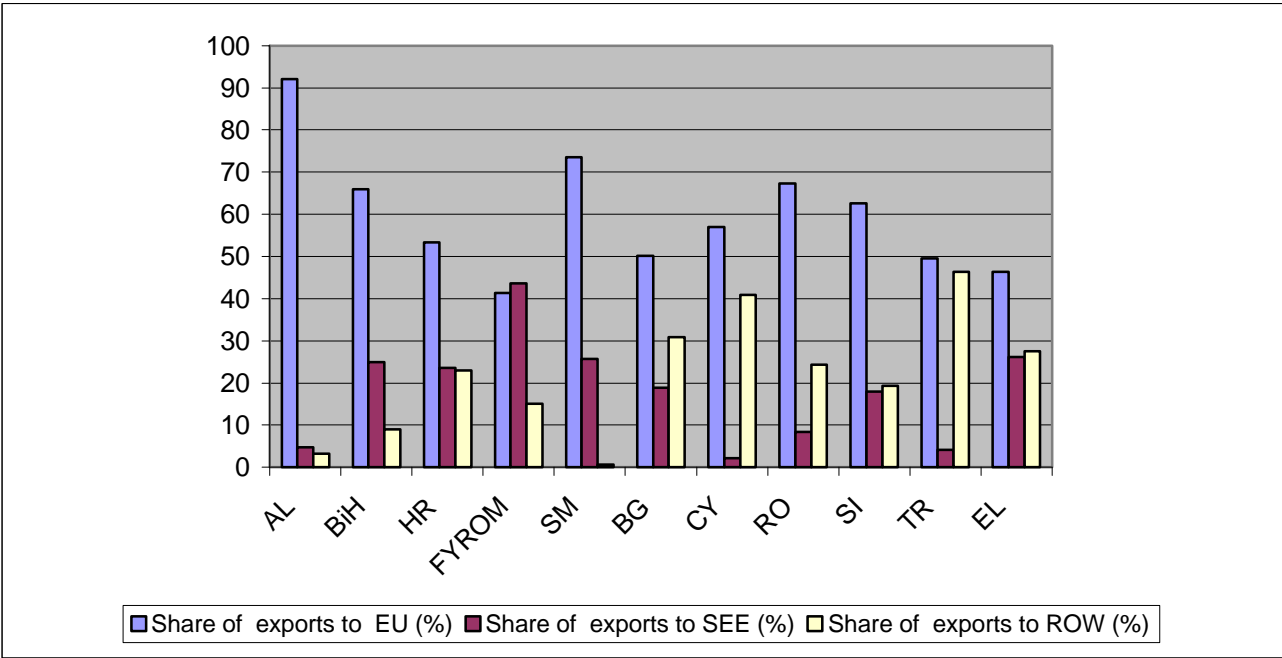
Country codes: AL = Albania, BiH = Bosnia and Herzegovina, BG = Bulgaria, HR = Croatia, CY = Cyprus, EL = Greece, FYROM = FYR Macedonia, SM = Serbia and Montenegro, RO = Romania, SI = Slovenia, TR = Turkey

**Chart 8: Exports of South - East Europe, by Country, 2001**



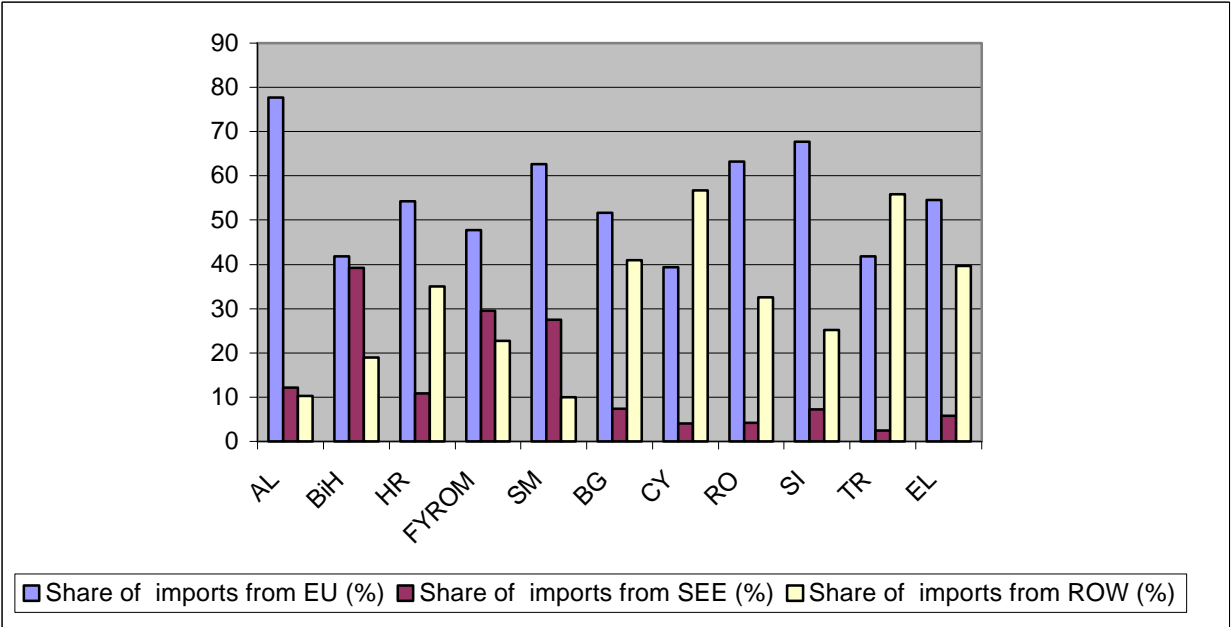
Source: Authors' calculations based on data from UNCTAD Handbook of Statistics (2002)

**Chart 9: Exports of South - East European Countries by Destination, 2001**



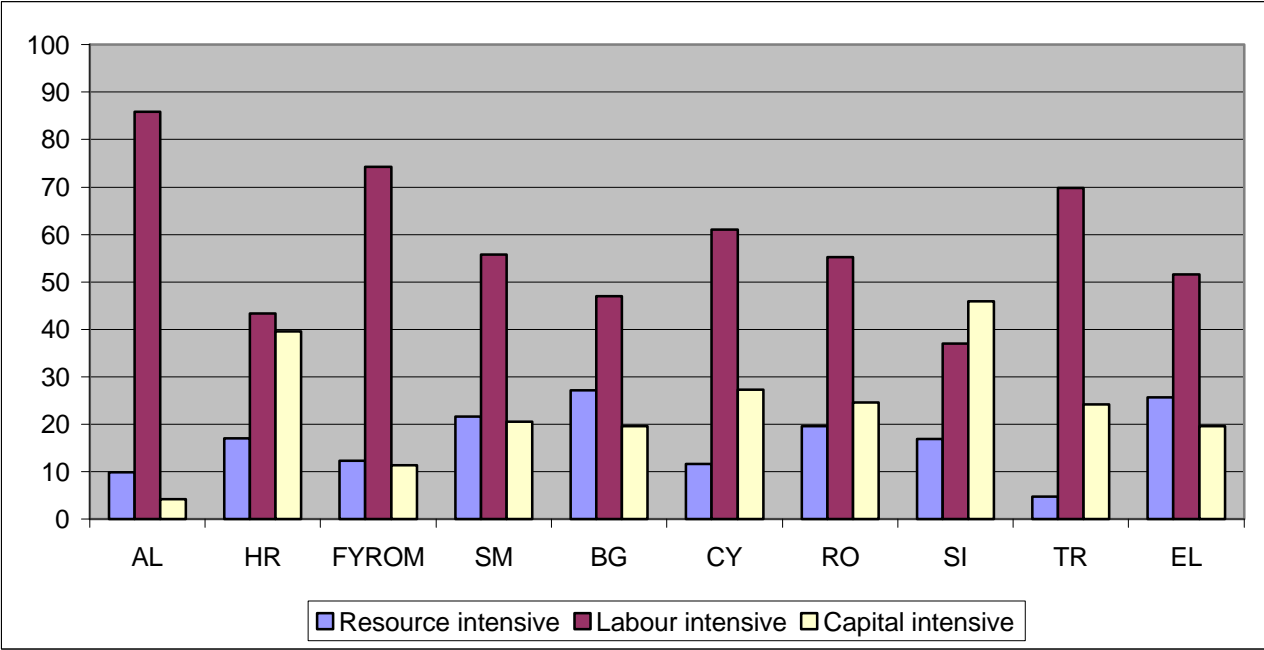
**Note:** Greece is included in the EU group and it is not included in the SEE group  
**Sources:** Authors' calculations based on UNCTAD Handbook of Statistics (2002); IMF Direction of Trade (2002)  
**Country codes:** AL = Albania, BiH = Bosnia and Herzegovina, BG = Bulgaria, HR = Croatia, CY = Cyprus, EL = Greece, FYROM = FYR Macedonia, SM = Serbia and Montenegro, RO = Romania, SI = Slovenia, TR = Turkey, ROW = the rest of the world

**Chart 10: Imports of South- East European Countries by Origin, 2001**



**Note:** Greece is included in the EU group and it is not included in the SEE group  
**Source:** Authors' calculations based on UNCTAD Handbook of Statistics (2002); IMF Direction of Trade (2002)  
**Country codes:** AL = Albania, BiH = Bosnia and Herzegovina, BG = Bulgaria, HR = Croatia, CY = Cyprus, EL = Greece, FYROM = FYR Macedonia, SM = Serbia and Montenegro, RO = Romania, SI = Slovenia, TR = Turkey, ROW = the rest of the world

**Chart 11: Composition of Exports by Factor Intensity, South - East European Countries, 2001**



Source: Authors' calculations based on UNCTAD Handbook of Statistics (2002)

Country codes: AL = Albania, BiH = Bosnia and Herzegovina, BG = Bulgaria, HR = Croatia, CY = Cyprus, EL = Greece, FYROM = FYR Macedonia, SM = Serbia and Montenegro, RO = Romania, SI = Slovenia, TR = Turkey

**Table 9: Export performance and specialization in South - East Europe, 2001**

| Country                       | Share in national export % | Share in world market % | RCA   | RCA Rank | Country                     | Share in national export % | Share in world market % | RCA  | RCA Rank |
|-------------------------------|----------------------------|-------------------------|-------|----------|-----------------------------|----------------------------|-------------------------|------|----------|
| <b>Albania</b>                |                            |                         |       |          | <b>Bulgaria</b>             |                            |                         |      |          |
| Leather products              | 32.00                      | 0.14                    | 24.62 | 2        | Basic manufactures          | 23.00                      | 0.20                    | 3.11 | 14       |
| Clothing                      | 36.00                      | 0.06                    | 10.86 | 16       | Clothing                    | 16.00                      | 0.32                    | 4.91 | 26       |
| Wood products                 | 3.00                       | 0.01                    | 1.04  | 55       | Leather products            | 4.00                       | 0.19                    | 2.80 | 27       |
| Basic manufactures            | 7.00                       | 0.00                    | 0.93  | 61       | Chemicals                   | 12.00                      | 0.07                    | 1.08 | 30       |
| Miscellaneous manufacturing   | 4.00                       | 0.00                    | 0.48  | 68       | Non-electronic machinery    | 6.00                       | 0.04                    | 0.61 | 33       |
| <b>Bosnia and Herzegovina</b> |                            |                         |       |          | <b>Cyprus</b>               |                            |                         |      |          |
| Leather products              | 9.00                       | 0.12                    | 7.06  | 7        | Chemicals                   | 20.00                      | 0.01                    | 1.80 | 9        |
| Wood products                 | 17.00                      | 0.09                    | 5.37  | 9        | Processed food              | 16.00                      | 0.03                    | 3.90 | 24       |
| Basic manufactures            | 24.00                      | 0.05                    | 3.27  | 11       | Miscellaneous manufacturing | 8.00                       | 0.01                    | 0.99 | 32       |
| Textiles                      | 4.00                       | 0.03                    | 1.56  | 27       | Leather products            | 2.00                       | 0.01                    | 1.28 | 47       |
| Miscellaneous manufacturing   | 9.00                       | 0.02                    | 1.12  | 27       | Clothing                    | 8.00                       | 0.02                    | 2.38 | 48       |
| <b>Croatia</b>                |                            |                         |       |          | <b>Romania</b>              |                            |                         |      |          |
| Transport equipment           | 17.00                      | 0.11                    | 1.32  | 16       | Leather products            | 9.00                       | 1.53                    | 7.24 | 6        |
| Leather products              | 4.00                       | 0.28                    | 3.24  | 22       | Basic manufactures          | 14.00                      | 0.37                    | 1.82 | 22       |
| Wood products                 | 6.00                       | 0.17                    | 2.03  | 34       | Clothing                    | 25.00                      | 1.48                    | 7.36 | 22       |
| Chemicals                     | 11.00                      | 0.08                    | 0.95  | 36       | Non-electronic machinery    | 6.00                       | 0.12                    | 0.59 | 35       |
| Clothing                      | 11.00                      | 0.26                    | 3.16  | 38       | IT & Consumer electronics   | 4.00                       | 0.07                    | 0.36 | 36       |
| <b>FRY Macedonia</b>          |                            |                         |       |          | <b>Slovenia</b>             |                            |                         |      |          |
| Basic manufactures            | 29.00                      | 0.08                    | 3.83  | 9        | Miscellaneous manufacturing | 14.00                      | 0.29                    | 1.74 | 8        |
| Clothing                      | 28.00                      | 0.17                    | 8.41  | 20       | Non-electronic machinery    | 11.00                      | 0.17                    | 1.02 | 18       |
| Leather products              | 3.00                       | 0.06                    | 2.68  | 28       | Electronic components       | 11.00                      | 0.20                    | 1.22 | 19       |
| Textiles                      | 3.00                       | 0.03                    | 1.26  | 33       | Chemicals                   | 14.00                      | 0.20                    | 1.24 | 21       |
| Processed food                | 9.00                       | 0.04                    | 2.21  | 44       | Basic manufactures          | 14.00                      | 0.30                    | 1.82 | 23       |
| <b>Serbia and Montenegro</b>  |                            |                         |       |          | <b>Turkey</b>               |                            |                         |      |          |
| Basic manufactures            | 29.00                      | 0.09                    | 3.84  | 8        | Textiles                    | 13.00                      | 2.75                    | 4.94 | 5        |
| Chemicals                     | 15.00                      | 0.03                    | 1.31  | 19       | Basic manufactures          | 15.00                      | 1.11                    | 2.02 | 20       |
| Leather products              | 4.00                       | 0.07                    | 3.01  | 23       | Clothing                    | 21.00                      | 3.56                    | 6.44 | 23       |
| Processed food                | 14.00                      | 0.08                    | 3.48  | 27       | Transport equipment         | 10.00                      | 0.44                    | 0.79 | 29       |
| Wood products                 | 6.00                       | 0.04                    | 1.89  | 36       | IT & Consumer electronics   | 3.00                       | 0.18                    | 0.32 | 38       |
|                               |                            |                         |       |          | <b>Greece</b>               |                            |                         |      |          |
|                               |                            |                         |       |          | Basic manufactures          | 15.00                      | 0.35                    | 2.06 | 19       |
|                               |                            |                         |       |          | Processed food              | 14.00                      | 0.56                    | 3.28 | 29       |
|                               |                            |                         |       |          | Textiles                    | 4.00                       | 0.27                    | 1.54 | 29       |
|                               |                            |                         |       |          | Clothing                    | 14.00                      | 0.71                    | 4.11 | 32       |
|                               |                            |                         |       |          | Chemicals                   | 10.00                      | 0.15                    | 0.89 | 39       |

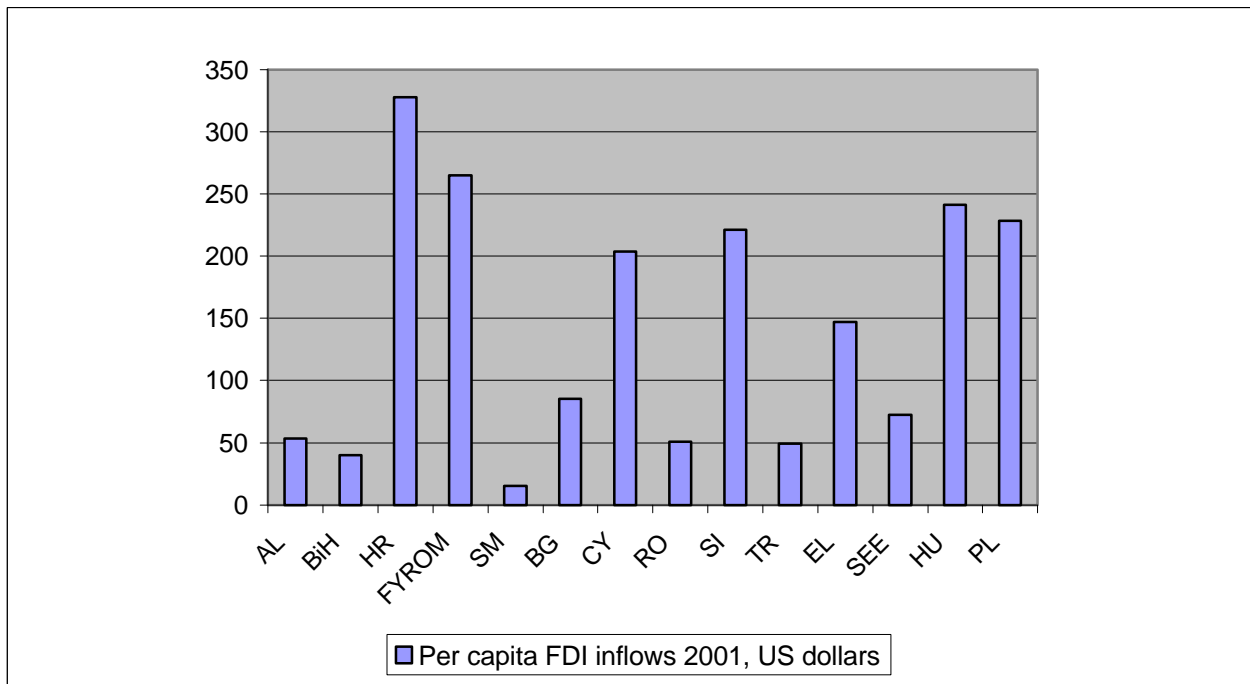
Source: International Trade Center  
www.intracen.org

**Table 10: Rankings and values of the UNCTAD inward FDI Performance Index and Inward FDI Potential Index, South-East Europe, 1998-2000**

|          | Inward FDI Performance Index |      | Inward FDI Potential Index |      |
|----------|------------------------------|------|----------------------------|------|
|          | Value                        | Rank | Value                      | Rank |
| Albania  | 0.6                          | 81   | 0.207                      | 100  |
| Croatia  | 1.7                          | 27   | 0.343                      | 46   |
| FYROM    | 0.9                          | 66   | 0.25                       | 86   |
| Bulgaria | 1.8                          | 24   | 0.321                      | 53   |
| Cyprus   | 0.4                          | 102  | 0.414                      | 34   |
| Romania  | 1                            | 57   | 0.248                      | 87   |
| Slovenia | 0.3                          | 110  | 0.429                      | 31   |
| Turkey   | 0.1                          | 123  | 0.275                      | 72   |
| Greece   | 0.1                          | 125  | 0.414                      | 35   |
| Hungary  | 1.1                          | 49   | 0.274                      | 42   |

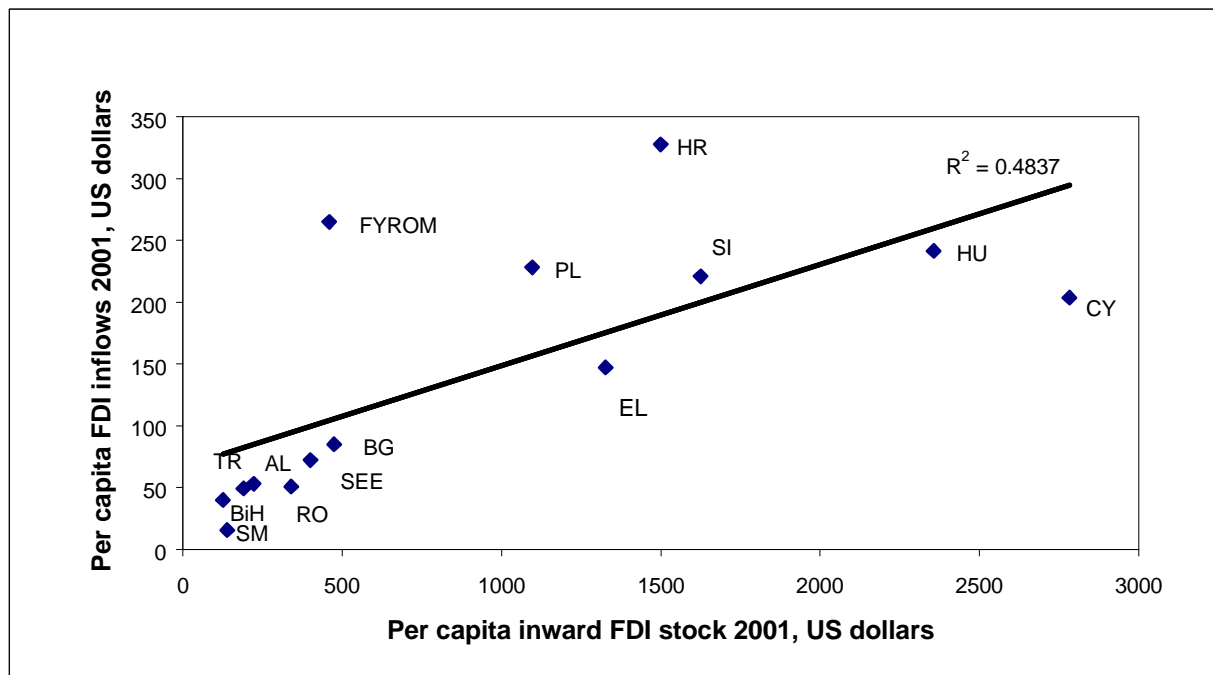
Source: UNCTAD World Investment Report (2002)

**Chart 12: Per- capita Inward FDI Flows in South - East Europe, 2001**



Source: Authors' calculations based on data from UNCTAD World Investment Report (2002); UNDP Human Development Report (2002)  
Country codes: AL = Albania, BiH = Bosnia and Herzegovina, BG = Bulgaria, HR = Croatia, CY = Cyprus, EL = Greece, FYROM = FYR Macedonia, SM = Serbia and Montenegro, RO = Romania, SI = Slovenia, TR = Turkey, SEE = South-East Europe

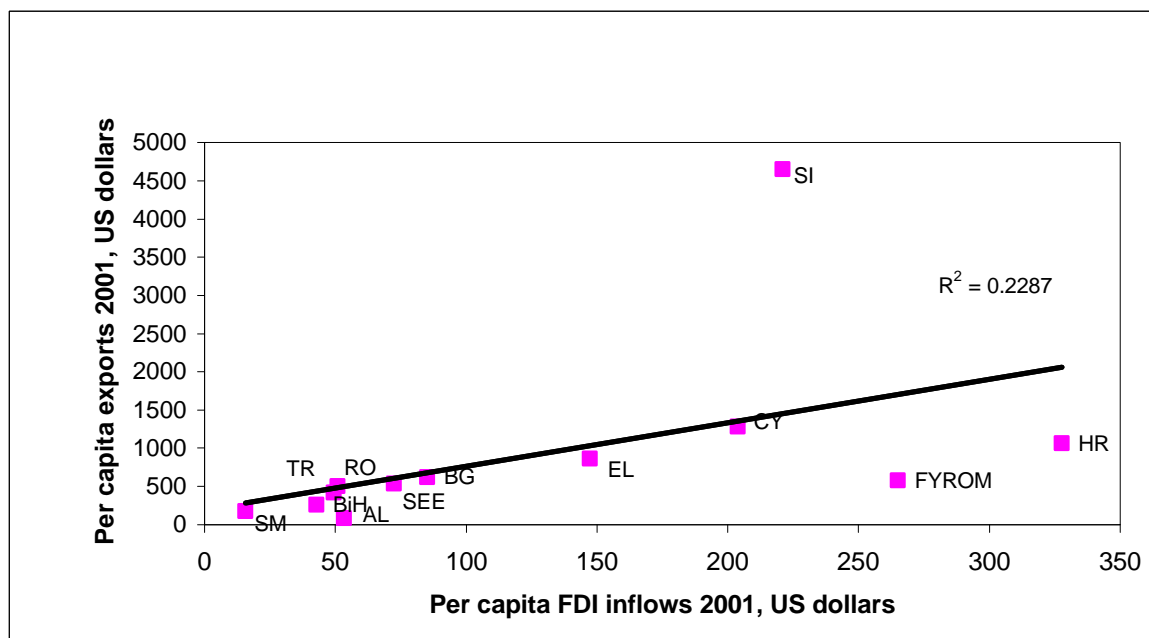
**Chart 13: Per - capita Inward FDI Stocks and FDI Inflows in South - East Europe**



Source: Authors' calculations based on data from UNCTAD World Investment Report (2002); UNDP Human Development Report (2002)

Country codes: AL = Albania, BiH = Bosnia and Herzegovina, BG = Bulgaria, HR = Croatia, CY = Cyprus, EL = Greece, FYROM = FYR Macedonia, SM = Serbia and Montenegro, RO = Romania, SI = Slovenia, TR = Turkey, SEE = South-East Europe

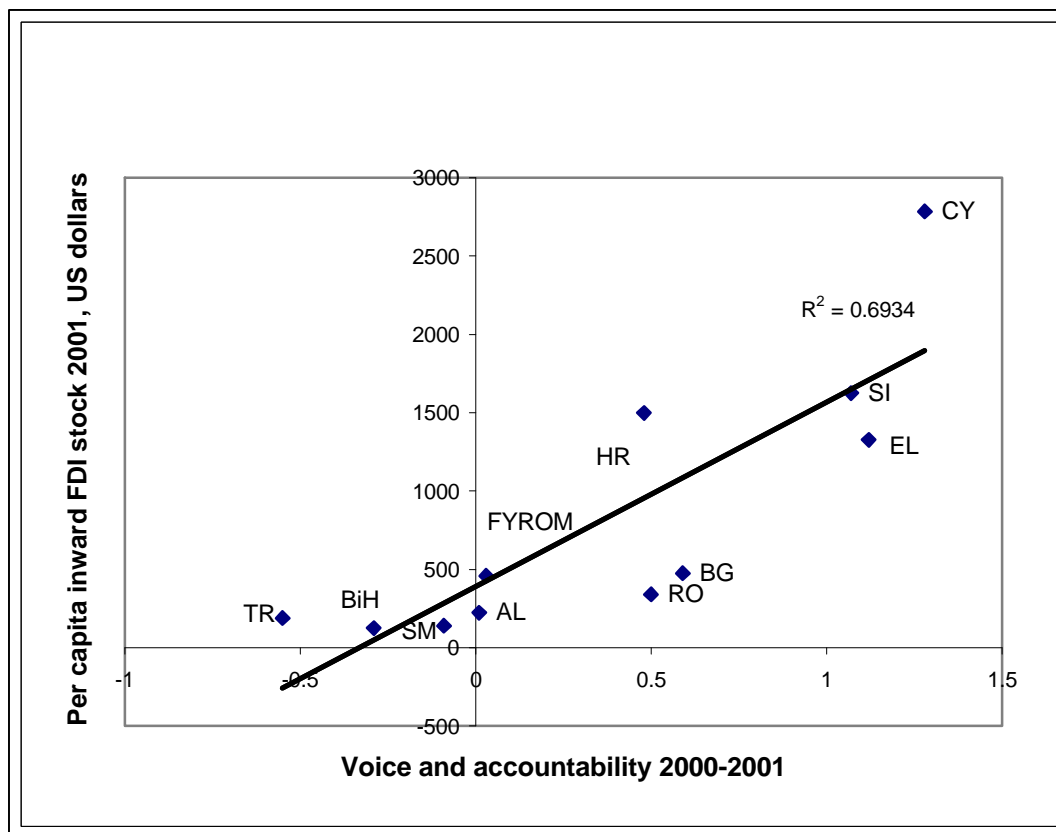
**Chart 14: Per - capita FDI Inflows and Exports in South - East Europe, 2001**



Source: Authors' calculations based on data from UNCTAD World Investment Report (2002); UNCTAD Handbook of Statistics (2002); UNDP Human Development Report (2002)

Country codes: AL = Albania, BiH = Bosnia and Herzegovina, BG = Bulgaria, HR = Croatia, CY = Cyprus, EL = Greece, FYROM = FYR Macedonia, SM = Serbia and Montenegro, RO = Romania, SI = Slovenia, TR = Turkey, SEE = South-East Europe

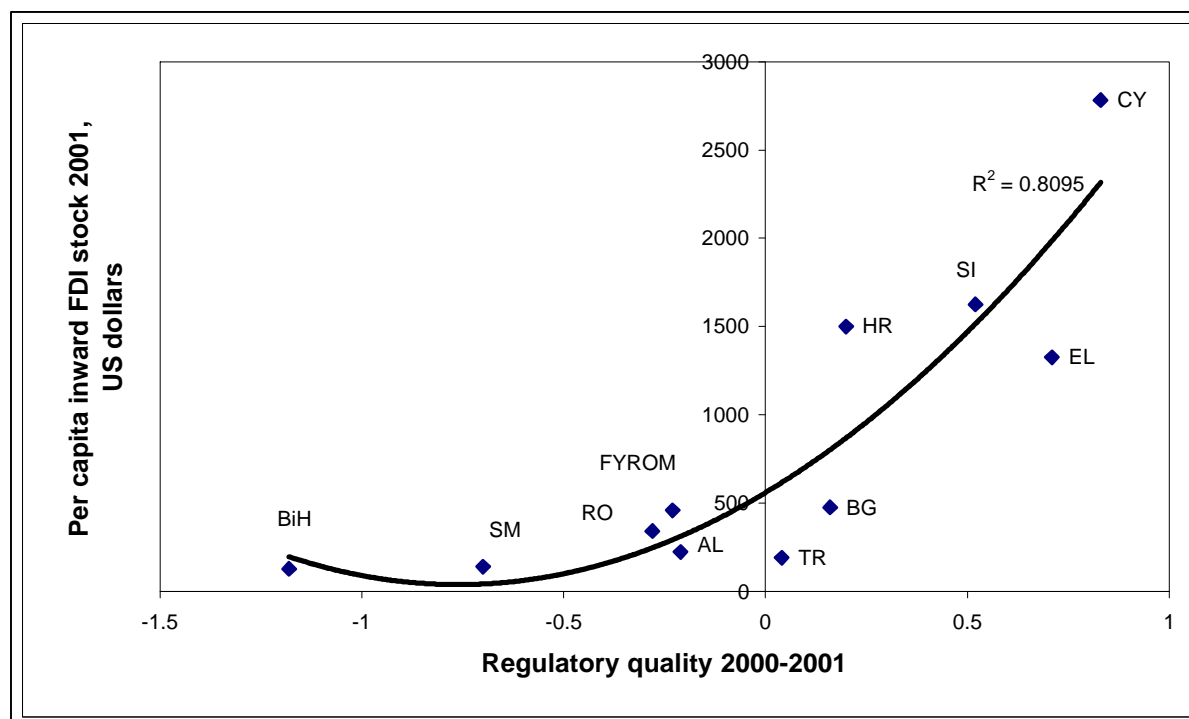
Chart 15: Voice and Accountability and Per - capita Inward FDI Stock in South - East Europe



Source: Authors' calculations based on UNCTAD World Investment Report (2002); UNDP Human Development Report (2002); Kaufmann et al (2002) Country codes: AL = Albania, BiH = Bosnia and Herzegovina, BG = Bulgaria, HR = Croatia, CY = Cyprus, EL = Greece, FYROM = FYR Macedonia, SM = Serbia and Montenegro, RO = Romania, SI = Slovenia, TR = Turkey



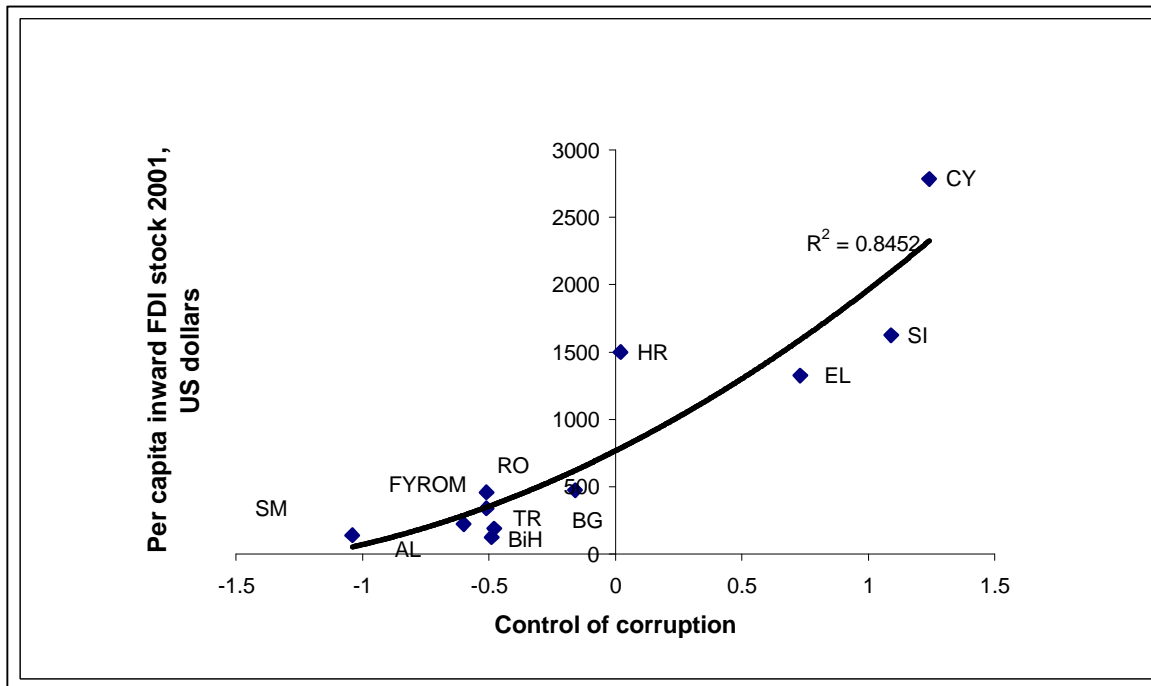
**Chart 16: Regulatory Quality and Per Capita Inward FDI Stock in South - East Europe**



Source: Authors' calculations based on data from UNCTAD World Investment Report (2002); UNDP Human Development Report (2002); Kaufmann et al (2002)

Country codes: AL = Albania, BIH = Bosnia and Herzegovina, BG = Bulgaria, HR = Croatia, CY = Cyprus, EL = Greece, FYROM = FYR Macedonia, SM = Serbia and Montenegro, RO = Romania, SI = Slovenia, TR = Turkey

**Chart 17: Control of Corruption and Per Capita Inward FDI Stock in South - East Europe, 2001**



Source: Authors' calculations based from UNCTAD World Investment Report (2002); UNDP Human Development Report (2002); Kaufmann et al (2002)

Country codes: AL = Albania, BiH = Bosnia and Herzegovina, BG = Bulgaria, HR = Croatia, CY = Cyprus, EL = Greece, FYROM = FYR Macedonia, SM = Serbia and Montenegro, RO = Romania, SI = Slovenia, TR = Turkey

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