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THE CEPS PLAN FOR THE BALKANS

**EDITED
BY
MICHAEL EMERSON
AND
DANIEL GROS**

**CENTRE FOR EUROPEAN POLICY STUDIES
BRUSSELS**

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Centre for European Policy Studies
Place du Congrès 1, B-1000 Brussels
Tel: (32.2) 229.39.11 Fax: (32.2) 219.41.51
e-mail: info@ceps.be
internet: <http://www.ceps.be>

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PREFACE

On 24 March 1999, NATO began its bombing campaign to stop the ethnic cleansing of Kosovo. This lasted for over two months until agreement was reached for the total withdrawal of Serbian forces, and the bombing ended on 9 June.

The conflict over Kosovo had been anything but unanticipated. For its part, CEPS had initiated in late 1998 a Working Party on the “Future of South-East Europe”, co-chaired by Erhard Busek, Coordinator of the Southeast European Cooperative Initiative, and Panagiotis Roumeliotis, Coordinator of the Royaumont Process. This initiative was born of the conviction that the European Union had no adequate strategy for the region.

The work was put into emergency mode as soon as the NATO bombing began. We sought to answer the question: “If, after the war is over, the European Union were to do everything in its actual or emerging powers to resolve the Balkan tragedy once and for all, what might its strategy consist of?”

A first draft of the resulting paper, entitled *A System for Post-War South-East Europe*, was circulated on 4 April 1999. Widespread consultations followed and a fourth revision was eventually published under the same title on 3 May as CEPS Working Document No. 131. This text, which came to be referred to as the “CEPS Plan” or the “CEPS Green Paper” is reproduced here with minor corrections in Part II. A complementary economic analysis of trade and monetary regimes in the region was developed in greater depth by Daniel Gros of CEPS in *An Economic System for Post-War South-East Europe*, a paper that also underwent successive revisions. The latest version of this work is also reproduced in Part II.

The CEPS Plan attracted a lot of attention. In particular, Romano Prodi, President-designate of the European Commission, expressed interest in participating in brainstorming sessions on the basis of the plan. These took place at CEPS on 28 April, and in a subsequent public conference also at CEPS, which took place on 19 May. A short account of the discussion at these two gatherings is reproduced here in Part III. An innovative contribution was also made at the May conference by Göran Lindahl, President of ABB, on how to organise the reconstruction and modernisation of the economic infrastructure of the region. A revised version of his paper is reproduced here.

The CEPS Plan was disseminated at an early stage in the countries of the region, and immediately elicited a lively and generally positive response. For example, Professor Mladen Ivanic of Banja Luka declared at the brainstorming session of 28 April: “This is the first time we have seen a realistic plan from the European Union, which really addresses the size and nature of the problems”. Also endorsing the plan at an early stage was George Soros, who proposed that the independent policy institutes of the region should be invited to come together to concert their response. As a result, a first conference of about twenty such institutes took place in Budapest on 4 June. There it was decided to form a network, called the *Europa South-East* policy forum.

A second conference of *Europa South-East*, organised with the collaboration of the Open Society Institutes and chaired by CEPS, was held at Ljubljana on 18-20 July. This gathering debated preliminary ideas for national strategies to respond to the challenges of the post-war situation. In addition, in view of the then forthcoming summit of Stability Pact participants that was scheduled for 30 July, *Europa South-East* decided to adopt a substantive Declaration on policies that it hoped the Stability Pact would itself adopt. This text is reproduced below in Part I, having been signed by 35 individuals from 25 policy institutes from every country of the region, including Serbia, Montenegro and Kosovo, as well as CEPS from the EU. The Ljubljana Declaration took the CEPS Plan as its starting point, but refined and adjusted the policy

recommendations. In this way it may be said that the region took over the process, or at least made it a two-way interaction.

The Ljubljana Declaration offers for the time being a benchmark against which the evolution of official policies may be assessed. For the members of *Europa South-East*, official policy for the post-war order remains insubstantial. The Stability Pact is the main official initiative. However the months of June and July were taken up at the official level by the immediate post-war priority of establishing basic order and starting the reconstruction in Kosovo, and in the procedural aspects of setting up the Stability Pact. The Ljubljana Declaration makes comprehensive proposals for the real agenda to come, both for the Stability Pact and for the announced common EU strategy for the Western Balkans.

Europa South-East has only begun its work. Its members have agreed to work out national strategies throughout the autumn of 1999, which they would propose to their governments, on the premise that the EU would itself be implementing the policies proposed in the Ljubljana Declaration. Also thematic sub-groups will explore horizontal issues such as infrastructure, security and education policy in greater depth. In this way it is intended that CEPS, with *Europa South-East*, will monitor the performance of the Stability Pact at EU, international and regional levels. It will also continue to advance constructive policy proposals for the EU, the Stability Pact and the governments of the region to consider. This will be a task for many years. CEPS itself intends to maintain a permanent centre of expertise in this field.

Michael Emerson & Daniel Gros
Brussels, 13 September 1999

Part I
Declaration of the
Europa South-East Policy Forum
on the Stability Pact
Ljubljana, 18-20 July 1999

The Europa South-East Policy Forum is a group of leading independent policy institutes from every country of South-East Europe, working in collaboration with the Centre for European Policy Studies, Brussels, and the network of Open Society Institutes. Our objective is to contribute to the full integration of the whole of the region into the European Union. We advocate accelerated political and economic reforms in our countries in the aftermath of the war, assuming that the European Union itself makes radical moves in its policies to support the process.

Objectives and Methods

1. *Constitution of Europa South-East.* We, representatives of 25 independent policy institutes of South-East Europe, working in cooperation with the Centre for European Policy Studies (CEPS) in Brussels and the network of Open Society Institutes, meeting on 18-20 July 1999 in Ljubljana, have constituted the Europa South-East Policy Forum.

2. *Aim.* European integration. Our aim is to contribute to the full integration of the whole of South-East Europe (including Moldova) into the European Union (EU). We advocate for our countries accelerated political and economic reforms in the aftermath of war, assuming that the European Union itself makes radical moves in its policies to support the process. Slovenia and Turkey, also members of the Stability Pact and candidates for full accession to the EU, will actively participate in this process.

It is good that the war over Kosovo has ended. But this will not now give way automatically to a positive new era. Without a comprehensive and fresh policy approach, the best outcome will be stalemate and stagnation, the worst a continuous descent into renewed conflict, chaos and impoverishment.

3. *Stability Pact.* We welcome the decision by the EU at the highest level in initiating and leading the implementation of the Stability Pact. Our aim is to offer substance to go into this framework, having in mind the summit meeting of the Stability Pact due to take place in Sarajevo on 30 July 1999.

4. *Benchmark timetables: 1.1.2000 and 1.1.2003.* To give immediacy and tangible political perspectives, we propose that these two dates be the occasions to accumulate multiple decisions and targets for action. By 1.1.2000, the new strategy should be set in motion. By 1.1.2003, there should be major achievements. There will of course be many differences in detailed timetables by country. We give examples below.

5. *Method.* We adopt a three-step action plan for our own work:

5.1 *Blueprint.* We have adopted the recent CEPS paper as our starting point, and elaborated on it.¹ We submit this and the present paper for consideration by the Stability Pact and its Working Tables.

5.2 *National strategies.* Our institutes are preparing proposed national strategies, each for its own country, but in cooperation with each other. We intend to submit a consolidated document in October 1999 to our governments and the Stability Pact and its Working Tables.

5.3 *Momentum.* We shall endeavour to create in our countries a momentum of awareness and support for both the regional and national strategies. If at last the whole region were to work constructively together towards shared goals, united also in the drive towards EU integration, then a mutually reinforcing virtuous circle could be initiated, with surprisingly rewarding results.

Policies and Structures

6. *Trade and market policies.* We refine the CEPS proposals as follows:

6.1 *Free trade within the region.* This should be generalised on 1.1.2000 multilaterally, between all countries of the region.

6.2 *Zero tariffs on EU imports from the region.* The EU should generalise on 1.1.2000 its zero-tariff regime for imports of industrial products from all countries of the region.

6.3 *Zero tariffs on the region's imports from the EU.* Countries of the region not yet in free trade with the EU should make four equal tariff reductions of one-quarter on all imports from the EU on 1.1.2000, 1.1.2001, 1.1.2002 and 1.1.2003.

6.4 *Agricultural produce.* There should be balanced agricultural concessions from 1.1.2000, to accommodate a substantial expansion of exports to the EU (e.g. quotas at the level of only 1% of EU production would give ample room as current agricultural exports of the former Yugoslavia and Albania amount to 0.01% of EU production, whereas the EU exports to them are twenty times as much).

6.5 *Free trade effective on 1.1.2003.* Thus, the whole of South-East Europe would effectively be joined in a multilateral free trade area comprising the EU, EFTA, CEFTA, and all accession candidate countries including Turkey.

6.6 *Compensation for loss of customs revenues.* Countries with extremely weak tax resources would receive budget grants from the EU to compensate for the early dismantling of tariffs. This exceptional assistance would be conditional on the willingness by the country in question to accept joint control with the EU over customs and port facilities, so as to cut out frontier corruption and trafficking. Such budgetary grants would also be associated with macroeconomic policy surveillance and conditionality.

6.7 *Customs union.* We would also propose to go an important step further on 1.1.2003, to unite the whole of South-East Europe with the existing customs union of EU and Turkey. This means adoption of the Common External Tariff of the EU. For this enlarged customs union to be ready technically by 1.1.2003, it is essential that preparatory work begin already from 1.1.2000.

6.8 *Single market.* Countries of the region that are not yet candidates for full accession to the EU would be invited nonetheless to align their domestic market reform and transition programmes to the maximum degree on the norms and legislation of the single market of the

¹ *A System for Post-War South-East Europe*, CEPS Working Document No. 131, Centre for European Policy Studies, Brussels, May 1999 (accessible at <http://www.ceps.be>).

EU, leading to a “European Economic Area - Mark II”, independently of the question of full membership of the EU.

7. *Monetary regimes.* The euro is surely going to become, sooner or later, a key element in the monetary stabilisation of the region. We advocate advancing this with the following concrete steps:

7.1 *Radical banking reform.* Radical reform and opening of the banking and payments systems coupled with support for regulatory and supervisory functions by the EU will be another key element in fighting corruption and diminishing the influence of the anti-reformist power structures.

7.2 *Euro-DM currency board.* This type of monetary regime could be adopted, from 1.1.2000, by the weakest entities of the region, with the initial required back-up of foreign exchange reserves provided by a loan from the EU where needed, conditional on the banking reforms mentioned above. Such regimes already operate in Bulgaria and Bosnia, but in the latter the full benefits of this monetary regime have not been reaped because of delays in banking reforms.

7.3 *European Monetary Association Agreement.* Starting from 1.1.2000, preparatory work would begin on the design of a new category of monetary agreements for those countries interested in going beyond the currency board to full euro-isation. This would be particularly appropriate for countries that do not intend to leave their currency board arrangement before joining the euro area in full, and should lead to substantial savings through lower risk premia. Details to be clarified include the reimbursement by the EU of the seigniorage and adoption of EU norms of banking supervision.

7.4 *Full euro-isation.* From 1.1.2003, full adoption of the euro, either under new European Monetary Association Agreements for countries not yet full member states, or as full EU member states (e.g. maybe Slovenia).

8. *Reconstruction and Investment*

8.1 *Reconstruction of Kosovo.* We welcome the swift setting up by the EU of the European Agency for Reconstruction (EAfR) for Kosovo, with substantial grant funding. However, the example of Bosnia shows that this initial physical repair work will not alone assure sustained economic growth, which requires also development of human resources and sound economic ground rules. And the region has to be considered as a whole.

8.2 *South-East European Infrastructure Initiative.* We therefore advocate that the EAfR operation form part of a wider initiative for the whole region:

- *Immediate priorities*, e.g. bridges across the Danube (connecting Bulgaria and Romania, transit through FR Yugoslavia – see Annex).
- *Organise financing capacities.* Between them, the European Investment Bank, EBRD and IBRD have vast resources to finance the pan-European corridors for transport, energy and telecommunication networks.
- *Jump to modern standards.* The objective would be to organise not just the repair of damaged infrastructures and the building of new alternative infrastructure networks, but to jump to modern standards of public/private partnership (PPP) for the management of the main economic infrastructure networks (ports/airports, rail networks, road systems, rail/road mass transit services, energy transmission and telecommunication network); and the “build-operate-transfer” method (BOT), which allow for a temporary title to be held by investors in assets, with subsequent reversion to public authorities.

- *A regulatory authority*, to which governments may voluntarily grant powers to set standards, to manage privatisation actions, and award and regulate new concessions. Operating across the region, this would, for example, take on the problems of the break-up and dilapidation of the former Yugoslav networks.

8.3 *Investment climate.* The vital need is for clear and clean ground rules for economic agents. This is why free trade across corruption-free frontiers, sound money and banks with access to international capital, efficient economic infrastructures, law and order in business relations and stable democratic government are all fundamental. Every country should initiate comprehensive anti-corruption programmes (e.g. as in Bulgaria). If these conditions are implemented, investment and growth will follow.

8.4 *Investment guarantees.* The Multilateral Investment Guarantee Agency of the World Bank group should be invited to make a general assessment of the needs of the region, and how existing national and international facilities could be strengthened to boost foreign investment in the region.

8.5 *SME finance.* There should be a priority for global loans from EIB/EBRD/IBRD/IFC to financial intermediaries to extend micro-loans to small- and medium-sized enterprises. However, this will work only if the appropriate investment climate and infrastructure are in place.

8.6 *Local procurement.* Business cooperation initiatives should be organised to ensure that enterprises of the region participate to the maximum extent in tendering and procurement, including through joint ventures with EU firms.

8.7 *Environment.* A new “Environmental Partnership for South-East Europe” should address current environmental priorities including those due to the war.

9. *Social Safety Net*

9.1 *Priorities.* There are now three major priority categories, each requiring specific methods, if economic reform is to proceed under conditions of political stability:

- refugees and internally displaced persons,
- persons unemployed or disabled through the ravages of war, and
- those unemployed due to the transition to the market economy.

9.2 *Instruments.* Where national social policies are inadequate, there has to be a reliance on:

- UNHCR for emergency operations for refugees, often lasting however for years;
- the World Bank, which has considerable experience of sector specific restructuring programmes; and
- the EU, whose Social Fund has long experience within the EU of retraining and job-creation schemes for areas badly hit by industrial restructuring, but little yet outside. The EU should prepare wider use of such mechanisms in the region in the framework of its strategy for the whole of the region, including its pre-accession strategies, adapted however with suitable mechanisms for selection of local partners and control, so to overcome weaknesses of national administrations.

10. *Democracy, Civil Society and Education*

10.1 *Norms.* Membership of the Council of Europe, accession to its Convention on Human Rights and implementation in practice of its political and human rights codes are necessary steps for integration with the EU (see below on conditionality).

10.2 Needs. The legacy of communism and the disintegration of Yugoslavia have produced tremendous political and social needs, which cannot be met without outside assistance. Existing programmes of the EU, such as Phare, are not so appropriate to the extent that government-to-government methods cannot go to the heart of the matter. The need is to strengthen a wide range of appropriate institutions and organisations, including independent judiciaries and media, political parties, local government, health care and educational institutions. Detailed needs assessments will be prepared.

10.3 Mechanisms. There has already been a considerable development of private initiatives in this area. The needs are however on such a scale that these efforts should be strengthened by a new grant-giving organisation directed at the region. We suggest therefore a broadly based South-East European Foundation for Democracy. This would receive funds primarily from the EU budget, but would also include the United States, other bilateral donors and private funders.

10.4 Operating priorities. Grants would be given to governmental bodies, local governments and non-governmental organisations in the region. Allocations would be made on the ability to perform. The budgetary allocation would be for the whole of the region, without fixed quotas by country. This would provide an appropriate incentive for performance. Western recipients would qualify only to the extent needed to support local initiatives. Partnerships between civil society and governments would be encouraged (the Albanian Educational Development Programme can serve as an example). The emergence of regional civil society structures should be among the priorities of the grant-giving. This approach will eliminate many but not all of the unintended adverse consequences of international assistance programmes, reducing political meddling and corruption and making the process more competitive.

10.5 Other mechanisms. A diversity of initiatives is the hallmark of this wide field. The EU should allocate resources to vital regional programmes in educational cooperation at all levels, including revision of curricula and renewal of textbooks (especially on the region's history). We highlight the value of regional educational institutions, which form new European elites, so important for South-East Europe. The Central European University and American University in Bulgaria are good examples; as also is the College of Europe, for which we recommend establishment of a third campus, to be located in the region.

11. Budgets and Financing

11.1 Budget financing. As the main sponsor of South-East Europe, the EU will be the leading financier. The CEPS paper suggested \$5 billion a year of budgetary expenditure per annum for the "5" countries of the former Yugoslavia and Albania for five years, scaled on the efforts planned for EU accession candidate countries. This amount, 5% of the total EU budget, could be accommodated within the maximum limit for the EU budget identified in the "Agenda 2000" decisions of the Berlin summit. There would also be grant contributions on a smaller scale from the US and other bilateral donors.

11.2 Capital financing. Here the European Investment Bank, the World Bank and EBRD would be the main public sector financiers. We are aware of the work now under way jointly by the World Bank and the EU Commission to evaluate both war damage and needs for sustainable development. Financing from these three institutions might amount to about \$3-4 billion per annum for the whole of the region. However, purely private investment, banking, security markets and guaranteed trade credits would become the most important source of capital, as long as the investment climate is dramatically improved (see Section 8 above).

12. Military and Civilian Security

12.1 New situation for military security system. The security system – of alliances, guarantees and partnerships – for South-East Europe needs to be radically reconsidered, in the light of the recent war. In particular we look forward to a new political regime in Belgrade that

accepts modern European norms. When this occurs it will be possible to design a new system on an all-inclusive and equal basis for all countries of the region, integrated with OSCE, NATO and EU structures.

12.2 Working group on a future system. The institutes for strategic and security studies among us are therefore setting up a working group to explore ideas for a desirable future security system.

12.3 Police cooperation. As the SFOR and KFOR operations should wind down in due course, there will be phased transfer to heavy policing operations. Elsewhere in the region there will be surely many different demands for police cooperation, ranging from the example of customs and ports (point 6.6 above) to training and exchange programmes to cooperation with Europol. These should be negotiated in Special Security Agreements between the EU (new 3rd pillar competences) and individual countries of the region.

12.4 Judiciary cooperation. The independence of the judiciary is not adequately assured in some parts of the region, and should be supported institutionally (e.g. EU participation in selection procedures for judges) and through training and exchange programmes with the EU.

12.5 Immigration and visa rules. The aim should be for all countries to aspire to, and prepare to qualify for visa-free travel, and, when full accession candidates, for the Schengen system of frontier-free travel. The EU should show openness to exploring a widening of categories for visa-free travel. The easing of EU visa restrictions would however depend on the performance of individual countries over their border controls and security policies.

13. Conditionality and Engagement

13.1 Unconditional. Some policies and categories of assistance should be offered to all countries, including the present FR Yugoslavia:

- free trade,
- support of non-government civil society institutions, and
- humanitarian assistance.

Aside from episodes of wartime blockade, trade sanctions may even have a perverse impact on such countries and their neighbours.

13.2 Conditions for full EU membership. The established Copenhagen criteria for EU accession regarding political institutions and economic performance should not be changed.

13.3 Conditions for associate membership. The government must respect basic rules of democracy and human rights and must be engaged in adequate programmes of reform where necessary (criteria include: positive monitoring assessments of the Council of Europe, elections satisfactory by OSCE monitoring standards, and acceptance of the jurisdiction of the International War Crimes Tribunal). Progress would be modulated by country according to individual performance.

13.4 Serbia today. Since the future of Serbia is central to the region, conditionality towards this country needs to be spelt out more precisely:

- Participation in free trade arrangements should go ahead now without further political conditions.
- Humanitarian assistance, as well as support for independent media, civil society, education and culture should be unconditional but provided in as manner that does not reinforce the authority or prestige of a pariah government.

- All sanctions should be lifted, except for arms and the freezing of the assets in the West of named individuals.
- Reconstruction and infrastructure assistance could begin in cities or regions where the local leadership is taking a stand in favour of radical political change in line with modern European norms.
- Planning work should begin already for investments in vital parts of the network of South-East European transport, energy and communications infrastructures, so major investments can proceed without delay when the political regime is renewed.
- Serbian diaspora: measures should be prepared to encourage the return of key personnel among recent emigrants.
- Public information efforts should show how radical economic and monetary reform programmes (e.g. those of Group 172) could be underwritten by the EU and international financial organisations.

We hope that these conditions will encourage the formation of a fresh interim government, to be followed by elections conducted under OSCE auspices.

13.5 Montenegro today. We support the efforts of the democratic leadership in building a new, open and democratic society and believe that it should not become a hostage to the leadership in Belgrade. Economic and social reforms in Montenegro should be encouraged, in particular through participation in the Stability Pact.

14. EU Integration

14.1 Full membership. For existing applicants for full accession to the EU we advocate a clarification of timetables by the EU. The opening of negotiations for Bulgaria and Romania should be set for 1.1.2000, and the target date for full accession of Slovenia and Hungary should be set for 1.1.2003 (as for other candidates from other regions). The whole enlargement process should be accelerated. However the EU should not be expected to waive its existing criteria for full accession, and so all these countries would have to calibrate, or re-calibrate the speed and intensity of their preparations accordingly.

14.2 Principles of new associate membership. We note the EU's acceptance of the need for a new and more powerful form of association. But the outgoing Commission's recent proposals for Stabilisation and Association Agreements are not sufficiently substantial. We support ideas for progressive inclusion into the EU institutions of new associate members as well as accession candidates, such as through participation in consultative bodies of the EU, staff exchanges and elected but non-voting members of the European Parliament, etc.³ This relates also to the interesting 1997 Poettering Report of the European People's Party on a new approach for pre-accession strategies.⁴

14.3 Timing of new associate membership. Negotiations for new associate membership should begin on 1.1.2000 for Albania and Macedonia in any case. This date could also be possible for Croatia, depending on the new government after the forthcoming elections. It could be possible too for FR Yugoslavia in the event of a swift political regime change in Belgrade. For Bosnia and Herzegovina, a special formula for contractual relations with the EU should be worked out at an early date.

² See <http://www/ceps.be> for a summary of the Group 17's recent book on this subject.

³ For details, see paper by Michael Emerson in Part II of this volume.

⁴ "Plea for a New Enlargement Strategy", reproduced as an annex to Michael Emerson's paper in Part II of this volume.

14.4 From associate to full membership. This would depend entirely on how far and fast each country was able to progress. Participation in South-East European regional cooperation will be advantageous to all, but must in no way hold back the advance of the most progressive countries in an artificial political grouping.

Annex

I. Principles of Infrastructure Development in South-East Europe

1. Developing complementary (and not alternative) national infrastructure strategies of the SEE countries as part of an integrated infrastructure for the region.
2. Implementing the principle of alternative transport opportunities for each one of the SEE countries in its trade routes to Central and Western Europe.
3. Balanced development of the South – North and the East – West axes of the SEE transportation system.
4. Diversification of energy resource supplies to SEE countries (oil and gas).
5. Priority linkage of the SEE countries' electricity systems to the European electricity network (UCPTE).
6. De-monopolisation and competitive development of the SEE countries' telecommunications systems.
7. Developing a flexible system of project investment into the SEE infrastructure involving EU public funds, private investment, concession options, BOT and BOO methods.

II. Infrastructure Projects of Urgent Necessity

1. Constructing two new bridges over the Danube: one between Vidin - Kalafat (Bulgaria – Romania) as part of Corridor #4 (Dresden – Prague – Vienna – Arad (- Bucharest – Constanta) – Sofia – Thessalonica); and the second between Becket – Oriahovo, or Rastu - Lom or Turno Magurele –Svistov (Romania – Bulgaria).
2. Constructing 56 km of railroad between the Macedonian town of Kumanovo and the Bulgarian border (Corridor #8 - also known as “East-West” through Bulgaria, Macedonia and Albania) as part of the Macedonian access to Corridor #4. This would connect Macedonia to Central and Western Europe and give it access to the Black Sea ports.
3. Reconstruction of the main Kosovo highways, connecting: Mitrovica – Pristina – Skopje; Pristina – Nis; Mitrovica – Podgorica; Pristina – Prizren – Durres.
4. Reopening of navigation on the Danube, stopped after the demolition of the bridges in Yugoslavia (Corridor #7 – the so-called Danube corridor).
5. Reconstruction of the Yugoslav bridges over the Danube and the destroyed sectors of the Corridor #10 (the so-called Trans-European Highway) in FR Yugoslavia.

Signatories to the Ljubljana Declaration*

Branislava Alendar, European Movement in Serbia, Belgrade
Srboljub Anić, Group 17, Belgrade
Fehmi Azermi, Riinvest Institute for Development Research, Tetovo/Pristina
Nicolae Chirtoaca, Euro-Atlantic Center of Moldova, Chisinau
Ljubomir Čučić, Europe House Zagreb (EGIDA)
Daniel Daianu, Center for Economic Policies, Bucharest
Anelia Damianova, Centre for Economic Development, Sofia
Aleksandar Denda, Group 17, Belgrade
Mladjan Dinkić, Group 17, Belgrade
Jovan Donev, OSI-Macedonia and Euro-Balkan Center, Skopje
Gérard Duchêne, Paris University
Michael Emerson, Centre for European Policy Studies, Brussels
Ahmet Evin, Sabancı University, Istanbul
Georgy Ganev, Centre for Liberal Strategies, Sofia
Yulia Gourkovska, Center for Liberal Strategies, Sofia
Daniel Gros, Centre for European Policy Studies, Brussels
Mladen Ivanić, University of Banja Luka
Petar Ivanović, Institute for Strategic Studies and Prognosis, Podgorica
Albina Karamitro, Albanian Institute for International Studies, Tirana
Ivan Krastev, Centre for Liberal Strategies, Sofia
Zlatko Lagumdžija, Faculty of Economics, University of Sarajevo
Jane Miljovski, University of St. Cyril and Methodius, Skopje
Ognyan Minchev, Institute for Regional and International Studies, Sofia
Nickolay Mladenov, European Institute, Sofia
Muhamet Mustafa, Riinvest Institute for Development Research, Tetovo
Pristina
Milan Nikolić, Center for Policy Studies, Belgrade
Sašo Ordanoski, Forum - Center for Strategic Research and Documentation,
Skopje
Senad Pećanin, DANI magazine, Sarajevo
Oleg Petrushin, Center for Strategic Studies and Reforms, Chisinau
Sandra Pralong, Democracy Works, Bucharest
Zef Preci, Albanian Centre for Economic Research, Tirana
Igor Rajner, Democracy Foundation, Sarajevo
Genc Ruli, Institute for Contemporary Studies, Tirana
Dritan Shano, Institute for Contemporary Studies, Tirana
Mladen Staničić, Institute for International Relations, Zagreb
Veselin Vukotić, Institute for Strategic Studies and Prognoses, Podgorica
Nicholas Whyte, Centre for European Policy Studies, Brussels

* *Signing in personal and independent capacities.*

Part II

A System for Post-War South-East Europe⁵

Michael Emerson⁶

Summary

The war in Kosovo may become the final dreadful catharsis of the Balkan tragedy. The end of the Second World War led to reconciliation and the institutions of the new European order (from the Council of Europe to the EEC, etc.). So now, after the latest Balkan war, definitive foundations for the inclusion of the region in the European civil order must be conceived and negotiated. The design of these foundations should build on the fact that several states of the Balkan region or the former Yugoslavia are already on the road towards accession to the European Union. While many of the policies of the EU are or can be extended to neighbouring countries, the EU cannot simply open all its political institutions immediately to numerous more small states, especially those without tested experience in meeting European political norms.

Therefore a new political solution needs to be devised that motivates the countries of the former Yugoslavia and Albania to converge towards modern European norms and to perceive, in relation to the EU, their own inclusion rather than exclusion. For this purpose new categories of EU membership are advocated, to which all states or regions of South-East Europe could aspire quite soon. This paper sketches out a path of progressive inclusion of these states or regions in the policies and institutions of the EU. The present EU enlargement negotiations would in no way be retarded, but elements of the “pre-accession” strategies would be extended to the former Yugoslavia and Albania so as to reduce the differentiation between them and the present accession candidates. The cost of a strategic initiative for these “5” states (Albania, Bosnia, Croatia, FYR Macedonia and FR Yugoslavia), on a similar scale to the cost of policies envisaged in Agenda 2000 for the accession candidates, would in normal circumstances be moderate (about 5 billion euro per annum), even supposing that all countries, including FR Yugoslavia became eligible, since the region is small in economic terms. This would be well within the margin of available budgetary resources of the EU, following the European Council’s Berlin agreement of Agenda 2000. However exceptional post-war reconstruction costs will raise the total bill substantially, calling for the combined resources of the international financial institutions as well as the EU.

NATO has been performing an indispensable task, deploying military force to try to stop the crimes against humanity. But as the military action ends, the civilian order will have to be built up, and here the European Union must assume its responsibilities. Indeed the European Council adopted guidelines in this sense at its meeting on 14th April. The present paper offers a fresh set of ideas for a comprehensive strategic initiative by the EU, putting together economic, monetary, political, security and institutional components of a long-term system for post-war South-East Europe, which should see the region become fully integrated into the modern European order.

⁵ A subtitle “Plan for Reconstruction, Openness, Development and Integration” (P.R.O.D.I.) has been suggested by Tom Spencer, MEP.

⁶ With Daniel Gros, Wolfgang Hager, Peter Ludlow and Nicholas Whyte.

Key Points

A. Premise

Needed: realistic European solution for integrating whole region into modern Europe (i.e. the EU) once and for all, including post-Milosevic Yugoslavia. "Realistic" means something strong enough to have real chance of achieving political objective.

B. Hard Core of Solution: Nine Innovations of EU Policy

1. *New Associate Membership*: New category of EU membership, open to the "5" (Albania, Bosnia, Croatia, FYR Macedonia, and FR Yugoslavia) on normal conditions of democracy, human and minority rights, and with a suspension clause (analogous to the Amsterdam Treaty article). Negotiations to open from 1.1.2000, for states meeting these conditions.
2. *Market regime*: Multilateral, pan-European, zero-tariff free trade; budget compensation for loss of customs revenues for New Associate Members. Scrap all tariffs on industrial goods completely on 1.1.2000, with subsequent transition into EU Customs Union and Single Market.
3. *Money*: Exploit new potential for wider euro, both for economic value and as a symbol for inclusion in modern Europe. Euro-based currency board regimes are already possible. Full euro-isation from 1.1.2003 with budget compensation for loss of seigniorage for New Associate Members.
4. *Reconstruction and investment*: Initiate on 1.1.2000 a new South-East European Agency for Reconstruction and Development (SEARD), as a subsidiary of the European Investment Bank. SEARD to have property rights in infrastructures.⁷
5. *Civil Society*: Initiate on 1.1.2000 South-East European Foundation for Democracy (SEFDEM) and South-East European Foundation for Education (SEFED).
6. *Security (civilian)*: Deployment, where necessary, of EU customs services and policing powers to control all port and frontier crossings, as a condition of New Associate Membership.
7. *Security (military)*: Implement ESDI doctrine, as from NATO Washington Summit of April 1999, and thus organise progressive EU leadership of peace-keeping operations.
8. *Institutional integration*: New model for progressive insertion of New Associate Members into EU institutions.
9. *Management capacity*: Strengthening of management, command and control capacity in the Commission and Council for their respective competencies, using new agencies and foundations for decongestion and debureaucratisation.

C. Game Plan by Country

1. *Croatia*: Signal for change of government in December 1999 and political normalisation (Slovakia model). On this condition open negotiations for New Associate Member on 1.1.2000.
2. *Albania*: Open negotiations for New Associate Member on 1.1.2000.
3. *FYR Macedonia*: Open negotiations for New Associate Member on 1.1.2000.

⁷ The above elements of economic and monetary integration offer strategic support for anti-mafia and anti-crony capitalist economic policies.

4. *Bosnia*: Open negotiations on economic and monetary agenda on 1.1.2000. Establish concept that Dayton regime will later be reshaped for EU integration with New Associate Member. EU leadership of SFOR from 1.1.2002.
5. *FR Yugoslavia*: First best, Milosevic replaced by enlightened leader. Immediately thereafter, open negotiations for New Associate Member. Whole Federation brought into EU integration process, with special EU responsibilities for governance of Kosovo. Much less satisfactory outcome: special protection for Kosovo and maybe Montenegro without political renewal in Belgrade.

D. Wider Europe

Any real solution in South-East Europe is certain to affect the EU's enlargement and wider Europe foreign policy strategies in very important, but potentially positive ways for pan-European stability.

1. *Relationship with existing enlargement process*. General acceleration, keep competitive incentives, but no leap-frogging of opportunities. The EU to set by 1.1.2000 a target date of 1.1.2003 for accession of next full member states. Accession negotiations to be opened on 1.1. 2000 for second group of candidates, (i.e. at same time as opening of negotiations for New Associate Members). Target date for entry into force of Treaties of New Associate Membership also 1.1.2003.
2. *Turkey*: Potential and need for renewal of enlargement perspectives.
3. *Russia*: Immediate priority, recognise its contribution to getting a successful resolution of Kosovo conflict. This would put EU strategy for Russia in new, highly positive context.
4. *Ukraine*: Also a new situation in prospect, with events in South-East Europe as well as forthcoming Ukrainian presidential elections.

E. Stability Pact

1. Immediate consensus over broad idea.
2. First one of 1994-95 useful, because linked to strong structure of full EU accession process.
3. This one for South-East Europe, a more uncertain proposition. Would only work if also supported by hard-core actions (e.g. as above); otherwise, risks being ineffective.

1. The Starting Point

The end of the military confrontation in Yugoslavia is hardly in sight,⁸ but it is already time to be preparing for a post-war order for the region. The war, when ended, will at least have created a new situation, in which more radical solutions for integrating the region into modern Europe should become possible politically.

A widely accepted view is that the populations and elites of the whole region look to ultimate EU membership for a positive future. Nevertheless, there is little understanding in the region of what this means, which is not surprising in light of the complex structure and evolution of the EU system. The EU itself will have to play a pro-active role in opening up the debate on what the possibilities might be in operational terms. But the process should then become interactive, since only the representatives of the region itself can legitimately decide how their aspirations might be met.

The EU has so far no clear or credible strategy for meeting these aspirations. Its so-called "regional approach" has been insufficient (Commission of the EU, 1998). Its instruments of conditionality are too finely graduated to have real leverage on the profound trends in the region. These instruments only deploy trade and aid incentives, without new or emerging competences in the monetary and security domains. Moreover the political destination is not clear for any politically relevant time-horizon, with the use only of loose expressions such as "having a European vocation".

Supposing that the war results in a political will to go for decisive solutions for a new general system and civil order for South-East Europe, a starting point could be to look at both sides of the question, which is to say:

- the *potential* of the EU for offering inclusive policies, institutional participation and financial resources; and
- the *needs* of the different states and communities in the region.

2. The Potential of the EU

2.1 The European Economic Area (Mark II)

The original European Economic Area (EEA Mark I) has been an interesting innovation. It was a deal between some small states which wanted to be wholly in the single market of the EU, without having to accept all the supra-national features of the EU. The small EEA states did not need the EU as an anchor for their political values, while the EU was not keen to have increasingly numerous small member states for institutional reasons (in the event, three of the countries concerned decided later that they preferred full membership, but three went ahead with the EEA).

The model is of interest, with important modifications, for South-East Europe. The general idea is to secure complete inclusion in selected EU policy domains, even when full EU membership is considered inappropriate (by one side or the other, or both).

EEA Mark II would start with an initiative to create a multilateral pan-European free trade area (zero tariffs on industrial goods) between the EU, EFTA, EEA (i.e. the 3 present members), CEFTA, the EU's customs union partners (Cyprus and Turkey) as well as the "5". Apart from zero tariffs, the rules of origin regime would be aligned on the existing multilateral, pan-European agreement of 1997 between the EU, EFTA, EEA and CEFTA. This highly technical subject is in fact of great importance for the integration of industrial structures, to allow

⁸ The present text was completed on 3 May 1999 in the middle of the war. References in the text to the ongoing war have been left deliberately without updating.

production processes for given goods to cascade value-added through a number of countries. The advantages of “full cumulation” are described elsewhere (Komuro, 1997), and their introduction for South-East Europe as a whole is an obviously desirable policy initiative waiting to gain political priority.

While the existing EEA (Mark I) would continue to function without change, EEA Mark II would also include an evolutionary clause for the “5” through three stages:

- Free trade,
- Customs union, i.e. joining the EU and Turkey, and
- Single Market, through adopting all relevant EU rules and legislation, and so join EEA Mark I.

The first stage, zero-tariff free trade, should be implemented very fast, preferably in a “big bang” on 1.1.2000, so as to have a major action concretely at the outset. There should be no political conditionality, except if overridden by trade sanctions or blockades as in a state of war (i.e. as at present for FR Yugoslavia, until the end of hostilities). Exceptional agreement from the World Trade Organisation should be requested to implement this tariff dismantlement before accession of all the states concerned to the WTO, in view of the special political circumstances and small economic importance for the rest of the world. To allow a longer period for harmonisation of customs policies, formal accession to the customs union with the EU and Turkey would be targeted for 1.1.2003, coinciding with the next enlargement.

Conventional thinking might suggest gradualism in the dismantling of tariff protection, but there are good reasons to do otherwise in this case. The EU on its side has nothing significant to lose and all to gain by bringing the “5” into a free trade relationship as soon as possible. The “5” for their part need to exploit the shock of the present conflict in positive ways, thus to make a clean break from the present use of customs posts as instruments of state corruption and the protection of crony capitalism, which today means disastrous disincentives for the expansion of trade and investment [see survey of Federation of Industries of Northern Greece, 1998]. Wage costs are sufficiently low in the “5” to afford adequate opportunities for cost competitiveness. Moreover the destruction through war of the Bosnian and Serbian economies means that industry has to start again. This should be done under conditions requiring international competitiveness from the outset, rather than to recreate again an inefficient, protected and corrupted economy.

Bosnia-Herzegovina introduced a new customs tariff law on 23 April 1999, unifying the internal market of the two entities, and stopping their preferential regimes with Croatia and FR Yugoslavia, respectively (OHR Press Release). While it is understandable that the trade barriers and distortions within Bosnia should be eliminated, it is by far preferable not to recreate tariff barriers within the region but to jump instead to free trade.

The only legitimate concern in scrapping customs tariffs is over tariff revenues for the budget. To overcome this problem it is proposed that the EU compensate all the “5” (which become New Associate Members – see below) by transfers from the EU budget. According to preliminary estimates such compensation could amount to between 1 and 1.5 billion euro for all the “5” (for details, see paper by Daniel Gros also in this volume). This would be conditional on accepting any necessary degree of EU monitoring and actual control (with EU police or paramilitary support) at port and frontier posts, so as to cut out frontier corruption decisively once and for all. Moreover, the New Associate Members would not be expected to contribute to the EU budget.

EEA Mark II countries would be included in a wide range of EU policies, particularly economic programmes in a manner analogous to the present pre-accession process. The model here follows the example of the PHARE programme, which is being progressively transformed into

something closer to the EU's (internal) Structural Funds, with participation also in the EU's (internal) educational programmes (Socrates, Leonardo). A similar process should be extended to the whole of South-East Europe.

In summary, EEA Mark II would consist of:

- zero-tariff free trade, multilaterally with the EU, EFTA, EEA and CEFTA countries;
- joining the existing pan-European rules of origin agreement;
- budgetary compensation for abolition of tariffs;
- evolutionary clause for full inclusion in the EU single market, with progressive adoption of EU legislation; and
- inclusion in educational programmes and structural fund-type operations in a manner analogous to the existing pre-accession programmes.

2.2 The European Monetary Area

Two events have created new perspectives for monetary cooperation between the EU and South-East Europe. The first was obviously the introduction of the euro. The second was the Russian financial crisis, which has created a new situation for economies with dubious or weak monetary stabilisation policies. The costs of monetary independence for such countries are now much higher than before. This is because risk premia for borrowing from international capital markets have risen to levels inconsistent with a strong flow of investment. This means that the prospects for economic growth in such circumstances are seriously damaged.

For some time now, much of South-East Europe has been accustomed to using the DM as an important parallel currency. Two countries of the region are currently operating currency board systems, initially fixed on the DM, and now effectively on the euro. The menu of monetary regimes with links to the euro has several options (see Table 1 for a schematic presentation of their costs and benefits in present circumstances):

- *Managed float regimes*, with the euro as a reference for exchange rate policies. In the most advanced economies on the edge of the region, such as Slovenia, there are already scenarios for fully joining the euro area a few years after accession.
- *Currency board regimes*, where the national currency is pegged to the DM/euro and monetary expansion is constrained by the need for full backing by hard currency in the central bank. This regime currently operates in Bulgaria with success, and in Bosnia a similar system is making headway. Such systems are not perfect, however, and should normally graduate to one of the other regimes mentioned here.
- *Total euro-isation*. Total dollarisation has already seen a certain experience worldwide, as mentioned earlier, with success for example in the case of Panama (Moreno-Villalaz, 1998), and new consideration of this option by Argentina (Hanke and Schuler, 1999). From an economic standpoint, this is a superior regime to the currency board, to the extent that it confers more complete access to money and capital markets and a higher (nearly total) credibility of stabilisation policy. It has the

Table 1. Cost-Benefit Calculus over Monetary Regimes for States with Weak Monetary Institutions and Capital Market Credibility

	Own Currency	Currency Board	Total Dollarisation or Euro-isation
Monetary stabilisation	poor/erratic	good	excellent
Interest Rates	impossibly high	very high	low
Independence of Monetary Policy	yes	no	no
Seigniorage	yes	some	no, unless negotiated
Debt Service Capacity	reduced	limited	restored
Living Standards (real exchange rate)	reduced	better	much better
Access to Capital Markets	no	some	yes
Incentives for Efficient/honest Resource Allocation	poor	better	good

Note: The table schematises the current situation following the Asian/Russian crisis, which has significantly worsened the terms of monetary independence for states that do not enjoy robust financial situations (including external debt).

- disadvantage that there is a loss of seigniorage revenues compared to the currency board, but this could be compensated through a cooperation agreement with the EU and European Central Bank.

The crucial difference between the currency board and total euro-isation is that only the latter allows complete integration into the payments system, money and capital markets of the euro area. Complete monetary integration in particular requires participation in the Target system, which requires that the commercial banks accept common prudential and regulatory rules. For these standards to be met there would almost certainly have to be a large presence of EU commercial banks, such as is already the case in Latvia (70% foreign control), or Hungary (60%) (EBRD, 1998). But all these constraints would in fact mean accumulating very important economic advantages. States presently unprepared politically for a loss of national control over their commercial banks should study the examples of Latvia and Hungary, which are greatly benefiting in terms of lower interest rates and less problems of having to recapitalise weak banks. In fact, Greek and other EU banks are already building up an important presence in Bulgaria, Romania, FYR Macedonia and Albania.

Moreover, regimes of partial dollarisation (or euro-isation) are far from offering the same advantages, and present considerable complications for the conduct of monetary policy by the central bank, as recently analysed thoroughly (IMF, 1999).

Scenarios for full euro-isation are temporarily complicated by the fact that euro banknotes will not be in circulation until 1.1.2002. This is not a problem in principle, since any existing euro area banknotes could be used, notably the DM in view of its customary use in South-East Europe. A temporary scheme is sketched by Gros in his paper, but this would still be somewhat confusing for the population, in light of the importance of clarity and credibility for monetary regimes. The more plausible scenario would therefore be:

- from now on, if not already, euro-denominated currency board regimes, with use of DM as parallel cash money; and
- as of 1.1.2003, introduction of full euro-isation, including euro banknotes. This would allow a full year for euro banknotes to become established as the exclusive cash money in the EU member states using the euro, before taking on the extension New Associate Members.

Full euro-isation would mean the loss of seigniorage, i.e. the profits which the central bank derives from its monopoly over the issue of the currency. Normally such profits are transferred, at least in part to the state budget. (More precisely seigniorage is defined as the interest income earned by the central bank on its holding of securities acquired as a counterpart to the banknotes issued, plus interest earned on obligatory and non-remunerated reserve deposits at the central bank by commercial banks. However the latter nowadays often do not exist).

In the European System of Central Banks, there will be a distribution of such profits between national central banks, which in turn will have to account to their national governments. In the event of New Associate Members opting for full euro-isation, it would be both fair and highly desirable from a budgetary point of view for the countries concerned to negotiate an agreement with the EU for reasonable compensation for the loss of seigniorage. In fact, according to Gros, the amounts involved would be limited to about 250 million euro per year. Other aspects of the transition to full euro-isation are also discussed in Gros' paper.

There is thus wide scope for opening up the domain of monetary cooperation between the euro monetary area and South-East Europe. Beyond narrowly economic effects, the currency is the most potent symbol of standards and of affiliation. The euro therefore could play an important role in South-East Europe in communicating a sense of inclusion in the EU.

2.3 Reconstruction and Investment

Infrastructure. The Pan-European Transport Networks and Corridors are well advanced in their design and planning for the needs of South-East Europe. Some of the region's transport axes are subject to steady investment, but mainly those which link the accession candidate countries, and here the European Investment Bank is a major player.

The new post-war situation will have two key issues:

- Whether or not to include Serbia in the integration process, with Belgrade being geographically a natural strategic point on the road, rail and river axes.
- If Serbia joins the integration process, there will also be the need for reconstruction financing, especially for fundamental infrastructure and investments (bridges, power stations).

The importance of Yugoslavia as a transit country has been illustrated by the extent of disruption of trade and economic activity in affected countries, ranging from Austria and Hungary through to Bulgaria and Romania. A reconstruction effort that excluded or even avoided Yugoslavia would be very expensive indeed, and would hold back productive economic expansion for many years.

Important decisions on the location of new oil and gas pipelines from CIS countries, which would pass through the region, can only be taken in the post-war context of increasing integration with the EU. Financing would be obtained from the EIB and international financial institutions (IFIs). Safe and cheap supplies of hydrocarbons would in turn facilitate investment in new and efficient non-nuclear power stations.

As regards total investment in public infrastructure – transport and environment – a target figure of 8% of pre-war GNP (3 billion euro for the “5”) would not be unreasonable, given a decade of neglect in many countries, and now war damage in some of them. This figure must be seen in the context of a desirable level of investment of 25% of GNP in any realistic catch-up scenario.

The region as a whole may be assessed in three categories. First are the countries for which pre-accession financing is already available and post-accession aid can be planned: Bulgaria, Romania and Slovenia. The cost of upgrading the road system of these three countries (major corridors) has been estimated at 12 billion euro; with expenditure for rail of about 7 billion euro. Two-thirds of this amount are for the Pan-European Corridors. But clearly, in a new post-war situation with Serbia joining European integration, the alignment of present corridors would need to be considered, especially Corridor No. 4, which avoids Serbia. A tentative Corridor No. 4a, the historical route through Belgrade, has already been pencilled into the Pan-European Corridors.

A second group consists of Croatia, Bosnia, FYR Macedonia and Albania. Bosnia apart, their only source of infrastructure funding has been through the IFIs and on a modest scale. Substantial aid flows to FYR Macedonia and Albania are now indicated politically. Economically, Croatia has considerable absorptive capacity, including a coastal highway serving the tourism sector and port upgrading to ease the integration of the region into the European economy. A total of 5 billion euro over a ten-year period would have a major impact on the economy of this group.

Thirdly are the three parts of FR Yugoslavia, Kosovo, Montenegro and Serbia. The first two have suffered loss of relatively minor bridges (unit price about 10 million euro). The Montenegrin port of Bar will gain strategic importance in an EU-integrated Balkans, with branches to Kosovo from the present Bar-Belgrade corridor clearly a priority. More generally, an immediate upgrading of road and rail infrastructure in Kosovo will be needed to support the civil reconstruction programme with its heavy transport demands.

Finally, in Serbia major bridges across the Danube will have to be renewed (at a unit price of 30 million euro), as well as a great deal of other basic infrastructures. An immediate allocation of about 1 billion euro would need to be made for the transition back to normality.

Management issues. The scale of the task of reconstruction and development in the regions raises issues of management capacity. The EU has two executive functions with demonstrated capacity to disburse enormous investment funds in an apparently acceptable manner with quite lean staff structures: the European Investment Bank, which disburses 25 billion euro of loans per year, and the Directorate-General XVI of the Commission, which disburses about 30 billion euro per year of grants on account of the Structural and Cohesion Funds. On the other hand the Directorate-General IA for external relations has had difficulty in building up its executive capacity to disburse the PHARE and TACIS programmes, partly because it has not been granted adequate staff resources promptly enough, partly because of extremely burdensome financial and management procedures.

For reconstruction and investment in the “5”, there would need to be innovations in management structures. The model of the Structural Funds, while itself functioning satisfactorily, is not appropriate because it depends upon reliable partnerships with the national and regional administrations of EU member states. The present Director-General, Eneko Landaburu, may be quoted as saying: “The system works reasonably, but in the case of Greece it took ten years of experience of joint programming and project management before our partners were meeting EU standards”. This example suffices to say that a completely different model is needed for the “5”.

One proposal is that a new South-East European Agency for Reconstruction and Development (SEARD) be created, as a subsidiary of the European Investment Bank. A new agency is warranted by the intensity of the reconstruction and investment effort needed in an area with particular conditions. Basically there has to be a double solution in one package: finance and sound governance (i.e. cutting out corruption). The latter will call for much hands-on management with good local knowledge, but also by way of control and ownership of projects. For economic infrastructure projects the idea would be for SEARD to have property rights in bridges and other suitable assets, and would thus be able to secure its own investments and be better able to attract third-party private finance. The link with the European Investment Bank is also highly desirable, in view of the enormous size of the EIB’s financial reserves and borrowing capacity. As soon as SEARD demonstrated a capacity for effective operations, its funding could be built up rapidly.

By comparison, the EBRD still has only limited financial capacity, and has to absorb for the time being extremely difficult operating conditions in CIS countries, following the Russian financial crisis. Nevertheless, the EBRD could be extremely valuable in building up its role as active shareholder in private enterprises of the region, including new ones that replace those destroyed in the present conflict. EBRD would here be a leading actor for improving corporate governance in the region, adding a further instrument for a comprehensive anti-corruption and anti-crony capitalism strategy.

2.4 Economic and Monetary Union

Putting together the EEA and EMA with a special initial boost from reconstruction and investment finance gives de facto membership of EMU. It is thus possible to envisage economic participation in the EMU without full EU membership (we return to the institutional questions below). This is not such an unusual formula. It applies already to several European micro-states including Monaco and Andorra, and as a closer model from the Americas with the case of Puerto Rico (4 million population).

For South-East Europe, inclusion in both the EEA and the euro area would transform economic standards and incentives. The newly independent states of the region have in several cases fallen

immediately into bad habits, exploiting the customs and monetary regimes for state corruption. Joining a European free trade and monetary area under these circumstances offers far benefits than is suggested by conventional economic analysis. The switch to a regime that allows no possibility for state protection and corruption becomes the most vital of reforms to secure the region's future prosperity, as well as its ethical order.

2.5 European Civil Society

Modern Europe's fundamental political values consist of three basic elements:

- Democracy, which is not legally codified at the European level, but is monitored by the Council of Europe, and is recognised where it exists or is abused;
- Human rights, as codified by the Convention of the Council of Europe and enforced by the Strasbourg Court of Human Rights; and
- Rights of minorities, as codified by the Council of Europe and the OSCE, who also monitor their observance.

Beyond these elements of formal democracy and human rights, the wider "civil society" is supported by extensive networks of non-commercial and non-government associations.

Via the Treaty of Amsterdam, the EU has become more explicit in its insistence on these values, by adopting a new "suspension clause", such that a member state that abused the vital principles may be subject to a decision by the Council and Parliament to suspend its voting rights in the Council. The present enlargement negotiations are also clearly giving real importance to these political criteria (viz. the cases of Slovakia and Latvia in the Agenda 2000 assessments).

These same principles and mechanisms would be applied to the "5" as conditions for them to become New Associate Members (see below), although the level of achievement of the ideal standards would be less demanding. Since the substructures of civil society are still very thin in the region (see Table 2), the main criterion should be whether the political institutions are sincerely and seriously working in the direction of modern European norms.

The EU has not yet allocated significant budgetary resources to vital pan-Balkan programmes of cooperation in education and training in "civil society" domains. In principle, 5 million euro has been allocated for such purposes to the "Royaumont Process for Good Neighbourliness in South-East Europe", but this only begins to be activated. Until now, the EU has given priority in practise to bilateral programmes of cooperation between it and individual countries of the region, with very limited possibilities for actions integrating the people of the candidate countries with other countries of the region. In a new post-war political environment, this policy should change. Such programmes, for example, for promoting civil society and educational objectives, are of very minor cost compared to the financial resources available to the EU. The issues are therefore ones of policy choice and management, rather than a lack of money. By way of illustration, the Balkan Schools Foundation of Sofia, dedicated to multi-cultural and multi-lingual schooling for all South-East European countries with text books written to exclude the customary aggressive nationalism of the region, has not been eligible for PHARE financing, precisely because it would be aimed at young people from both the candidate countries and other countries. Such a project finds itself therefore ineligible, although it has now won support from bilateral sources (Austrian, British and Greek).

To give a new impetus to the development of civil society in the whole of South-East Europe, and to avoid administrative congestion with too many projects at the Commission in Brussels, greater resources and reliance could be attributed to specialised foundations (i.e. separate legal entities, subject to EU policy directives, receiving PHARE funding from the EU budget). Two principle initiatives would thus be a South-East European Foundation for Democracy (SEFDEM) – there is already a proposal of this type, whose scope may be reconsidered in the

post-war context; and a South-East European Foundation for Education (SEFED). A new South-East European campus of the College of Europe should be established for post-graduate courses in contemporary European studies, following the extension of the Bruges college already to a campus at Natalin near Warsaw.

TABLE 2
Indicators of Political, Civil and Economic Liberty

	Political Rights	Civil Liberties	Status	Political Process	Civil Society	Ind. Media	Governance & Public Admin	Rule of Law	Corruption	Privatisation	Macroecon.	Microecon.
Slovenia	1	2	Free	2	2	1.75	2.5	1.5	A	2.5	2	2
Hungary	1	2	Free	1.25	1.25	1.25	1.75	1.75	A	1.5	1.75	1.75
Bulgaria	2	3	Free	2.75	3.75	3.5	4	3.75	C	4	4	4.25
Romania	2	2	Free	3.25	3.75	4	4	4.25	C	4.5	4.5	4.5
Croatia	4	4	Partially Free	4.25	3.5	4.75	4	4.75	C	4	3.75	3.75
Yugoslavia	6	6	Not Free	5	5	4.5	5	5	D	4.5	4.5	5
Macedonia	4	3	Partially Free	3.5	3.75	4	4	4.5	C	4	5	5
Bosnia	5	5	Partially Free	6	6	6.25	6.5	6.5	C	6.5	6	6
Albania	4	4	Partially Free	4.5	4.25	4.75	5	5.25	D	4	5	4.5
Moldova	3	4	Partially Free	3.5	3.75	3.75	4.5	4.5	C	4	4.25	4.25

NB: The higher the number, the worse the rating.

Source: Taken from *Nations in Transit 1998*, Karatnycky, Motyl and Graybow (eds.), Freedom House, 1998.

Administrative bottlenecks in Brussels can also be eased by granting decentralised responsibilities to the Commission delegations in the region. Experience acquired in Central and Eastern Europe shows that substantial capacities can be built up quite rapidly, as long as there is flexibility in recruitment rules and then real decentralisation of responsibilities, especially for managing micro-projects. For example, the Moscow Delegation initiated a successful so-called “Bistro” facility for projects costing under 100,000 euro, for which responsibility was virtually wholly decentralised. This is especially valuable for people-related projects in the broad civil society area, where the essence often consists of spotting the individuals whose personal projects are worth backing, and then intervening fast to sustain motivation.

2.6 European Area of Freedom, Security and Justice

This is the language of the Treaty of Amsterdam. The EU’s own work in this domain is now developing extremely fast. Proliferating activities are regrouped under three thematic headings:

- immigration and asylum,
- police, customs and security, and
- judicial cooperation.

With respect to South-East Europe, the EU faces the policy dilemma of wanting to protect itself against importing floods of refugees, illegal migrants and (from some countries of the region) large-scale criminal activities, while not wanting to create a new iron curtain between itself and countries which with it should be integrating. For this reason, the EU will have to develop proactive policies within the countries of South-East Europe, to limit the problems at their source. Moreover these policies must be comprehensive and multi-dimensional (from peacekeeping, to law and order actions, to the economy, etc.) in order to have any chance of answering the amplitude of the problems.

For actions to go to the root of the problems of criminality, corruption and weak law and order institutions, there is no sense in dividing South-East Europe into multiple categories of countries. Fortunately, there are examples of initiatives embracing the accession candidates and other countries of South-East Europe, notably the Octopus II programme, which also includes Albania, Croatia and FYR Macedonia. This programme seeks already to prepare all these countries in the context of “Third Pillar” policies of the EU. The scale of this project, which is a cooperative venture between the EU and the Council of Europe, is nonetheless modest (2.5 million euro). Europol, which is now becoming an operational EU instrument with a doubling of its staff to over 400 in the next five years, will no doubt need to establish serious links with the “5”, e.g. over drug trafficking (especially Albania).

Judicial cooperation is also required in the human rights area. The Convention of the Council of Europe and the Strasbourg Court of Human Rights will have jurisdiction throughout the region, but the capacity of the judicial systems to implement these laws locally has to be greatly strengthened.

In the field of visa and immigration policies, the prospect of new iron curtains is most obvious. The EU has adopted a list of countries for which visas are required by EU member states, and this is part of rules that the accession candidate countries will need to adopt. This list divides South-East Europe as follows:

- first group of accession candidates, Slovenia and Hungary, together with Croatia (not on obligatory visa list); and
- second group of accession candidates, Romania and Bulgaria, together with FYR Macedonia, Bosnia, Albania and FR Yugoslavia (all on the obligatory visa list).

Under present policies, it could be that the EU accession process would require Hungary to impose visa requirements on its neighbour Romania.

Bosnia has provided an example of a situation in which there has been relatively successful peace-making and -keeping, with heavy military resources. Albania has provided the example in 1997 of utter anarchy being stopped with the aid of an Italian-led military presence. But as the war or anarchy ended, the peace saw the emergence or re-emergence of deeply criminalised and corrupt elements of society. This emphasises the need for the EU to organise substantial capabilities for para-military and police support to take over where the military leaves off. (The European Council Conclusions of 14 April point towards the EU supplying operational support for local police forces in Kosovo as well as assuring civilian administration.)

In general, the EU faces the need now for a wide *spectrum* of operational capacities in the security domain in the case of South-East Europe, ranging from “soft” cooperation through to “hard” military intervention. Such operations will warrant development of different models of “security agreements” between the EU and countries and territories of the region.

2.7 European Area of Military Security

The conflict of Kosovo became a defining event. The NATO action relied upon the unique US military capabilities, especially its unmanned delivery systems. But at the same time the US was and remains extremely reluctant to become further engaged with ground troops. Opinion polls show EU citizens more prepared to commit ground forces, for understandable reasons of proximity, even when the US and the EU share the same political values and judgements. It is evident that the long-run solution to the Balkan conflicts will entail the integration of the region into civilian, civilised Europe, and that there will have to be a progressive transition from militarised to civilian order. This transition will necessarily require a dovetailing of military, police and civilian presences in the region. The EU will have to take the lead role in assuring the coherence and adequacy of such operations.

The EU has of course been moving in the direction of creating its own military capabilities, including the development of doctrine and organisation within NATO for the European Security and Defence Identity. In recent months there have been important advances, beyond the hesitant and sketchy provisions of the Amsterdam Treaty. The St Malo declaration on European Defence agreed at a UK-French Summit in December 1998 signalled a fresh willingness to move forward. The conclusions of that meeting (see Schake, Bloch-Laine and Grant, 1999, for a full analysis) were taken further by the German EU Presidency in a document addressed to EU Foreign Ministers in March 1999. This text gives the most recent indication of the potential of the EU in the defence domain:

The aim is to strengthen CFSP and complement it by the development of a common European policy on security and defence. This requires a capacity for action backed up by credible military capabilities and appropriate decision-making bodies. Decisions to act would be taken within the institutional framework of the European Union. The European Union Council would thus be able to take decisions on the whole range of activities in the external relations of the Union (Trade, CFSP, Defence). The Amsterdam Treaty incorporates the Petersberg tasks (“humanitarian and rescue tasks, peace-keeping tasks and tasks of combat forces in crisis management, including peace-making”) into the Treaty. The focus of our efforts therefore would be to assure that Europe possesses appropriate capabilities (including military capabilities) and structures to conduct crisis management in the scope of the Petersberg tasks. This is the area where a European capacity to act is required urgently....

For effective implementation of its operations, the European Union will be able to choose, according to the requirements of the case, either EU-led operations using NATO assets and capabilities, or EU-led operations without recourse to NATO assets and capabilities. ... Furthermore the EU will need a capacity for analysis of situations, sources of intelligence, and a capability for relevant strategic planning. This may require in particular: - regular meetings (or ad hoc) of the General Affairs Council, including

defence ministers; - a permanent body consisting of representatives with pol/mil expertise; - Committee consisting of military representatives; a Military Staff including the Situation Centre...

While the above text is not a decision, it none the less gives an authoritative insight into the direction of EU thinking.

Official policy was carried a step further at the NATO Washington Summit of 23-24 April as follows:

We stand ready to define and adopt the necessary arrangements for ready access by the European Union to the collective assets and capabilities of the Alliance, for operations in which the Alliance is not engaged militarily as an Alliance. The Council in Permanent Session will approve these arrangements, which will respect the coherence of its command structure, and should address:

- assured access to NATO planning capabilities to contribute to military planning for EU-led operations;
- the presumption of availability to the EU of pre-identified NATO capabilities and common assets for use in EU-led operations;
- identification of a range of European command options for EU-led operations, further developing the role of SACEUR in order for him to assume fully and effectively his European responsibilities;
- the further adaptation of NATO's defence planning system to incorporate more comprehensively the availability of forces for EU-led operations.

The potential capabilities described are exactly what is appropriate for operations in South-East Europe, especially from the time that heavy bombing operations give way to peace-making and peace-keeping. Planners for the future of South-East Europe may therefore develop implementation scenarios for completely integrated EU operations in the region, bringing together the entire spectrum of military-political-justice/home affairs-economic competences.

In the case of Bosnia, following the above lines of military policy and in the context of a New Associate Membership, the NATO SFOR might be transferred into an EU-led operation in about two years time, say by 1.1.2002.

2.8 New Membership Categories

The EU faces a dilemma. On the one hand, it understands that its unique integration process, which is built around its institutions and law, has already proved its capacity to achieve reconciliation and civilised order among countries that were formerly at war. On the other hand, it senses that its present enlargement process, involving the jump from 15 to perhaps 27 member states, presses against its maximal absorptive capacity for expansion. Yet experienced observers of the present Balkan conflicts (such as the successive High Representatives Carl Bildt and Carlos Westendorp) express the view that the communities there will not manage to change their behavioural modes from conflict to reconciliation without the strongest incentives for insertion into the structures of modern Europe (i.e. the EU).

Could there be a way out of this dilemma? For there to be a debate on this question, the nature of the limits to the EU's expansion must first be clarified. It is suggested that the limits today are essentially of three types:

- *Values*: The absolute priority must be not to dilute the fundamental values of the EU's political, economic and social order.
- *Powers*: There should be a concern not to disturb too sharply or rapidly, and with unknown possible consequences, the balance of powers and influence between the member states and between the institutions.

- *Management*: The legislative, decision-making and executive processes should not be allowed to become too congested.

A way of proceeding might be to consider, while respecting these three concerns, how far the EU might maximise the participation of the non-candidate countries of South-East Europe, so as to create the greatest possible sense of “inclusion” within the EU. This concerns both the policies of the EU (as already been sketched above) and its institutions, as follows.

The established category of *associate member* is not adequate, since the need is for a fresh formula with greater substantive integration, carrying a real sense of immediate inclusion in the EU, not just through a vague prospect of full membership at some distant date. The need is for *virtual membership* (although the term is not suitable for official use), in the sense of creating a perception of “inclusion”, even if some features of institutional participation might be missing. The EU has already been accommodating some major opting-out arrangements for the non-euro and non-Schengen countries. There hardly needs to be a doctrine of absolutism for the “5”, if a pragmatic formula could be found. Both sides (the EU and the “5”) might explore the possible content of new membership categories, enabling all of the region to aspire quite soon to becoming members of the EU in a manner taking duly into account political imperatives.

One might characterise the status of a New Associate Member as follows:

Necessary conditions:

- International statehood recognised (but should not be a micro-state)
- Inclusion in the European Economic Area (Mark II)
- Civil Security Agreement

Possible conditions:

- Inclusion in the European Monetary Area
- Military Security Agreement

Expectations:

- To become a full member state in due course
- Extensive but incomplete representation in EU institutions (see below).

The relationships with the EU institutions might then be sketch as follows.

Council of Ministers. Here would lie the most fundamental limit to the institutional participation of autonomous states or regions, for all the three reasons listed (values, powers and management). This limit should, however, ease over time with growing constitutional maturity of the EU itself (e.g. with the evolution of voting weights and the extent of majority voting in the Council), as well as of the political systems of the autonomous states. When these limits are relaxed, however, there would effectively be room for autonomous states to become full member states.

In the foreseeable future, there could be specific joint sessions of the Council with the autonomous states and regions, but without voting rights. There would be inclusion in the so-called European Conference, which provides for the “structured dialogue” between the Council and the accession candidate countries. Useful experience in “EU culture” can be acquired through participation in various working parties and committees handling those policies in which the New Associate Members might participate (as in the pre-accession programmes). Selected civil servants could be detached to the Council secretariat for temporary periods.

Commission. The number of Commissioners is already a sensitive issue awaiting solution at the next IGC, e.g. reduce the large member states to one. The idea of introducing graduations between senior and junior Commissioners may also have potential, drawing on the example of governments which conventionally have junior ministers without seats in the cabinet or council of ministers (because otherwise there would be too many). The idea of a constituency or rotating

member for autonomous states might also be explored, but this is not a straightforward proposition either for the ideology of the Commission or for the states that might be concerned. Staff members could possibly be on detachment for three-year periods.

European Parliament. The European Parliament could consider the proposition that New Associate Members could elect Members of the European Parliament, as long as the European Parliament was itself satisfied with the democratic credentials of the state concerned. Initially there would be non-voting status (modelled on the experience of Puerto Rico in the US Congress). Voting powers could be recognised later, but at this stage, the number of members would have to respect the Treaty limit (700).

European Court of Justice. As a start, junior professional lawyers could join the staff of the Court (temporary contracts of three years, with some maybe to return as judges twenty to thirty years later).

European Central Bank. No board member, but observer status for fully euro-ised states. Staff members for temporary periods.

European Investment Bank. Constituency representation on board possible (as EBRD). Staff members possible.

Consultative institutions. These include the Committee of the Regions and the Economic and Social Committee. Full participation possible.

High Representative. May be designated by EU in New Associate Members or other regions, especially where security agreements are substantial.

Other institutional innovations. EU sponsorship of overlapping jurisdictions or organisations where the frontiers do not match the needs of specific cultural communities.

2.9 Financial Resources and Costs

EU finances. The Berlin agreement over Agenda 2000 offers some perspectives. By 2006, the annual EU budget expenditure should reach 104 billion euro, including 14 billion euro for six new member states (whose populations amount to 63 million). This total leaves a margin of about 20 billion euro unallocated, before reaching the statutory limit of 1.27% of GDP (124 billion euro). Of this sum, 10 billion euro may reserved for the remaining accession states, three non-Balkan states with a population of 11 million (Latvia, Lithuania and Slovakia) and two Balkan states with a population of 31 million (Bulgaria and Romania).

The remaining “5” states have a population of 25 million (Croatia, FR Yugoslavia, FYR Macedonia, Bosnia, Albania). Similar scales of financing suggest annual expenditures of about 5 billion euro in normal circumstances, which would suffice to make a great difference to their economic prospects (this amounts to about 10% of their current GDP). A substantially greater amount risks encountering serious problems of absorptive capacity or of creating conditions of aid dependency, and should of course be avoided.

The amounts cited are thus within the margin of uncommitted resources allowed by the present 1.27% GDP ceiling. The Agenda 2000 negotiations have just been completed with considerable difficulty. However they do leave room for accommodating a new political imperative, such as a major initiative for integrating the whole of the Balkans.

An amount of 5 billion euro per year in budgetary funds would allow large-scale investment and reconstruction programmes to be financed, in addition to the proposed budgetary compensation for loss of customs duties and monetary seigniorage. However such resources from the EU budget do not include investment funding from the European Investment Bank, which has very large financial capabilities. By the end of 1998, the EIB had loaned a total of 9 billion euro to Central and East European countries, and had opened a pre-accession lending facility for candidate countries for the years 1997-99 of 7 billion euro.

Costs of war. The above figures do not take into account exceptional post-war reconstruction costs. Estimates of war damage so far to the FR Yugoslavia have begun to emerge. The EU Commission has mentioned 30 billion euro, Carl Bildt has quoted 50 billion euro and the Yugoslav authorities have quoted 100 billion euro. For the cost of military operations on the side of NATO, the US spent \$1 billion on air strikes in the first month of the conflict, and has voted an increase of \$12.9 billion in budgetary appropriations for the rest of the 1999. Military analysts say that the cost of a protracted war with ground operations could mount to \$30 billion, whereas the Gulf war in 1991 cost \$102 billion.

Macroeconomic needs. First estimates of the macroeconomic effects of the conflict (IMF and World Bank, 1999) point to a balance-of-payments gap of about \$1.5 billion in 1999 for Albania, Croatia, FRY Macedonia, Bulgaria and Romania. Details of these estimates are given in Tables 3 and 4. The EU and IFIs now have considerable experience at cooperative operations, notably wherever the EU is deploying important resources. This is largely positive and should continue in South-East Europe for many years.

Table 3
Projected Average Number of Refugees from the Kosovo Crisis
In the Six Most Affected Countries Q2-Q4 1999
(in thousands)

	Scenario A "Prolonged Military Campaign"	Scenario B "Crisis Quickly Resolved"
Albania	417	168
Bosnia-Herzegovina	33	14
Bulgaria	4	2
Croatia	7	3
FYR Macedonia	182	74
Romania	6	2
Total for 6 countries above	649	262
Other countries and regions	276	91
<i>Of which: Montenegro</i>	79	33
TOTAL	925	354

Note: Estimates made around the middle of the war.

Sources: UNHCR, World Bank and IMF staff estimates.

TABLE 4

Additional External Financing Needs Arising from the Kosovo Crisis in the Six Most Affected Countries*, 1999
(\$ millions)

	Scenario A "Prolonged Military Campaign"	Scenario B "Crisis Quickly Resolved"
Refugee costs**	311	139
Balance of payments gap	1.515	668
Total financing needs	1.826	807
In percent of GDP	2.5	1.1
Memorandum item:		
Budgetary gap	652	308
In percent of GDP	0.9	0.4

* Albania, Bosnia-Herzegovina, Bulgaria, Croatia, FYR Macedonia, and Romania.

** Additional cost for displaced persons in Montenegro estimated \$43 million under Scenario A and \$22 million under Scenario B.

Sources: IMF and World Bank staff estimates.

Note: Estimates made around the middle of the war.

2.10 General Aspects of EU Strategy

Three strategic points need bringing together, having been dispersed through several of the above sections.

Conditionality. Opening of negotiations for New Associate Membership would be conditional on respect for the established democracy/human rights/minority rights criteria, but with two qualifications. The depth of the culture of modern European "civil society" cannot be achieved in the Balkans for a generation, so what counts here is a judgement whether the political institutions are respecting the fundamental rules and sincerely driving in the right direction.

For accession to the zero-tariff free trade multilateral trade regime, there should be no political conditionality, beyond that associated with the removal of sanctions and cessation of military conflict. This would be because of a) the value of free trade as a key mechanism for openness, fostering sound governance, and b) the position of Serbia in the economic geography of the whole region.

Executive capacities of the EU. These need serious strengthening, but this is surely achievable. Several innovations come to mind for decreasing the congestion in the Commission and Council in Brussels, including:

- creation of a South-East European Agency for Reconstruction and Development (SEARD), to function as a subsidiary of the EIB;
- creation of a South-East European Foundation for Democracy (SEFDEM);
- creation of a South-East European Foundation for Education (SEFED); and
- delegating responsibility to Commission Delegations for micro projects.

Timing, enlargement and pre-accession strategies. There have to be some landmark dates, although the essence lies in a long process. 1.1.2000 should be capitalised on, to initiate new directions, with formal opening of accession negotiations for a second set of candidates, and opening of negotiations for a first set of New Associate Members. 1.1.2003 should be the target date for the first set of full member state accessions and the entry into force of the treaties for a first set of New Associate Members (preferably all “5”, but depending on political conditions).

3. Needs of South-East Europe

If the objective is to integrate the states of South-East Europe into modern Europe, they must all align on the common set of political norms and policies adopted by the rest of the EU. But the transition to these common standards will follow varied paths, and in this sense call for specific agreements at least for some years. The current performance of the countries of the region is summarised according to political, legal and economic criteria in Tables 5 and 6 and Figure 1. These illustrate that the region falls in a category less advanced on both accounts than the EU enlargement candidates – on the whole and with some exceptions.

TABLE 5
LEGAL TRANSITION INDICATORS, 1998

	Extensiveness	Effectiveness	Total
Hungary	4	4	4
Slovenia	3	3	3
Croatia	4	3	3
Bosnia-Herzegovina	2	1	1
FYR Macedonia	3	4	3
FR Yugoslavia			
Albania	2	2	2
Bulgaria	4	4	4
Romania	4	4	4
Moldova	4	3	3

Source: EBRD Transition Report, 1998.

Table 6
Transition Indicators in South-East Europe

	% Privatised	Large-Scale Privatisation	Small-Scale Privatisation	Governance & Restructuring	Price Liberalisation	Trade Policy	Competition Policy	Banking Reform	Securities Markets	Average
Hungary	80	4	4+	3+	3+	4+	3	4	3+	28
Slovenia	55	3+	4+	3-	3	4+	2	3	3	25
Croatia	55	3	4+	3-	3	4	2	3-	2+	24
Bosnia-Herzegovina	35	2	2	2-	3	2	1	2	1	15
FYR Macedonia	55	3	4	2	3	4	1	3	2-	22
FR Yugoslavia	40									
Albania	75	2	4	2	3	4	2	3	2-	21
Bulgaria	50	3	3	2+	3	4	2	3-	2	22
Romania	60	3-	3+	2	3	4	2	2+	2	21
Moldova	45	3	3+	2	3	4	2	2+	2	21

Sources: *EBRD Transition Report*, 1998, and for FR Yugoslavia, Freedom House.

Figure 1
Regional Patterns of Reform

Bosnia

Source: EBRD, *Transition Report* 1998.

3.1 Croatia

Croatia's GDP per capita is at the same level as some in the first group of EU accession candidates, such as Hungary (Table 7). Moreover, qualitative indicators of progress in the transition towards a normal market economy and legal system published by the EBRD suggest that in these respects Croatia is at a standard comparable to some first group accession candidates, such as its neighbour Slovenia (Tables 5 and 6). It therefore could aspire on economic grounds to full EU membership. Furthermore, Croatia is a country whose population size (nearly 5 million) is larger than Slovenia or any of the Baltic states.

Table 7
Macroeconomic Performance in South-East Europe, 1998

	GDP per capita \$	GDP per capita (100=1989 level)	GDP % growth
Hungary	4 462	95	5.0
Slovenia	9 101	103	3.9
Croatia	4 267	79	4.8
Bosnia-Herzegovina	1 087		
FYR Macedonia	1 663	59	4.1
FR Yugoslavia	...		
Albania	708	87	7.9
Bulgaria	1 227	66	3.1
Romania	1 549	78	-2.8
Moldova	504	35	1.3

Source: *EBRD Transition Report*, 1998.

Yugoslavia in 1988: GNP per capital (Slovenia = 100)

Slovenia	100
Croatia	57
Bosnia-Herzegovina	29
Macedonia	36
Serbia-Montenegro	36
Serbia	39
Vojvodina	55
Montenegro	32
Kosovo	10

Source: *Statistical Yearbook of Yugoslavia*, 1990.

However, Croatia's leadership has been slow to implement its commitments on improving democratisation, human rights and the return of refugees, which were laid down in the Erdut and Dayton/Paris agreements, and in Croatia's accession to the Council of Europe. Although there has been slow and begrudging movement on some of these issues recently, the impression given by the current government is that it does not move decisively towards implementing international norms on election laws, local government, the administration of justice, the protection of minorities or the freedom of the media.

It is entirely possible that there will be a change of attitude in the very near future. If opinion polls are to be believed, the ruling HDZ is likely to lose its parliamentary majority in the elections which are due before the end of 1999. Whether the new government is an alignment of moderate HDZ elements with other moderates or, as seems more likely, a completely new coalition comprising the Social Democratic Party, the Croatian Social Liberal Party, the Croatian Peasants Party and others, there could well be a new willingness to face up to the real meaning of integration into the modern European system.

The situation may be in some respect analogous to that of Slovakia a year ago, where the EU and NATO had clearly signalled that the Meciar leadership was insufficiently respectful of the accepted norms of democracy and minority rights. In this case, the incentive of being reclassified from the second to first category of EU accession candidates seems to have been effective. An important point here is that the new Slovak government credibly claims to be promoting reconciliation with the country's minority Hungarian population. Any new Croatian government will need to similarly demonstrate its commitment to reconciliation with the country's Serbs, and not only with those who are still resident but also with those who left during the war years.

The urgent need therefore is for the EU to devise a strong and clear incentive for the normalisation of Croatian political standards: for example, the opening of negotiations to become a New Associate Member of the EU as soon as political conditions are met.

3.2 FYR Macedonia

FYR Macedonia's GDP per capita is a category lower than Croatia, but it is none the less comparable to some second group of accession candidate countries, such as Romania and Bulgaria (Table 7). Its progress in terms of structural economic transition indicators is assessed by the EBRD to be the same overall as both Bulgaria's and Romania's. Its current macroeconomic performance has recently been remarkably positive, however, in terms of rapid growth (5% in 1998), and low inflation and public sector deficit. In these respects, FYR Macedonia is to be ranked alongside Bulgaria as the most positive performers of the region, whereas Romania is performing poorly (high inflation and negative growth). Still, FYR Macedonia has a formidable agenda of economic reforms to pursue, including pushing back widespread corruption.

Contrary to the case of Croatia, FYR Macedonia deserves already to be rewarded for its remarkable political achievement in acting as a bulwark against the widening of the Bosnian and Kosovo conflicts, and in achieving reasonable standards of inter-ethnic political cooperation between its Macedonian, Albanian and Serb communities. In late 1998, for instance, the outgoing multi-ethnic coalition government was replaced by a new multi-ethnic coalition government. The new coalition is inexperienced, however, and remains fragile. FYR Macedonia's political system would need and deserves external support, even without the enormous pressure now exerted on the country's institutions by the Kosovo war, the substantial influx of refugees and the visible protests of the Serb minority against NATO action.

The leadership of FYR Macedonia wrote to the President of the Commission in March 1999, asking for the immediate opening of negotiations for associate member status with a view to full membership. Later the same month a joint group of members of the European and FYR Macedonian Parliaments supported this request. The EU reportedly is currently reflecting on whether to agree to open negotiations for an association agreement. The urgency of the situation warrants a change of speed and priorities. A full array of economic opportunities and aid should be opened up, comparable to the pre-accession programmes for candidate countries. Given its small population size, the EU may be hesitant about creating early expectations of full membership. On the other hand, there is an urgent case for offering the opening of negotiations to become a New Associate Member now without further preconditions.

3.3 Albania

All its state institutions are chronically weak, and in 1997, the country came to a state of virtual anarchy. Its leaders and elite express the desire to join civilised Europe, but there are deep internal political divisions, reflecting the legacy of the disastrous regimes of Enver Hoxha and Sali Berisha. Berisha's party continues to boycott parliament, and there is a persistent legacy of distrust after the assassination of one of Berisha's party colleagues and the subsequent riots last autumn. Nevertheless, the gravity of the Kosovo conflict has provoked a few minor acts of reconciliation between Berisha and the current Prime Minister, Pandeli Majko, who came to power after the autumn 1998 crisis.

Criminal interests are very widespread, to the extent that smuggling, corruption, and trafficking in drugs, weapons and refugees are major economic activities.

In the economic domain, the Bosnian model of a euro-based currency board, controlled by a Westerner as the central bank governor, could be applied. The more radical step would be to euro-ise totally the Albanian economy as well as allow for predominant ownership of the banking system by EU banks. If euro-isation were to be undertaken cooperatively between the EU and Albania, then it would be fair for the EU to make a grant to the Albanian budget corresponding to a normal amount of seigniorage gains by a central bank running a stable currency.

If it were also agreed that Albania moved to zero-tariff free trade, it would also be fair for the EU to make a compensatory grant to Albania for the loss of customs revenues to the state budget. Given the high degree of smuggling and low performance of the Albanian economy at present, the EU could make an offer of tariff compensation that should be attractive to the Albanian state (higher than what the Albanian authorities can actually collect, but still a small amount for the EU budget).

These two actions – euro-isation and free trade, both accompanied by financial compensation to the budget – would completely transform the incentive structure, ground rules and governance of the economy, in the sense of a radical cleansing of corruption, criminality and cronyism.

The EU and its member states have already been supplying support for security services:

- the Italian led military and para-military force which in 1997 stopped the violent anarchy, and permitted restoration of more normal democratic governance;
- technical assistance support for training the police force (EU financed); and
- support in staffing customs posts from the Italian and Greek customs services.

Also Greece has made a major contribution in easing social and political tensions by absorbing very large numbers (between 300,000 and 400,000) of Albanian migrants.

The support from security services and the military of the EU member states has been a limited response to needs, but the scale of outstanding problems is still enormous. Even the most transparent criminal activities have not been overcome. At the southern port of Vlore, for example, the police report that smugglers operate 180 speed boats (each worth about \$100,000, thus amounting to a major investment). Recently the senior Albanian police official in Vlore, deployed from Tirana and reinforced with an enhanced anti-smuggling law, impounded nine of these speed boats. Nevertheless, he was then confronted by 300 smugglers, who kidnapped him and held him hostage until the boats were released (*Financial Times*, 17-18 April 1999). Italy

has posted substantial soldiers and coast guards in Albania in order to try to limit trans-Adriatic trafficking.

Stronger intervention could be envisaged, if the Albanian authorities at a certain time wished to make a more decisive break with the status quo. Customs posts could be run, not just advised, by EU/member state services, thus to stop frontier corruption. Police and para-military forces, presumably from Italy and Greece, could control the flow of illegal migration, especially across the Adriatic, through being able to operate on the Albanian coast more effectively, rather than chasing speedboats in the night across the Adriatic. The police force could be directed for a while by EU nationals, supported by para-military contingents.

The Kosovo crisis is quite directly linked to the lawlessness of the northern part of the country. Western support in arming and strengthening the Kosovo Liberation Army will do nothing to alleviate the problems of organised crime in Albania.

It is of course for the Albanian government to choose its strategy. Albania requests accelerated integration with the EU. The response of the EU tends so far to emphasise the need for prior convergence on EU norms first. A more pro-active but very frank response seems worth trying in the new circumstances. The EU could test the Albanian requests, to see whether the implications for a complete change in the ground rules of society and the economy could be accepted, including implementation systems. The trade, monetary and budget compensation mechanisms have already been outlined. To this would have to be added an open examination of the scale of heavy police cooperation adequate to control the situations such as those described. If Albanian political preferences were to go less far than might be adequate, that would be their legitimate choice, but if Albania was really willing to turn the page on the past, the EU should be willing to invest in much more comprehensive actions.

3.4 Bosnia-Herzegovina

Since the Dayton agreement of 1995, Bosnia has a complex protectorate regime, keeping the peace between ethnic communities and enforcing the multi-entity map. NATO/SFOR troops stands alongside the international High Representative, who has sweeping powers under the Dayton agreement (as extended by the Bonn meeting of the Peace Implementation Council of December 1997). The monetary regime, a DM/euro-based currency board, is controlled by a Western central bank governor (from New Zealand), designated by the IMF. Large-scale reconstruction aid is being supplied by the EU and World Bank. The organisation is summarised in Table 8 below.

Table 8
Bosnia-Herzegovina: International Governance since Dayton

Annex	Area of Authority	International Body
1.A	Military aspects	NATO (IFOR/SFOR)
1-B	Regional stabilisation	OSCE
2	Inter-entity boundaries	NATO (IFOR/SFOR)
3	Elections	OSCE
4	Constitution	High Representative
Article IV	Constitutional Court	European Court of Human Rights
Article VII	Central bank	IMF
5	Arbitration	OSCE
6 part B	Human rights ombudsman	OSCE

6 part C	Human rights chamber	Council of Europe
7	Refugees & displaced persons	European Court of Human Rights
8	National monuments	UNESCO
9	Public corporations	EBRD
10	Civilian implementation	High Representative
11	International police force	UN

Source: Chandler (1999).

Bosnia provides a unique experience on the practical organisation of a modern protectorate system, the lessons of which need to be drawn. It is evident that the attempt to motivate Bosnia more strongly towards progressive governance still faces a daunting uphill struggle.

Although there has been a certain recovery of economic activity from the very reduced levels of war-time, the economic performance of Bosnia remains very poor. This is in spite of massive international financial assistance (pledges of \$5 billion in 1996 for four years, of which \$4 billion had been committed and \$2.7 billion spent by the end of 1998). While much physical infrastructure has been rebuilt, economic reform policies have been stalled by old communist mentalities, intrusive bureaucracy, inter-entity frictions and endemic corruption. For example, the trade regime was until very recently splintered between the three entities, with the Croatian and Serb areas continuing free trade with Croatia and Serbia, while inter-entity trade was subject to illegal taxes. The banking system is inefficient and corrupt, distorted by so-called Payments Bureaux, controlled by political parties, holding monopolistic privileges. Foreign investment is deterred.

In brief, Bosnia has so far wasted the chance to make a lasting economic recovery (ICG, 1999b). Deputy High Representative Jacques Klein remarks:

The economy of Bosnia will never prosper without free trade and market economics throughout the region. ... The answer lies in more enlightened government, not more enlightened map-making, across the region. It lies in an open, democratic, free-trading Balkans, with close links to Europe and the rest of the world (Klein, 1999).

On the performance of the Dayton system of international governance, Klein also has a message:

In Eastern Slovenia, as UN Administrator, I had control of both the civilian part of the mission and the military force.... The two sides of the mission were therefore completely integrated, and working in tandem. In Bosnia ... the NATO-led force operates under its own mandate, and may – or may not – assist the implementation of the civilian aspects of the agreement. Carlos Westendorp as High Representative is *primus inter pares* amongst a plethora of civilian implementing agencies which include the UN, UNHCR and OSCE. He has no control at all over SFOR, although we work closely alongside them. Things work out remarkably well in the circumstances, and SFOR, especially in recent months, have been immensely supportive of the civilian effort.

But in drawing up future mandates, there is no doubt in my mind that the chain of command is one aspect that needs careful attention, and that a single individual – be that individual military or civilian – in charge of both the civilian and military aspects would be preferable. This is regarded as heresy in some quarters. But ...

The post-Dayton political regime in Bosnia has recently been assessed in an independent study as follows:

Although Bosnia remains formally a sovereign state, the extension of international mandates over the state has left little space for Bosnian state institutions to make or to implement policy. The extension of the administrative powers of the High Representative, in particular, has meant that policy is made at international forums and implemented within Bosnia through a parallel system of internationally-run committees and task forces. This experiment in externally imposed democratisation raises questions about the relevance of sovereignty and political autonomy to the long-term success of the democratisation process, whether international democratisation strategy has been able to facilitate the development of Bosnian self-government or whether the level of involvement has made it more difficult for the international community to exit from Bosnia (Chandler, 1999).

There is a reply to these questions from the modern EU integration model, which contrasts with the precepts of the system of international relations to which the preceding quotations relate. The political values – of democracy, human rights and market economics – are common to both systems. But EU integration strategy has no place for “exit”. On the contrary, there is progressive osmosis between democratic governance at three levels at least (EU, nation and region), to the point that political identities become blurred and overlapping. Only the EU has the potential legitimacy and resources to deliver the long-term solution through integration. It is a circumstance of history that the EU had not yet developed a full capacity ready for taking in hand the collapse of Yugoslavia. Indeed, there was not beforehand a clear geo-political imperative for the EU to undertake ambitious systemic advances of this type.

With the war over Kosovo now following the Bosnian war, this imperative does however assert itself. There are implications for the Dayton regime in Bosnia as well as for Kosovo (see below). For Bosnia, the international regime’s only “exit” strategy is to transform itself into an EU integration strategy. In practical terms, this points to a carefully phased, progressive transfer of responsibilities from the US and international organisations to the EU. For example:

- The NATO IFOR would in due course become an EU-led operation, continuing to use NATO assets still under existing ESDI doctrine, in say two years time.
- The High Representative, an EU national whose budget is paid 50.6% by the EU, would become the EU High Representative, whereas today he is the international High Representative.
- The European System of Central Banks would take over the guidance of the Central Bank of Bosnia from the IMF.
- The EU, under its newly developing competences for Justice and Home Ministry Affairs, would take over the running of the UN international police task force.
- The EU would continue to rely on the Council of Europe (Court of Human Rights) as its partner and implicit agent in the human rights field.

Bosnian UN Ambassador (former Foreign Minister) Mohammed Sacirbey has argued for deeper consolidation of this system into the EU. Similarly, the High Representative Carlos Westendorp has given evidence to the European Parliament, arguing that it is only through a vivid prospect of integration into the EU that the ethnic communities might be induced to concentrate on becoming part of modern European civilisation, rather than to carry on with yesterday’s conflicts.

3.5 FR Yugoslavia

Serbia. The only good solution is one in which Serbia becomes truly democratic, converging on modern European norms. A liberated and protected Kosovo, facing a militarily weakened but

still defiant Serbia, would have poor prospects. The position of Serbia is also of great importance for the economic prospects for FYR Macedonia, Romania and Bulgaria.

There has, therefore, to be a positive framework for reconciliation with Serbia, and for it to become a normal European state. Such is the deepest lesson that Western Europe has learned for itself in the last half century. The expectation has to be created that Serbia, with political renewal, will have a path ahead for full integration into the EU, no doubt also initially as a New Associate Member, and to derive great economic and societal benefits. Post-Second World War Europe saw emerge an astonishingly successful model for the reconciliation and integration of former enemies according to civilised norms. This model is all the more poignant in the present Balkan context, where pessimistic fatalism abounds, since both Western and South-Eastern Europe shared comparable horrors in the first half of the twentieth century. Serbia at the heart of the Balkans should be invited, with political renewal, to become a new spectacular recovery case.

The central place of Serbia in the region would also be reflected in many key features of a desirable post-war programme, for example measures to reverse the very serious brain-drain in recent years of the former Belgrade elite, programmes to build up new or stronger non-governmental organisations, and renewal of the region's strategic transport corridors that pass through Belgrade.

Clearly, democratic renewal in Serbia would allow the FR Yugoslavia to survive and recover as a sovereign, federal state.

Montenegro. It is not for this paper to advance other ideas for the constitutional future of Montenegro, but to take note of what its democratic leadership declares. Thus M. Djukanovic, President of Montenegro:

What we have here is a permanent attempt by Milosevic to destabilise Montenegro and to overthrow the government by force. It is not realistic to expect that Mr Milosevic can succeed. At this point the very survival of the Federal Yugoslavia is being very much threatened.

My ambition is to preserve peace and build Montenegro into an open democratic society, economically prosperous and integrated into Europe, and to preserve its multi-ethnic character. If that could be done in the federal Yugoslavia I would fully support the federation. If Serbia had a different view of the federation, we shall have to look for another path, but this is not the moment for such crucial decisions (*Financial Times*, 22 April 1999).

Kosovo. The draft Rambouillet Agreement leaves Kosovo as part of the FR Yugoslavia. As the war has deepened and the mass deportation of the Albanian Kosovar population forced by Serbian forces under cruel conditions, the chances have obviously greatly diminished (probably to zero) that the Rambouillet Agreement could ever be signed by both the Kosovar Albanians and the Milosevic regime.

If initially there has to be a complex international protectorate regime, there are the lessons of Bosnia to be borne in mind (see above). The EU has already declared its willingness to establish an interim administration. Responsibility for creating a suitable police force, holding elections and deploying military forces to protect the population is mentioned also, without saying who would be responsible.

As for economic prospects, Kosovo was already by far the poorest part of the former Yugoslavia before the present conflict, with GNP at a level in 1989 only one-third that of either Montenegro and FYR Macedonia (see Table 7). The economic infrastructure has now been severely damaged. For what was until recently the economy of Kosovo, a detailed study is

available (RIINVEST, 1998). However, more to the point would be how to start again after the war. If there is to be anything more than a subsistence economy, there will have to be complete economic openness, preferably without any customs tariffs with any of its neighbours. Especially if initially there is a considerable "aid economy", there should be no room opened for the kind of state corruption observed elsewhere the region. The free trade and euro-based monetary regime already described, with compensation for loss of customs revenue and seigniorage, would be a safe way to begin.

3.6 Existing Accession Candidates

An EU initiative such as outlined for New Associate Member States in South-East Europe immediately puts the spotlight also on the implications for the existing accession candidates.

Among the states of the region or on the edge of it, Hungary and Slovenia are already deeply engaged in the accession negotiation process. For these two countries, there is a reasonably clear scenario, for example that the EU would by the end of 1999 set a target date, such as 1.1.2003, for their accession. The hypothesis for the present paper is that such a scenario is likely, desirable and should not be affected.

For Bulgaria and Romania, the scenarios are much less clear, both because the degree of preparedness of these countries according to the Copenhagen criteria remains far behind the first group of accession candidates, and because they are more sharply affected by the new situation in the region. These two countries do already suffer the immediate economic consequences of the war, and would be concerned about receiving relatively or absolutely less favourable treatment from the EU if the "5" became beneficiaries of a major new initiative.

The position of the EU towards Bulgaria and Romania might be as follows:

- There would be assurances that their own applications for full accession would not be changed because of creation of a New Associate Member category.
- The strategy would be about raising the integration prospects of the "5", not retarding the integration prospects of the two (a positive sum game, not a zero sum game).
- There should be extra economic assistance to the two to help them absorb the adverse economic effects on them of the war.

Pre-accession strategies continue to be enriched for all candidates for full member state accession, and this is particularly important to reassure Bulgaria and Romania. The candidates for New Associate Membership would also be brought into the same process, however, or something closely related, as regards progressive inclusion in the policies and institutions. See the 1997 Poettering report (reproduced as an annex to this paper) that was prepared for the Group of the European Peoples' Party of the European Parliament. It serves as a useful guide to the full range of existing possibilities that go far beyond what is happening so far. This report could also be used as the basis for bringing together the pre-accession strategies for both New Associate Members as well as the full accession candidates.

To make clear that the New Associate Members would not be leapfrogging over the present accession candidates, the target date of 1 January 2003 could be set also for the earliest formal entry into effect of the new agreements (although negotiations could begin without delay where political conditions are met, and various operating programmes could start also earlier).

The existing accession candidates of the region would for their part be expected to support maximum extension of cooperative programmes to the whole area in their own enlightened interests, and not to adopt competitive attitudes. EU budgetary provisions should also make such attitudes unfounded.

3.7 South-East Europe Conference and Stability Pact

The EU Council (foreign affairs) decided on 8 April 1999 to prepare a new Stability Pact for South-East Europe, going beyond the previous regional Stability Pact work of 1994-95. The European Council on 14 April then decided that “the European Union will convene a Conference on South-Eastern Europe to decide upon further comprehensive measures for the long-term stabilisation, security, democratisation and economic reconstruction of the entire region. In this context, the Heads of State and Government underline that all the countries in the region have the prospect for an increasing rapprochement to the European Union”. There have followed British and Greek proposals exploring the same terrain, as well as contributions by individual politicians (Balladur, 1999, and Bildt, 1999). The German Presidency has now convened the Conference to initiate a Stability Pact process on 27 May 1999.

The previous Stability Pact initiatives, now transferred to the OSCE, were essentially aimed at getting EU accession candidates to resolve in a cooperative and stable way any outstanding issues affecting their own borders, including geographic border delimitation, and the treatment of national minorities across such frontiers. This helped consolidate positive trends and reduces the risks of problems emerging in the future.

It seems to be envisaged that a new Stability Pact for South-East Europe would have a considerably wider agenda, including security, economic and civil society issues. On the other hand, the intensity of the tensions and conflicts in South-East Europe are such that a loose Stability Pact device is unlikely to be a substitute for hard commitments to a basic strategy for integration of the region into the EU (e.g. as in the core proposals of this paper). The initial official working papers for the Stability Pact were manifestly preliminary, with many topics mentioned without any indication of what kind of mechanisms would be involved.

The British 8-point action has the quality of seeking to order responsibilities as between EU, NATO and OSCE as the lead actors. However, the EU would follow a very gradualist approach, with an upgrading of present Cooperation Agreements, which “would lead on, in time, to tailored Association Agreements, and eventually the perspective of EU membership (governed by the Copenhagen criteria)”. This evolution is so gradual, if any, in relation to existing doctrine that it would hardly register on the radar screens of the countries in question.

It is also proposed (in German and British papers) that the OSCE Round Table for the region should bring together the many overlapping regional cooperation initiatives: the Royaumont Process, South-East Cooperative Initiative (SECI), the Central European Initiative (CEI), Central European Free Trade Area (CEFTA), Black Sea Economic Cooperation, and the so-called “Balkan Conference” of South-East European States, not to forget the truly pan-European organisations (Council of Europe and OSCE). For an account of these activities, see Busek (1999). Their simple enumeration invites the observation that these are many well intentioned initiatives, but that they do not add up to a decisive and synergetic impact.

The time has certainly come to sort out these initiatives and organisations in more fundamental terms. This cannot be done without, first, greater clarity of strategic intent by the EU, together with an understanding over the future role of both the US and Russia in the region.

First the EU has to decide whether it is operationally serious about *integration* (economic, political and institutional) of the whole of South-East Europe into the EU over a time horizon that begins immediately and goes on forever (integration has no “exit” strategy). If the answer to this is yes, then CEFTA will be scrapped and all market, monetary and pan-European infrastructure questions will be governed mainly by the EU integration framework. In this case, the concept of Balkan integration is largely subsumed in European integration.

This point has to be made, since there are advocates mainly in the US (e.g. The Carnegie Endowment for International Peace, 1993 and 1996) of regional integration which would appear to be largely apart from European integration. The argument is sometimes presented as if the Balkan region should transform itself after the present conflict as Western Europe did fifty years ago with Marshall aid. Of course, the experience and ideology of the Marshall Plan have engendered a solid common wisdom in both the US and the EU equally. But its transposition into the present Balkan context could be done in either of two ways.

One variant is to envisage that the emphasis is on Balkan regional integration. But this particular thesis is a non-starter as a strategic option, since the region is too small to prosper on its own economically, whereas politically the governments and peoples want European (EU) integration, and do not trust the prospect of regional integration amongst themselves – with good reason to say the least. There will of course remain some useful room for regional cooperative mechanisms that are based on proximity. But a consolidation and ordering together of a whole collection of regional mechanisms (as in the proposed OSCE Round Table) is no substitute for the integration with the EU as the main game. If the main game does not have a sufficiently strong organisation, the regional Round Table cannot succeed. These arguments are hardly disputed as a matter of principle, at least in Europe. The problem is elsewhere, namely in the inherent difficulty of organising the European integration strategy quickly and strongly enough. Otherwise, the EU may drift into *ersatz* policy of elaborate diplomatic activity with less than strategic force.

The second variant, in which Balkan integration with the EU is the main game, has exactly the same philosophy, which traces back to the Marshall Plan. But history has moved on in some respects (EU economic and political integration), although less so in others (continuing US leadership of heavy military operations). This is the reason why the new Balkan order has to emerge from a joint strategy of the EU and the US. EU-US cooperation is solidly founded upon virtual identity of political values. It is obvious that the unique military capacity of the US is essential today in a war situation, while equally obvious also that the EU has to become the framework for the future. Beyond defining the strategic concept, there will have to be a precise dovetailing of these complementary roles over time, and this has to be built into the design of a strategy at an early stage.

Carl Bildt's sketch of a Stability Pact (Bildt, 1999), has a clear form:

1. *Military security*: Initially NATO, but gradually acquiring a European character;
2. *Economic integration*: free trade, then customs union, then single market within the European Economic Area, with a new Balkan Reconstruction Agency (similar to the proposal in Section 2.3 above); and
3. *Political security and integration*: structures to move the "5" into the European Union during the next decade. Reconstruction should aim at 2005, full European integration at 2010.

The OSCE has the great advantage of involving Russia, Ukraine and Turkey as well as the US. OSCE has specialised capabilities (disarmament, conflict resolution, etc.). It is also a forum on many subjects, and operates by consensus. There should be no illusions, however, that an enhanced OSCE role can be the main game. It has to be a valuable supporting player, with EU integration as the main game.

The historical connotations of Balkan conferences are about the redrawing of the maps of state boundaries. Already the EU has signalled that this is *not* the sense of the Conference proposed by the European Council. The need is to bring South-East Europe to join in the way the map of modern Europe *is being* redrawn. This is about extending the area of jurisdiction of key rules of the modern European political and economic order (often EU rules, but also those of the Council of Europe, OSCE, etc., as set out analytically elsewhere). See Emerson (1998). These

rules govern large areas, overarching national frontiers. As these jurisdictions become more important, so also is the significance of national frontiers diminished, especially as people have complete freedom of choice of where to live and work. This is of course the exact and total antithesis of ethnic cleansing, where people are moved forcibly to make the national/ethnic frontiers even more important.

3.8 Wider European Dimensions

First on Turkey, which by virtue of its size and situation calls for special consideration. A new system for South-East Europe needs to become an opportunity for a positive recovery of EU-Turkish relations. It would be for examination, initially perhaps by a special EU-Turkish forum, how Turkey might want to position itself in relation to ideas developed in this paper, retaining the premise that the EU continues to view the Turkish accession request by the standard Copenhagen criteria.

The European Council has recently invited the EU institutions to work out several foreign policy “strategies”, in relation to Russia and Ukraine as well as South-East Europe and the Middle East. With the importance now of defining a strategy in relation to South-East Europe, it is necessary to consider two kinds of interrelation with strategies for EU relations with Russia and Ukraine. First, and most immediately, is the question of how Russia’s active diplomacy in Belgrade may contribute to the management of the regional situation. Second, at a more technical level, several of the mechanisms of policy discussed above are also highly relevant to both Russia and Ukraine, for example on economic (pan-European free trade, transport corridors) and “third pillar” policies.

More fundamentally, however, the political dynamics in the wider Europe could become deep and powerful following a major initiative along the lines described above. If the whole of South-East Europe were to join seriously in the EU integration process, then perceptions of exclusion in the remaining parts of the wider Europe would be intensified. Moldova for its part would probably ask to join the new South-East Europe as a New Associate Member.

In Russia, political dynamics are now particularly fluid, given the pre-electoral atmosphere, the severity of economic problems since the financial crisis of August 1998 and the acute sensitivities aroused by the NATO bombing of Serbia. If a new initiative for South-East Europe were initially undertaken with a Serbia that was still (for the West) the rogue state, then the negative interaction with Russian political dynamics would risk being seriously aggravated (see Emerson, 1999, on the dynamics of chaos and conflict, as well as integration). In the contrary and more positive case, Russia could be a major contributor to the processes of pan-Balkan reconciliation, helping Serbia to become truly democratic. In Ukraine political dynamics are also fluid in a pre-electoral period, with renewed internal tensions over the nation’s geo-political orientation aggravated by the conflict over Kosovo. The future of EU-Ukrainian relations will also warrant a fresh examination.

These implications of the Yugoslavia crisis for EU relations with each of its three big neighbours are thus also very large matters, which have to be borne in mind when the outline of the post-war Balkan order is defined, and further developed in detail thereafter.

4. Conclusions

The war over Kosovo has been waged because concepts of sovereignty and political norms have changed in Europe, such that (to paraphrase the words of the OSCE “Moscow Mechanism” of 1991) the events in Kosovo are being regarded as a matter of internal European affairs. By this logic, Europe must be inclusive for peace as well as war.

A change of gear in EU strategy for the region needs now to be prepared. For the current EU enlargement process, the doctrine of deep and durable prior convergence on the *acquis*

communautaire has dominated. This may be appropriate for countries with a clear national sense of purpose in joining modern Europe, but is less adequate for communities suffering chronic disorders or consumed by conflict. The “regional approach” [Commission of the EU, 1998] for the former Yugoslavia plus Albania has been a poor and distant cousin to the enlargement process, deploying only very limited incentives with its conditionality.

A new policy needs to comprise a far more powerful, pro-active, and comprehensive approach, offering a far higher and quicker “inclusion” quality than has been present so far. For this reason, the idea of New Associate Membership of the EU has been presented.

The EU’s natural responsibilities are further increased by the intensity of NATO’s present military engagement. This crisis may produce a bending or even the collapse of the Milosevic regime. But looking ahead, with the EU intending to acquire growing security and military capabilities alongside its existing economic, monetary and political competences, it is incumbent upon it to take the lead in organising the post-war South-East Europe. The European Council decided on 14 April 1999 to convene a Conference on South-East Europe to devise a comprehensive approach for the rapprochement of the whole region to the European Union.

The present paper debates the possible substantive content of such a comprehensive approach. We advocate real *integration* of the region into modern Europe, not just *rapprochement*. Also a process of dialogue with the political and opinion leaders of South-East Europe must of course be initiated without delay, to test ideas and adapt them more closely to locally perceived needs. The present (unofficial and independent) paper by CEPS may at least serve as an initial basis for reactions and counter-proposals. CEPS will intensify its own work along these lines in the light of reactions, and prepare more fully articulated proposals in due course.

From discussions over earlier versions of this paper we have received much encouragement and support for our approach, but also heard three objections, which may be summarised as follows:

1. The US would not like it.
2. The EU is not up to it.
3. The region is not up to it.

Concerning the first objection, we do not agree that this is a correct perception of US strategic interests. Of course, the US speaks for itself, and we for our part hear the US hoping that the EU will mature into taking even more solid responsibility for the European political, economic and security order, according to our common values. We warn against a persistent tendency towards timidity in some EU quarters, which are of the same type as heard for over twenty years ago over whether the EU should aim at monetary union.

On the EU, new capacities for execution of an integrated set of policies in the region would have to be created. Today there are insufficiencies, but the EU has shown repeatedly its capacity to grow into major new tasks with quite lean administrative structures (e.g. Structural Funds, European Central Bank). South-East Europe would, to implement the present proposals require some important new investments in administrative and political control mechanisms. So be it. Political imperatives command.

On the countries of the region, who is to say that the populations would not respond to a drastic change in the groundrules and perspectives? It is clear that massive incentives and constraints would be required to induce real change in political, economic and societal behaviour, effectively a categorical change in the course of their history. Both the double ills – of ethnic conflict and corrupt governance – have to be faced up to in the region, which is what we propose. But far from all the region is mired in both. The forces of civilisation have increasingly surrounded the remaining islands of darkness. The populations need no persuading to aspire to a normal life, even if in some cases they have been tragically misled and carried away by criminal politicians.

There can be no illusions over the magnitude of the operation for the EU, if it were to take over the main responsibility for integrating the region – even just for these five small countries with a population of only 25 million. The task will lead, inevitably, to a new context for EU relations with Russia, Ukraine and Turkey, with far-reaching implications. Whatever its long-term resolution, the present Balkan conflict, will surely lead back to the wider agenda of unresolved issues of pan-European stability and security. The whole task is in the same category as other recent EU projects of the last decade (single market, euro, the present enlargement negotiations): tasks requiring systemic change, not just policy management. Within the EU, the time is right for this task, with the euro now in place and the imminent renewal of the European Parliament and the Commission.

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Annex
Plea for a 'New Enlargement Strategy'
for the European Union (EU)

Report by Hans-Gert Pöttering
Vice-chairman of the Group of the European People's Party
(Christian Democrats in the European Parliament)

2 July 1997

The people of the Central and Eastern European countries (CEECs), who, after the catastrophe of the Second World War, had Communism forced upon them, have regained their freedom and independence in a bloodless revolution. For these nations the concept of 'Europe' is synonymous with civilisation. 'Europe' symbolises democracy, human rights, the rule of law and a market-economy system. One expression of the maintenance and protection of this free system is the European Union. Ten Central and Eastern European countries (CEECs) have concluded 'Europe agreements' (association agreements) with the European Union. They are: Estonia, Latvia, Lithuania, Poland, the Czech Republic, Slovakia, Hungary, Bulgaria, Romania and Slovenia. The ultimate goal of these Europe agreements is accession to the European Union. The people of the CEECs want to join the European Union because they identify with its aims, as expressed in the preamble to the Rome Treaties of 1957: 'to lay the foundations of an ever closer union among the peoples of Europe... and by thus pooling their resources to preserve and strengthen peace and liberty'.

The European Union is bound for political and moral reasons to open its doors to the Central and Eastern European countries. Accession by the Central and Eastern European countries is not only in their own political and economic interest, but also in that of the European Union and its Member States.

The establishment of democracy and the rule of law, the recognition of human rights and the rights of ethnic minorities, a market economy and the adoption of Community law are preconditions for accession by the Central and Eastern European countries to the European Union. The Europe agreements and a preparatory strategy should and must enable the Central and Eastern European countries gradually to become members of the European Union.

The preparatory strategy of the summit meeting of Heads of State and Government in Essen (1994) gave significant momentum to the promises to enlarge the EU made in Copenhagen in 1993 and deepened the association with the Central and Eastern European countries. In accordance with the guidelines set out at the Madrid Summit (1996), the Commission will present its proposals for the accession negotiations to the European Parliament in Strasbourg on 16 July 1997. The Heads of State and Government of the EU Member States noted at their summit of 16 and 17 July 1997 in Amsterdam that with the completion of the IGC and agreement on a draft treaty, the way had been opened for the enlargement process to begin. This applies to the Central and Eastern European countries and to Cyprus. The pre-accession stage will thus move forward into specific enlargement negotiations. This means that preparations by the EU and the applicant countries must be given new momentum. In the case of the PHARE programme countries the Commission already did this in March with its new guidelines. It is still more important, however, to extend this momentum to political relations with the applicant countries and to fulfil interim objectives on the way to full membership. These interim objectives should result in:

- a general speeding up of the enlargement process,
- individual results of negotiations being transposed in a legally binding way before accession,

- an additional mechanism on the long road to accession being made available to applicant countries which lag further behind, and
- substance being given to the planned Europe Conference.

The new enlargement strategy should include the following elements:

I.

All the Central and Eastern European countries with which Europe agreements have been concluded, and Cyprus, which has been promised accession negotiations, would be invited by the European Union in early 1998 to a 'Standing Conference on Europe'. It would be decided that accession negotiations with the most advanced group of countries could begin. These countries, as well as those which do not yet belong to the group, would be brought increasingly closer to the European Union by means of the 'Standing Conference on Europe'. The task of the Conference would be to develop the preparatory work on enlargement by Member States and applicant countries on a multilateral basis and gradually to bring about political, economic and institutional integration of the Central and Eastern European countries into the European Union.

II.

Even before accession the countries to which the European Union is bound by Europe agreements would be institutionally linked to the European Union. The European Parliament, the Economic and Social Committee and the Committee of the Regions would invite to their meetings permanent observers from the applicant countries with speaking, but not voting, rights.

The Economic and Social Committee and the Committee of the Regions would set up bilateral joint committees with the applicant countries.

In order to provide the public in the applicant countries with more information about the European Union, the European Parliament would open local information offices in their capital cities. These would work closely with the Commission delegations and familiarise Parliaments and public in the Central and Eastern European countries with the European Union.

European Union directives and regulations, as well as the main Commission and European Parliament decisions and recommendations, would be published regularly in the languages of the applicant countries. The EU's automatic translation system would be extended to include the languages of the Central and Eastern European countries.

All the institutions and other bodies of the EU would start to recruit staff on a short-term basis from the applicant countries for training purposes. The applicant countries would be included in the EU's programme of exchanges for officials.

In parallel with the necessary harmonisation of legislation in the context of implementing the Europe agreements, the applicant countries would send associate members to the relevant administrative and consultative committees in the Commission and Council.

The applicant countries would be fully involved in the activities of the various decentralised Commission offices and bodies (the Patent Office, the Agency for the Evaluation of Medicinal Products, the Environment Agency, etc.) and send national officials for the purpose.

The applicant countries would be given the opportunity to bring internal legal cases related to European Union law before the Court of Justice of the European Communities as the court of last instance.

III.

The applicant countries would be associated fully in the EU's common foreign and security policy, including its instruments - common positions and joint actions. This is intended to

ensure that the European Union and the applicant countries agree at an early stage on a common policy.

IV.

The Europe agreements would be extended to cover all the components of the present third pillar (provisions on cooperation in the fields of justice and home affairs). In particular, the countries would be associated in the Schengen and Europol agreements and given support in their preparations for these by PHARE and participation in the Commission programmes connected with the third pillar.

The European Union would conclude pre-accession agreements with the applicant countries with the aim of combating organised crime. These agreements would also include ratification and implementation of the relevant international agreements, particularly those of the Council of Europe and the European Union, by the applicant countries.

V.

One of the priority tasks of the 'Standing Conference on Europe' would be to prepare and conclude a multilateral convention on the founding of a customs union with all the applicant countries.

The 1995 White Paper on the single market gives clear guidelines on harmonisation of applicant country law, but only covers one core area of Community law, that of the single market. The Commission should therefore present a second White Paper setting out additional harmonisation objectives for the legal systems of these countries (environment, agriculture, social affairs, transport, etc.) equally clearly.

As part of the harmonisation of legislation, all non-tariff barriers between the EU and the applicant countries must be removed. In particular, the conclusion of the European Certification Agreement, including the related information procedure, must be speeded up.

A joint supervisory board would be set up to monitor commercial competition and state aid in the applicant countries, along the lines of that set up for the European Economic Area (EEA). This would prepare decisions of the relevant association councils in the framework of the Europe agreements. At the same time the Union's anti-dumping instruments vis-à-vis the applicant countries would be suspended.

The legal form of the European Economic Interest Grouping (EEIG) would be opened to participants from the applicant countries.

VI.

The applicant countries would coordinate their economic and monetary policy with the EU in accordance with the procedure set out in Article 103 of the EC Treaty.

The applicant countries would gradually begin to participate in the new Exchange Rate Mechanism (ERM 2). They would become associate members of the Enlarged Council of the European Central Bank.

VII.

The Community is continuing with the process of reform of the common agricultural policy begun in 1992. Gradually, and taking account of the conditions relating to the various areas of agricultural policy, the latter is being adjusted to tie in with the global market situation. Both sides are working towards a convergence of the relevant domestic farm prices. In parallel with this, the Community is reducing its export refunds to the applicant countries with a view to doing away with them completely. This will create the conditions for more rapid integration of the applicant countries into the agricultural single market.

The conclusion of the planned bilateral veterinary and plant health agreement is being brought forward in order to eliminate the most dangerous threats (such as swine fever) and the corresponding trade barriers. The Community would support the applicant countries in developing the necessary animal and plant health structures.

By simplifying the preferential quota system and eliminating import charges in the context of preferential trade, the Community would improve market access for the applicant countries. The Community would gradually extend its preferential trade system to products which currently still come within the Community's usual 'third country system' (these cover all areas of bilateral trade in agricultural products which do not qualify for the preferential treatment under the Generalised System of Preferences (GSP) provided for in the Europe agreements, customs quotas, etc.).

At the same time the Community would support the applicant countries in developing a policy of integrated land development and would make resources available via an 'enlargement fund'. This 'enlargement fund', the successor to the PHARE programme, would be made up of the 70% capital content of the latter programme, the portion of the Cohesion Fund released by the introduction of the euro, European Investment Bank funding and surpluses from the agricultural guideline along the lines of the reformed structural funds within the new financial perspective for 2000-2006. Low-interest loans would have special priority. Budgeting by individual states, procurement and monitoring of the fund would also take place in accordance with uniform principles and the rules of the reformed structural funds under the supervision of the Court of Auditors.

Regional and structural policy, which have not hitherto been subjects for structured dialogue, would also be included in the agenda of the 'Standing Conference on Europe'.

VIII.

All the Community programmes (Socrates, LIFE, Research, etc.) would be opened to the applicant countries in a simplified form and on an equal footing. The funding for the programmes would be made available from the 'Enlargement Fund'. Coordination of national research policies would include the research and development policies of the Central and Eastern European countries in its work.

IX.

In extending the guidelines for the development of the trans-European transport network (by 1 July 1999) the Commission should propose to the Council that selected trans-European transport corridors ('Crete corridors') should be included in the priority projects, e.g.:

- the Helsinki - Tallinn - Riga - Warsaw corridor; road + rail
- corridor IV (Berlin - Prague - Budapest - Constanta - Thessaloniki); road and rail
- corridor VII (Danube); inland waterways.

In the development of Europe's own satellite navigation system for air, sea, road and rail transport the applicant countries should be taken into account from the outset in planning the network strategy.

In parallel with their adoption of the Community's safety and environmental standards, the applicant countries should be granted, gradually and on a basis of reciprocity, the same access to transport markets (passengers and freight) in land, air and inland waterway transport as the EU Member States.

X.

The legal transposition of the new enlargement strategy should take the form of additional protocols to the association agreements (Europe agreements). At the same time the Commission should see which other Community rules and measures, particularly those introduced by the Amsterdam Treaty, can be included in the enlargement process.

The accession negotiations should take a condensed form, in order to achieve rapid accession. With a negotiation period of 2 to 3 years and a ratification procedure lasting 1 to 2 years, accession of the first group of Central and Eastern European countries could take place in 2002 or 2003.

Economic & Monetary Dimensions

Daniel Gros

Summary

Sustained economic recovery in the region requires stable currencies and open markets. The best way to establish these two basic conditions quickly is for the countries concerned to immediately link their currencies to the euro via a currency board and join the customs union of the EU. The EU should support this radical approach financially in two ways: a) through compensation for lost tariff revenues (conditional on clean and efficient border controls), and b) emergency loans to acquire the necessary backing for the currency board. The currency boards should graduate to full euro-isation in 2003. The total cost for the EU would be modest: around 2 billion euro p.a. if all countries participate.

The package should be available also to the FR Yugoslavia provided it becomes democratic and liberates its economy. Yugoslav workers who lost their jobs as a result of allied bombing should receive unemployment compensation from the EU (at an approximate level of 100 euro per month for two to three years, costing a total of about 120 million euro per annum.). Their factories, however, should not be rebuilt with public money.

1. General Considerations

The starting point of any discussion of an economic order for post-war South-East Europe must be the recognition that regional integration is not viable. The region is simply too poor to provide a significant market on its own. Integration with the EU is thus the only viable option.

A second basic point that must be kept in mind is that there was practically no viable industrial activity in a large part of the region before the hostilities erupted. The few industries that existed in most of the poorer parts of the former Yugoslavia (and Albania) had been implanted under the old regime and cannot survive in an open market. In economic terms, one starts thus essentially with a *tabula rasa*.

The basic elements of the economic order proposed here (multilateral free trade and euro-isation) should not be established gradually over a number of years using normal procedures and negotiation practice. In this emergency situation, the basic elements of the new order need to be established immediately, before special interest groups and political rivalries can come into play. In any event, there is no need for long lists of exemptions for specific products or transition periods.

It is often assumed that the international financial institutions (IFIs) i.e. the IMF, IBRD, EBRD, etc., will play a key role in any economic settlement. This will be the case to some extent, but the effectiveness of the IFIs is limited in two crucial aspects. The first difference between the EU and the IFIs is that the latter can provide only credits. The EU is the only game in town for substantial transfers (although some countries in the region might not appreciate the difference). The natural division of tasks is thus the following: the EU provides income support whereas the IFIs provide credits for reconstruction and as balance-of-payments assistance to help neighbouring countries weather the temporary disruption to important transport routes. The second difference is more important: only the EU can offer an established economic (and political) framework that is attractive for these countries and can constitute the basis for a sustained recovery. This will be the main thesis of this contribution.

The cost of reconstructing bridges and other infrastructure damaged by the war will probably attract most attention, but this task is relatively straightforward compared to the one of creating an overall economic order that fosters a lasting economic revival of the region. Even in pure cost terms, the bill for reconstruction of infrastructure is likely to remain modest. A bridge over the Danube will cost about 50 million euro. Even ten of them would thus cost only about 500 million euro. Reconstructing the factories destroyed by allied bombs might cost more, but would not make economic sense. Experience over the last decade has shown that a fundamental condition for success in the transition to a market economy is the acceptance of the idea that most of the large industries inherited from the socialist period are obsolete and cannot be saved. That Bosnia-Herzegovina, Albania and Kosovo have no heavy industry left should be viewed as an advantage. Much more important than re-building the factories will be re-training their work force.

Economic activity in the part of the region directly affected by war came virtually to a standstill. To give the population something to think about (and to do) other than seeking revenge, it is important that recovery starts quickly. This should be the easiest part of the problem. Substantial sums will soon flow into the region in the form of emergency loans (preferably not all to governments, but also directly to households affected by the war). The real challenge will come in the medium to long run, when the reconstruction of infrastructure and housing has neared completion and the boom in construction tapers off. When emergency loans will have to be serviced, these economies will face a serious adjustment problem, as Bosnia is about to discover. The countries not affected directly by the bombing are already facing a serious shock. If a substantial part of the region falls back into the trap of declining economies presided over by corrupt and unstable governments, the danger of renewed conflict will remain and a substantial part of the population will have to seek employment in the EU.

Growth in the region will have to come from the grassroots or it will not be sustainable. It is unlikely that foreign direct investment will play a large role since the region is not an attractive site for large industrial plants. Fostering the growth of small- and medium-sized enterprises cannot be done from the outside. The EBRD and other organisations are trying to achieve this, but it cannot be done with personnel that are paid internationally competitive rates. Consultants who bill at \$1000 a day are of no use in advising a small shop in a region where the average monthly wage is around \$150-200. In any event, capital is unlikely to be the main constraint on growth since most countries of the region also benefit from the transfers of that part of their workforce that is already in the EU.

This paper is organised as follows: Sections 2 and 3 discuss the proposed trade and currency regimes. Section 4 considers the case of Yugoslavia. A final section offers concluding remarks. Annex 1 correlates countries on the strength of their monetary and financial institutions and their choice of exchange rate regime. Annex 2 details the cost calculations implicit in the proposed economic reforms advocated for South-East Europe. Annexes 3 and 4 draw lessons from the experiences of Panama and Puerto Rico.

2. Trade Regime: Free Trade with Compensation for Lost Tariff Revenues

All of the states and territories of South-East Europe are so small in economic terms that they can develop only if they have access to a larger market. In practice, this must mean unrestricted access to the EU market. At present, trade within this group of countries is less than one-tenth of their trade with the EU (see Table 1) and the dominance of the EU in trade terms is not likely to diminish over time. Gravity equations that simulate the trade patterns the countries in the region would have in a free trade environment and after a reasonable recovery indicate that the EU market would take 70-80% of their exports (see also Gros and Steinherr, 1995). The EU should thus eliminate all barriers to imports from the region. Given that the combined exports of the entire region amount probably to less than 1% of overall EU imports, this would have a negligible impact on the EU market.

The free trade should not be limited to industrial products because the only sector in the region that still works is that of agriculture. Unfortunately, the EU's Common Agricultural Policy (CAP) consists of such a jungle of distortions that it is not possible to extend it to the region. However, the EU should grant generous tariff-free quotas. In order to illustrate to politicians and the farmers lobby that the countries from SEE do not represent a serious threat to the CAP, one could put the duty-free import quota at 1% of EU production. As the combined imports from all SEE countries amounted to about 0.01% (one-hundredth of one percent!) of EU production in 1997 (see Table 2a), such a quota would allow for a very substantial expansion of SEE exports to the EU without any appreciable impact on the EU market. But this could be particularly important for the countries hardest hit because they have no industry left and agricultural production should be the easier to re-start. In any event, they would specialise in products (fruits and vegetables) which are least problematic for the CAP.

If the EU continues to subsidise its own agricultural exports to SEE (which are anyway 20 (!) times as large as EU imports; see Tables 2a and b), the importing countries should impose countervailing duties of the amount of the EU subsidies. The impact of any EU subsidies would thus be neutralised and their effect would simply be to provide revenues for SEE government. EU subsidies for exports of agricultural products would thus result merely in transfers.⁹

But access to the EU market is not enough. It is also imperative that governments are prevented from protecting inefficient domestic industries against external competition and that the potential for corruption at the border is reduced to a minimum. Import tariffs should also be abolished. The easy way to achieve this is via a free trade agreement with the EU. In order to keep borders within the region as open as possible, the principle of free trade should also be extended to trade within the region.

It would thus be desirable to go beyond a "mere" free trade arrangement and invite the countries to join a customs union with the EU. Having differentiated tariffs against the rest of the world would not be significant for them anyway and it would not remove the temptation to use tariff policy in particular sectors. Moreover, it would make customs controls more difficult and thus provide more occasions for corruption.

In states with weak fiscal structures, taxes on trade constitute an important source of revenues. In the Balkans, however, frontier controls are also a major source of corruption and harassment so that in reality trade barriers are much higher than suggested by official tariff rates. Given the great difficulties that governments in the region will face in raising revenues in the post-war situation, the EU should recognise the fiscal need for trade taxes and compensate the countries concerned for the loss of tariff revenues that arise through the customs union regime. (Tariff revenue on trade with the EU will disappear completely. The external tariffs of the EU are very low and hence very little tariff revenue can be obtained from duties on third-country imports.)

For the states of the region for which data are available, trade taxes yield between 1.5 and 2.5% of GDP. For the states and territories for which no data on trade are available, one can use this figure to calculate an approximation. We would consider a value of 3% of GDP as an upper limit which would correspond to an average ad valorem tariff rate of 10% and a openness ratio (imports-to-GDP) of 30%. Based on this – generous – assumption, the total transfers to all former Yugoslavia minus Slovenia, but plus Albania would amount to approximately 1.5 billion euro annually. Present Yugoslavia plus Bosnia-Herzegovina would cost less than 1 billion euro, two-thirds of which would be accounted for by Serbia.

Payment of the compensation for tariff revenue would be subject to strict monitoring of the effective implementation of an honest and efficient border control (still necessary for rules of

⁹ One is thus tempted to argue that these subsidies should be as high as possible in order to help SEE governments.

origin, third-country trade and excises, which should be approximated). Placing customs functions under foreign supervision is not an unusual step for weak countries. A particular Swiss company, in fact, performs this service for a number of countries

Even with open borders, some sectors still might not become fully competitive. Application of strong competition policy rules (i.e. those of the EU) would thus also be necessary. The general purpose of opening the economies in SEE as much as possible to competition could be furthered in a next step which would extend the opening to sectors that have become tradable only through the international market programme. The most important examples here are utilities, which are usually organised as local monopolies and which in weak states are often dominated by party politics. It would therefore be important, for example, to link SEE to the electricity grid of the EU and then to liberalise and privatise this sector. Experience has shown that privatisation that preserves local monopolies (e.g. in telecommunications and other network industries) does not eliminate the influence of political structures. Countries in SEE should thus progressively adopt the *acquis communautaire* of the internal market. The logical final step in this process would be that they could de facto participate in a sort of European Economic Area mark II long before they become full EU members.

Going beyond free trade and the customs union will of course be much more demanding in terms of implementation, and therefore in the time required. The *acquis* of the internal market basically involves the entire administration of a country. Proper implementation thus requires a minimum degree of efficiency (and honesty) throughout a large number of ministries, regulatory agencies, local administrations, etc. Implementation of the customs union "only" requires the exercise of discipline within the customs administration to ensure that it conducts the necessary controls at the EU border and applies the common external tariff at the external border, with a minimum cost for traders. Even in the larger countries of the region, this would involve less than 1,000 civil servants, which could be put under the supervision of EU personnel where needed, as mentioned above. It is not possible, however, to subject the entire public administration of a country, which runs in the tens, if not hundreds of thousands of employees, to this level of supervision.

3. Monetary Regime: Euro-ise Quickly

A second indispensable basis for economic recovery is a stable currency. In countries with a weak fiscal administration, seigniorage can be an important source of revenue for the government, but high inflation rates also have economic costs (and erode the real value of tax revenues). Seigniorage considerations are thus not a sufficient argument for a high inflation regime. But a credible low inflation regime cannot be created overnight by conventional means. This is why in times of crisis one has to resort to unconventional measures. Examples are the currency board of Bulgaria, introduced in the wake of hyperinflation and the DM regime for Bosnia-Herzegovina.

Another key advantage of a currency board (followed by full euro-isation) would be its systemic impact, in transforming the political economy inside the country, and thus the chances of healthy economic growth. Almost everywhere in South-East Europe, the banking system is a key conduit for large-scale corruption and political intervention in the economy. A political class that cannot run large deficits and that cannot control the banking system will be forced to leave more room for really productive private enterprise. Supporting loss-making state enterprises or just favouring politically well connected "business men" will become more difficult and apparent because such actions would have to go through the budget. Entrepreneurs will learn to concentrate on managing their enterprises more efficiently, because that will become the main avenue for success. Political connections will count for less. Petty corruption and favouring some enterprises through tax breaks, etc. will of course remain, but the sums that can be allocated this way pale in comparison with the wealth that can be controlled through the banking system and large-scale inflationary finance.

The main argument usually advanced against currency boards (or full dollar-isation/euro-isation schemes) is that they might make it more difficult to adjust the real exchange rate. This argument is based on the observation that nominal wages and prices are usually rigid in well established economies, in the sense that they are very difficult to lower. However, this argument does not apply to the situation in the countries of this region. In many of them, wages are not set by national agreements and can thus adjust much more easily to market conditions. Moreover, labour leaders in the more settled countries should recognise that under these exceptional circumstances it does not make sense to refuse any reduction in wages, even if this would be required by a shock to the local economy. (See Annex 1 for a brief discussion of the costs and benefits of pegging to the euro for different countries in Central and Eastern Europe. Annexes 3 and 4 briefly discuss the experiences of Panama and Puerto Rico in this regard.) Any attempt to apply differentiated monetary policies would thus face at any rate considerable problems as the DM is already playing an important role in all the countries of the region (see IMF, 1999, for a discussion of monetary policy in dollarised economies).

The quickest way for the countries of the region to acquire a stable currency would be to adopt the euro. This can be done in one of two ways: creation of a currency board or the wholesale adoption of the euro. The latter would be difficult to implement before 2002, as it would require the use in the interim of one of the 11 national forms of the euro that will exist until then, such as the DM. This would not change the economic aspects, but might nevertheless be confusing for the public, which would have to change the unit of account against which it is measuring monetary value again after a couple of years. Bulgaria and Bosnia faced the same issue not so long ago, and in both of these cases, it was deemed very important to have a "real" currency as the anchor. The euro did not exist then, but it does now, so that it would be possible to establish currency boards that link a new domestic currency one to one to the euro (as in Argentina with the dollar). Full euro-isation (with the introduction of notes and coins) would then be possible in 2002 without any change in monetary units. The time leading up to full euro-isation should be used to negotiate the details, particularly the liberalisation and reorganisation of the banking system, in the absence of which euro-isation does not make much sense.

For some countries in the region, full euro-isation might be preferable to a mere currency board basically because of the full credibility it provides and because it allows considerable savings of foreign exchange reserves. For the practical reasons mentioned, however, full euro-isation would be difficult to implement quickly. Hence, it might be best to start with a currency board to the euro at 1 (local currency): 1 (euro) as quickly as possible. This could then be transformed into full euro-isation without much effort in 2002.

The backing for the currency board should be provided by a zero-interest rate loan by the EU to the countries concerned. In this way, a country that links itself to the euro does not lose its seigniorage (the central banks can place the funds it receives on the money market and keeps the assets it had). The loan would have to be repaid upon accession as a full member or if the country de-links from the euro. The cost for the EU would consist of the debt service. See table below.

Table 3
Approximate Budgetary Costs for the EU

	Tariff Revenue Compensation		Charge for ation	Total Cost	
	% of GDP	millions of \$	Millions of \$	millions of \$	per capita
Albania	1.6	37	24	62	19
Croatia	2.8	534	94	628	140
Bos./Herz.	3.0	134	22	156	38
FRY Mac.	2.9	93	16	109	55
FRYugo	3.0	672	112	784	65
memo:					
Serbia	3.0	588	98	686	70
Kosovo	3.0	57	10	67	35
Montenegro	3.0	27	5	32	53
Total		1470	269	1739	

3.1. Implementation and Cost

The mechanics of a currency board with the euro is straightforward. Currency boards have already been implemented in a number of East European countries showing that this can be done quickly.

When a country creates a currency board arrangement, it must dispose of adequate reserves to back the monetary base. This backing should be provided by the EU. The funds necessary to make the currency board viable, i.e. 100% of the currency in circulation, should be provided to the local authorities in the form of a zero-interest loan. The EU would have to raise these funds from the capital market, and the budget of the EU institutions would have to carry the interest cost. How much would this be?

In countries with moderate inflation, and at least a rudimentary banking system, the ratio of currency in circulation to GDP is generally between 5 and 10%. Given that the states of the region are all very poor, the euro value of their currency in circulation is actually quite low (e.g. 500 million euro for Albania – which has very high cash ratio because it has no banking system – and 300 million euro for FYROM). With interest rates currently between 3 and 5%, the amounts to be charged to the EU budget on these amounts would be minuscule: less than 25 million euro annually for Albania and 15 million euro for FYROM. All of ex-Yugoslavia in war (Serbia, Bosnia-Herzegovina, Montenegro and Kosovo) would need 3 billion euro in cash (by comparison, the total for the euro area is 300 billion euro) which would mean interest costs of 100-150 million euro p.a. (two-thirds of which would be accounted for by Serbia). These sums would thus definitely be below 1% of the overall EU budget of 80 billion euro.

In this way, the EU would effectively lend its currency (and hence its monetary stability) to the countries concerned. The countries would not lose their seigniorage because they could keep the assets that their central banks had accumulated through the issuance of their defunct national

currency. Of course, this leaves them only with the small amount of seigniorage that is compatible with price stability, but this is entirely appropriate, as argued.

IMF monitoring (reduced primarily to fiscal policy and to some extent the banking system) should continue. Normal IMF credit lines should still be available subject to conditionality, which would, however, have to be adapted. Full euro-isation would only make apparent what has de facto already been happening in many instances: a petition for IMF credits is not motivated by nor are they used for a balance-of-payment deficit; rather, they are used to finance a fiscal deficit.

Once the currency board is established, negotiations on full euro-isation should begin immediately. Euro-isation is also technically straightforward. The key is that the government of the country in question simply declares that as of a certain date, the national currency will be replaced by the euro and the old national cash will be exchanged for new notes and coins (which are legally considered the local form of the euro as in Euroland) at the current market rate. If the country or region did not have a functioning currency regime, one could just announce a fixed per capita distribution to provide the population with a minimum initial endowment (50-100 euro).

With full euro-isation, the seigniorage would revert to the ECB as the country in question would have to buy its currency from the Eurosystem. The national monetary authorities would of course have no seat on the Governing Council of the ECB, which would thus not be affected, but it would still be preferable to have an explicit agreement on the details of euro-isation. For example, there should be a commitment to radically liberalise the domestic banking system (in particular, allowing EU banks to acquire local ones), and to institute deposit insurance and a proper banking supervision. EU authorities, including the national central banks in the Eurosystem, should be able to provide the required technical assistance.

4. Changing the Outlook for the FRY

All countries in the region that fulfil democratic norms should be offered the package consisting of currency board plus customs union. The FRY would thus also be a potential beneficiary, but this would make sense only if it drastically reformed its economy.

The experience of Bosnia-Herzegovina is instructive in this respect. Despite massive inflows and a stable currency provided by a currency board, the local economy has not developed any sustainable independent productive capacity. One of the reasons for this is that in the absence of economic reforms, local political elites have a stranglehold on the economy. This applies in particular to the housing market and the payments system. These two elements are the keys to the political power of the old elite and thus acquire particular importance in the case of Yugoslavia. In a socialist system, housing in cities is usually not private, but linked to the workplace. This implies that local officials who can influence employment decisions (for example, in the public sector or large state-owned enterprises) wield immense power. Privatising housing must thus be one priority. (In rural Kosovo, this should be less important. Most of the housing destroyed was in the countryside and thus presumably was private property.)

The payments system is even more important as a source of power and corruption. In the socialist Yugoslav economy, payments among enterprises were channelled through a central system (ZPP) which gave bureaucrats the power to interfere with all transfers of funds. This system still exists in the FRY (and also in Bosnia-Herzegovina, thus making a mockery of the official currency board) and even partially survives in Croatia. It must be abolished immediately; otherwise the institution of a currency board does not make sense. As borne out by the experience of Bosnia-Herzegovina, the practice of allowing local politicians to interfere with the payments system is a recipe for disaster, especially in a situation in which the legal system does not really function and the lines of political responsibility are unclear.

Structural economic reforms (including rapid privatisation) in the FRY are thus not only a *conditio sine qua non* to ensure that foreign assistance can initiate sustained economic growth, but are also a key element to assure the survival of political reforms.

If radical reforms are adopted now, the prospects for a sustained recovery of the Yugoslav economy are good. Before the break-up of the Federation, the per capita income in Serbia (and especially the Vojvodina) was similar to that in Croatia where the middle class now appears to be strong enough to lead the country to a switch in policy towards democratic reforms. At present, GDP per capita in the FRY is perhaps only one-quarter of that of Croatia (which also went through a war not so long ago and which still devotes a large share of GDP to the military). An economically reformed Yugoslavia should thus have a considerable growth potential and should be able to reconstitute the economic base for a stable democracy.

For the FRY, the size of economic assistance for reconstruction will be an important additional element of the post-war economic system. Reconstruction of basic infrastructure (bridges, electrical transmission stations, etc.) is relatively straightforward in the sense that the damage and the cost of reconstruction can be easily measured. This is not the case for the industrial plants. In many cases it might not make economic sense to rebuild them to the *status quo ante*. The experience in many other countries has shown that especially the large factories in heavy industry cannot survive in an open market economy.

Yugoslavia should thus not receive any funds for the reconstruction of the large factories destroyed during the hostilities. But it would be appropriate for the West to provide compensation in the form of unemployment subsidies to the workers who have lost their jobs as a result of the allied bombing. Workers formerly employed in bombed-out factories should be eligible for unemployment benefits at about 100 euro per month (this figure corresponds to an average wage). This compensation should be a lump sum transfer. The beneficiaries (the individuals concerned, not the government) would thus be free to take up work somewhere else. This would be a far preferable arrangement than paying people to do nothing. The total cost of such an operation would be moderate. It is estimated that at most 100,000 workers lost their job through the bombs. The total cost would thus be a maximum of 120 million euro per annum. These transfers should be provided for two to three years, which is about the length of time required to reconstruct the factories. After this period, the workers should either have found new jobs or returned to their old ones in a new factory.

Whether or not the factories are rebuilt should be left to the market. It would be impossible in any event to re-establish the *status quo ante* since these factories certainly did not incorporate the latest technology. Whether or not it makes sense to establish a basically new factory in place of an old bombed-out one, how large it should be and what technology should be used are all economic questions that the government is not well placed to answer. Given that Yugoslavia still has a generally well educated work force and rather low wages, foreign investors might be interested to serve regional markets or even the EU from this base. Foreign investment will materialise, of course, only if the other elements of the package are in place (a stable and free currency) and if property rights are respected by the new regime. Although FDI can be extremely useful in some cases, it would be a mistake to expect that FDI can play an important role in reconstruction. Preliminary estimates done at CEPS indicate that even if Yugoslavia were a full market economy, it would be unlikely to receive even 100 million euro per annum in FDI.

Much more important than rebuilding the factories will be rebuilding the human capital, i.e. retraining the workers. This is very difficult to achieve through formal courses. But given the relative isolation of Yugoslavia in recent years, some formal training in techniques that have been developed over the last decade might be useful in the software and telecommunications sectors.

5. CONCLUDING REMARKS

A major key to any economic reconstitution of the region affected by the Kosovo war is the recognition that it does not make sense to try to foster regional integration. Instead, one has to start from economic and political realities: in both economic and political terms, the links with the EU are much stronger than any local ties that survive within the region. Experience in Central Europe has shown that the prospect of eventual participation in Europe provides the most powerful stimulus for economic reform (and acceptable political behaviour). For South-East Europe, an additional concern is speed. The people of the region who are suffering from the war must be quickly shown tangible signs of their European future.

The two elements proposed here, currency boards and a free trade/customs union with the EU, should thus be implemented as quickly as is practically possible. If planning starts immediately, their implementation should be possible by early 2000.

Creating a new economic order for the area will be more important than the size of the sums allocated to reconstruction. In Germany, industrial production continued to decline for three years after the war had ended although during this period the basic infrastructure had already been repaired. Growth started only after the radical reforms that came with the currency reform of 1948.

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Annex 1

The Strength of Institutions and the Choice of the Exchange Rate Regime

In thinking about the exchange rate arrangements between the euro and the rest of the (non-EU) Europe, three groups of countries should be distinguished, according to their relative strength:

- fiscally and institutionally very strong countries with Maastricht-conforming policies;
- countries that are not yet at the Maastricht level, but are heading in that direction; and
- countries in states of acute financial crisis, with very weak institutions.

i) *The very strong countries*, i.e. those that could become members of the EU at any time and that fulfil the Maastricht criteria most of the time (e.g. Switzerland and Norway) would gain from pegging to the euro because the EU is their major trading partner in any event. They would thus experience considerable savings in transaction costs. Moreover, pegging to the euro gives financial markets an anchor for longer-term expectations, thus reducing the impact of financial shocks. For these countries, the classic criteria of the Optimum Currency Area approach are close to being fulfilled as their economic structures are close to that of the EU. Nevertheless, even if their interest in joining the euro area is strictly economic, these countries can afford the luxury of taking a wait and see stance. Given their strengths, they can comfortably survive outside.

ii) *The middling countries*, with moderate inflation rates (now usually below double digit) and fiscal deficits, for example, the countries of Central Europe. But with rather large current account deficits, they are vulnerable to speculative attacks. These countries are also experiencing an intense process of structural change whose outcome is difficult to foresee. They might therefore need some flexibility in their real exchange rate for some time. But the cost of retaining some flexibility in the exchange rate is that the economy is left open to the threat of speculative attacks, as exemplified by the Czech Republic. Their experience also suggests however that the cost of such an attack is limited, and does not result in outright catastrophe as in the case of Russia. The costs and benefits of different exchange rate regimes are thus often finely balanced and must be considered on a case-by-case basis.

iii) *The very weak cases*, namely countries that are very far from fulfilling any of the requirements for EU membership in general (and the Maastricht criteria in particular). These countries usually have large fiscal deficits and high inflation, their currencies are often under pressure and real interest rates are highly variable and often unsustainably high when the government tries to stabilise the economy. These countries would gain from being able to enter the euro-area, because that would be a way to import sensible macroeconomic policies and decisively gain the confidence of financial markets. Since the alternatives are hyper-inflation and/or enormous risk premia on foreign debt, the benefits of this confidence effect and of a stable currency can far outweigh any potential costs of not being able to react to asymmetric shocks with exchange rate changes.

One way for non-EU countries to enter the euro-area is to opt for a currency board, as already done by Bosnia, Bulgaria, Estonia and Lithuania. The first three chose the DM as the anchor and are now de facto members of the euro-area. A currency board can deliver the benefits of credibility with financial markets and low inflation. As the experiences of Argentina and Hong Kong also show, however, even currency boards that are run in a very conservative manner can come under attack. Although the mechanism of the currency board itself is usually technically unassailable, these attacks are costly because they lead to increases in domestic interest rates, which have a negative effect on demand. Defending a currency board is thus technically easy,

but can have a high price in terms of unemployment. Financial markets know this and this is why a currency board is never 100% credible. This weakness of currency boards has recently prompted the Argentine government to consider plans to switch totally to the US dollar.

The economic benefits of full dollarisation or euro-isation are similar to those resulting from a currency board, but they are more certain. They can be reaped even by countries whose institutional and political weakness would leave doubts in the market that it could follow the rules of the game of a currency board (e.g. Russia and Ukraine). Under a currency board regime, the country still has a domestic monetary authority that might cede to government pressure and violate the rules of the currency board, e.g. by giving credit to the government.

Therefore, the radical solution of unilateral, total adoption of the euro (or dollar) as the domestic currency offers even more benefits, compared to the currency board, for countries with very weak institutions. The case of Argentina suggests that the idea is one of practical, and not just theoretical interest. But it is not to be thought of as something more for advanced emerging markets such as Argentina. On the contrary, in the case of Central and Eastern Europe, euro-isation meets the objection that the national authorities would still be quite free to abandon their commitment to the monetary rule of the currency board, which in present circumstances would mean costly interest rate risk premia. Abandonment of the euro would be much more costly in political terms. Total euro-isation should thus result in a more credible regime.

Annex 2 Details of Cost Calculations

Most of the data necessary to make a reasonable estimate of the potential costs are available for the established countries in the region, i.e. Albania, Bulgaria, Croatia and FYROM. For the remainder (Bosnia-Herzegovina and rump-Yugoslavia), one has to rely on older data and statistics concerning the republics of Yugoslavia before the break-up. A key variable, GDP per capita, had thus to be estimated on the basis of 1979 data for Serbia, Kosovo and Montenegro. This problem cannot be avoided. For Bosnia-Herzegovina only some variables are available, from the EBRD.

The main purpose of all calculations was to provide an upper bound. The implicit dollar/euro exchange rate was set at 1:1 to avoid complications that in any event would be minor compared to other sources of uncertainty.

1. Compensation for Lost Tariff Revenue

The EBRD gives tariff revenues as a percentage of imports for most countries in the region. This can be combined with the available information on GDP in dollars and the share of trade in GDP to obtain the corresponding dollar amounts. The assumption implicitly used here is that the EU's support would be at most equal to this amount. In reality, it would be considerably lower because the EU should provide compensation only for the tariff revenue on trade with the EU. Trade with the EU is a large and growing proportion of the overall trade of countries in the region, but in some cases the proportion is closer to 50% than to 100%. In reality, therefore, the amounts required might be only about one-half of the sums mentioned here.

Moreover, for a country that aspires to full EU membership (e.g. Bulgaria), tariff revenue would disappear anyway. The part based on trade with the EU is scheduled to disappear soon under the Europe Agreements and the part based on trade with the rest of the world will shrink considerably when the country adopts the common external tariff, whose rates in most cases are close to zero.

For countries for which tariff revenue data are not available, the potential for compensation was set at 3% of GDP, which is somewhat higher than the average for the other countries; this appeared justified on the grounds that this group is generally poorer. The dollar amounts were then calculated as 3% of GDP in dollars.

2. Capital Needs for 100% Backing for Currency Board (=Cash Needs for Euroisation)

For the countries for which financial data are available, one can simply use the latest figures on currency in circulation converted into euro at the latest available exchange rate. This was done for Albania and Bulgaria. For the other countries it was assumed that the ratio of cash-to-GDP is 10%. This high figure was used on purpose because the countries for which no financial data are no longer available have a functioning banking system.

The initial endowment in euro that is needed can then be easily calculated as 10% of GDP measured in dollars (or euros). The burden for the EU budget was then set equal to 5% of this sum. As interest rates are at present somewhat lower, this is again meant to be a ceiling rather than an accurate estimate.

In the case of full euroisation, the country concerned would use the same type of loan as for the currency board backing to buy the initial stock of cash from the Eurosystem (in reality from any of the national central banks in the euro area). The national central banks that provide the euro cash should immediately transfer the euros they obtain from the South-East European

country/region to the ECB who would then invest these funds.¹⁰ The interest income of the ECB would thus increase by approximately the same amount that the EU institutions would have to pay to service their own borrowings. As the profits of the ECB are distributed each year to national governments, the net cost to the EU as a whole (national governments and EU institutions consolidated) would thus be close to zero. (Not exactly zero if the interest the EU institutions pay on their borrowings is higher than the return the ECB obtains from its investments. Another complication is that all 15 governments contribute to the EU budget, but only the 11 euro area governments would receive a share of the revenues of the ECB. However, as the sums involved are minuscule, this issue will not be taken up here.)

The net cost of the operation would be essentially zero for the EU. But the budget of the EU institutions would have to carry the interest cost, which would be the same as for the backing of the currency board.

While it is straightforward to account for the initial endowment of cash, it is more difficult to deal with subsequent developments from an economic point of view. If a euro-ised economy grows, its demand for cash should also grow. Unless the EU makes further loans of its currency, the country in question would have to run a balance-of-payments (either current account or capital account) surplus. However, the magnitudes would again be so small that this is not an important issue.

Comment [A1]:

¹⁰ It is necessary to book the counterpart to the transfer of cash at the ECB and not at the NCBs that provide the cash because the treaty provisions concerning the distribution of seigniorage are not yet operative. If the transfer of cash were not booked at the ECB, only those member countries that are asked to provide euro cash would benefit from the implicit seigniorage, whereas all member countries would have to contribute to the debt service of the EU institutions. The accounting would of course be simpler if the ECB could provide the cash directly, but this would be incompatible with its statutes.

Annex 3

Euro-isation: Any Lessons from the Panamanian Experience?¹¹

The main example of a country that has adopted a foreign currency is Panama. A brief review of the experience of that country is therefore instructive. Panama uses the US dollar, has no central bank and no official foreign exchange reserves (they are not needed). This arrangement has worked without technical problems for almost a century. The balboa is mainly used for accounting purposes and exists only in the form of silver coins. (Guatemala had a similar fixed rate regime against the dollar until the mid-1980s, but this ended with its civil war in which over 10% of the population were killed.)

In the following we will address three key issues that arise when discussing euro-isation for South-East Europe: 1) Is Panama a useful example for South-East Europe (SEE)? 2) Are perfect labour markets a prerequisite for the adoption of a foreign currency? 3) Can euro-isation protect against financial shocks? The answers, in short, are: yes, no and yes.

1. Is Panama a useful example for South-East Europe?

Panama is often perceived as a special case which has no relevance for other situations. Even a superficial examination reveals, however, that in three key areas there are close parallels to the countries in SEE.

i) *Size*. Panama has a population of about 2.7 million, larger than Kosovo or Macedonia and only slightly smaller than Albania. Its total GDP, around \$900 billion, is much larger than that of these countries, and in the same order of magnitude as that of Bulgaria.

ii) *Weakness of its institutions*. Panama also resembles the countries of SEE in that it has rather weak administrative structures and democratic institutions (as can be seen from the coup d'état of the 1980s.)

iii) *Importance of transfers from abroad*. Panama is often perceived as an artificial country which lives off the canal and has no significant economic activities of its own. But this impression is wrong. The country does have a sizeable industry, and its exports of goods are at the same level, per capita, as in its larger neighbour, Colombia. Agriculture also employs a similar share of the population.

Moreover, the transit fees from the Canal make Panama actually more comparable to the countries in SEE for which the euro-isation option should be considered because these countries will also receive substantial transfers from abroad. These transfers will be reduced sooner or later, which will require substantial changes in relative prices, but this is not an insurmountable problem. Panama had to deal with large swings in the revenues from the canal, but there was never any question that the country would need a flexible exchange rate to deal with them. The importance of the revenues from the canal should also not be exaggerated. In 1998 total revenues from the canal amounted to about \$650 million, equivalent to about 7% of GDP. But the canal is not a free lunch: operating costs were of a similar magnitude (with about one-half for labour). The (net) rent the country perceives from the canal is thus probably only around 3% of GDP, which is less than what the countries in SEE can expect over next few years (and much less than what Bosnia-Herzegovina receives at present).

The canal is more important for public finances. The Canal authorities and users contributed about \$150 million to an overall budget of about \$1.1 billion. It is interesting to note that, even

¹¹ This section is based on information from the IMF (1999) and Moreno-Villalaz (1997).

after a reduction in rates, import tariffs still amount to about \$250 million, or slightly less than the 3% of GDP used as a benchmark.

2. Are perfect labour markets a prerequisite for the adoption of a foreign currency?

It is often argued that a national currency is needed as a safety valve in the event that domestic price and wage pressures mount. Many opponents to EMU implicitly argued that poorer countries with weak institutions especially would run this danger. This concern is not borne out in the case of Panama. There has been no long-term price pressure on the dollar/balboa link. On the contrary, over the last 30 years prices have actually increased less in Panama than in the US, on average by 1.7% less each year. Over the entire period (between 1967 and 1997), the US consumer price index (CPI) increased by about 370%, whereas in Panama the increase was only 170%. There is also absolutely no indication that Panamanian labour priced itself out of the market. Unemployment in Panama presently hovers around 13%, but this compares well with other Latin American countries, and is much below the 20-40% unemployment rates that currently plague some of the countries in SEE. The data from overall employment is even stronger. Despite its young population, the overall employment rate (employment/population) is 33%, which is much higher than its Latin American neighbours (Colombia 15%, Guatemala 8%) and the countries in SEE with their much older population (the employment rate in Macedonia is 17%, and in Bulgaria, 22%).

This is not to say that the labour market in Panama is perfect. On the contrary, it was actually the model for the Harris-Todaro model of a dual labour market in which there are two sectors: a modern international one and a traditional rural one. The first sector pays above-market clearing wages to reduce the incentive to shirk. (High transactions costs make it impossible to enforce contractual behaviour by labour.) The second, traditional sector absorbs surplus labour at a wage rate that is determined informally through household and other non-market activities (subsistence agriculture, small-scale commerce, etc.). In equilibrium there is substantial unemployment in the cities until the cost of moving there just equals the expected wage differential (which in turn depends on the probability of finding a job, i.e. the unemployment rate). This is exactly what is likely to happen in SEE (and was already the norm in pre-war Kosovo). A different monetary regime does not change the fundamental reasons for this dual economic structure, which characterises many Central American countries. But the experience of Panama shows that a stable currency regime does not increase the problems that result from such a dual labour market. On the contrary, each time Panama had to face a major political or economic crisis (e.g. the US embargo or an oil price increase), the informal sector was able to absorb the surplus labour liberated by the formal sector without causing excessive unemployment problems in the cities.

The countries in SEE are likely to have imperfect labour markets whether or not they adopt the euro quickly. Their problems are likely to be similar to the ones faced by other countries, such as Panama, with a similar income per capita (and weak institutions) but different from the ones facing EU members with their highly developed social systems. The experience of Panama suggests that the absence of a national monetary policy does not exacerbate the unavoidable problems that arise from dualistic labour market structures.

3. Can euro-isation protect against financial shocks?

The clear answer here is yes. Adopting the dollar has protected Panama against most financial problems and allowed it to survive the recent global financial crisis much better than other countries in the region. The latest IMF report notes that its economy was affected by the fall in demand in the rest of the region, but that there were no signs of financial instability in Panama itself. Deposit and lending rates remained essentially at the average of the five preceding years (around 7 and 10%, respectively) whereas dollar equivalent rates in other Latin American

countries were often 20 percentage points above Libor. Dollarisation thus protects the domestic economy against external financial shocks.

A key issue for many countries with large external debts is to what extent could euro-isation lower the risk premium paid on foreign debt. For a country with an external debt to GDP ratio of 100% (e.g. Bulgaria), a risk premium of 10% (not unreasonable under current circumstances) implies an additional annual transfer of 10% of GDP to foreign creditors. The experience of Panama shows that euro-isation could be a big help in this area as well. The public external debt of Panama is also substantial, now around 60% of GDP (after a peak of 75% in 1995), but the government never had to pay a large risk premium on its indebtedness. Why should dollarisation lead to radically lower risk premia also on external debt? Per se, the monetary regime does not cure the chronic difficulties of the public sector in countries with weak institutions to raise tax revenues (and limit pressures for more expenditure). But euro-isation has several consequences.

First of all, it eliminates the difference between external and internal debt. This in turn has two consequences: the government cannot discriminate against foreign creditors and it cannot rely on a captive domestic market to finance deficits.

Secondly, it eliminates a key source of uncertainty about the capacity of the government to service external debt because the wide swings in the real exchange rate that result from the large sudden depreciations that often arise during currency crises are no longer possible. Russia is a case in point. When the exchange rate of the ruble quadrupled last year (going from 6 to 24 rubles per dollar), the capacity of the Russian government to service its foreign debt was cut to one-quarter (and the price of Russian eurobonds went to 25% of their face value). After a year domestic prices have doubled so that the real devaluation is “only” 50%, but this still implies that the dollar value of Russian tax revenues has been halved (and the price of Russian eurobonds went back to 50%). With euro-isation swings of the real exchange – and the price of foreign debt – of this order of magnitude will not happen.

Euro-isation thus improves debt service capacity in a number of ways, and a much lower country risk premium is therefore entirely appropriate.

Annex 4

Associated Territory: Any Lessons from the Puerto Rican Experience?¹²

The main empirical example of a territory that is fully integrated in the economic space of a large country is Puerto Rico. A brief review of its experience is therefore instructive.

1. The Basic Facts

Puerto Rico has a population of about 3.5 million (similar to that of Panama or Albania) with a GDP per capita of over \$12,000, more than twice that of the richest country in Latin America (Argentina) and a multiple of that of its immediate neighbours, Haiti, the Dominican Republic and Jamaica. Its total GDP of over \$40 billion is larger than that of the entire South-East European region. Puerto Rico is thus a shining example in Latin America, not only in terms of its current level of income, but also in terms of per capita growth, which has been the highest in the hemisphere over the last decades (3.9% per annum). In 1960, Puerto Rico was not much better off than the rest of Latin America. It then had a GDP per capita below that of Argentina (about level with Chile), but it is now between two and three times richer than these two countries. Puerto Rico is also by far the most open of all Latin American economies and its exports per capita (about \$6,000) are five to ten times higher than those of other Latin American economies of similar size.

The basis for Puerto Rico's links with the US is a Commonwealth Agreement (ratified by a referendum in 1951) whose key elements are:

- full trade integration with guaranteed market access
- use of US dollar plus an integrated financial system, overseen by the US Federal Reserve
- integrated labour market
- official transfers to the Puerto Rico government and to individuals
- integrated legal and judicial system and
- non-voting representation in the US House of Representatives.

The first three points define the "economic and monetary union" of Puerto Rico with the US and could be replicated in SEE (although labour mobility would take time). The one element that could not be replicated in Europe would be the *application of (US) minimum wage laws*. This is the key to the understanding of Puerto Rico's unemployment problem. Employers in Puerto Rico have to pay the full US minimum wage. On the mainland the minimum wage affects only a small proportion of the work force, but this is totally different in Puerto Rico where it is estimated that 60% of the employed are paid the minimum wage.

2. The Main Problem: Unemployment

The excellent growth performance of Puerto Rico suggests that full integration into a large economic space with a stable currency and a stable regulatory framework brings enormous benefits. These benefits do not seem to flow primarily from the mere access to capital since Puerto Rico has grown much faster than the rest of Latin America, although its investment rate (about 20% of GDP) is only average. But most investment in Puerto Rico has come from abroad and thus embodies technology and know-how that would otherwise not have been available to the country.

¹² This section is based mainly on Hausman (1995).

The only really important problem that remains for Puerto Rico concerns labour markets. Labour mobility should be part of economic integration and is also part of established EU norms, even if it will not be quickly acceptable for the EU side in the case of SEE. The problem in the case of Puerto Rico is that its integration with the US goes beyond labour mobility in one critical area: the US minimum wage applies in Puerto Rico although the average income is less than one-half that of the US mainland. As this wage norm is binding for 60% of the employed on the island, it has led to an unemployment rate around 18%. Massive transfers from the US federal budget cannot cure this problem.

That wage equalisation leads to problems does not come as a surprise to a European observer. In economic terms the problems of Puerto Rico are those of East Germany. The only difference is that in Puerto Rico the US minimum wage norms are imposed by law, whereas in Germany the high East German wages are the result of agreements between employers and trade unions. The political economy is, however, the same. In both cases labour representatives in the richer part of the country press for higher wages in the less productive region in order to protect their own interests. The low-skilled workers who became unemployed as a result of this wage equalisation are usually not represented in the wage bargaining process. The same happens in many countries with regional problems, e.g. southern Italy (where unemployment is even higher than in Puerto Rico) or Wallonia in Belgium. In the case of Puerto Rico, the difference in size (50:1 in favour of the richer mainland) also explains why the fiscal burden has been bearable so far.

Fortunately, nothing suggests that integration into the EU (including adoption of the euro) should lead to wage equalisation. In richer countries, labour movements push for wage equalisation within their own jurisdiction, but have so far shown much less interest in wage rates abroad. This relative lack of interest has two reasons: labour mobility is much lower across national (and linguistic) frontiers and the transfers that would be required to back up minimum wages in poorer areas are not feasible outside a political union.

3. Lessons for SEE?

The experience of Puerto Rico suggests that adopting the euro and taking over the regulatory framework of the EU internal market would bring large economic benefits for Southeast Europe. The only danger, namely premature wage equalisation, should be easy to avoid given that trade unions are still organised along national lines and operate within national political frameworks.

Table 1
Matrix of Trade Relationships of South-East Europe*

	Slovenia	Hungary	Bulgaria	Romania	Croatia	Yug./Serb	FYR Mac	Bosnia	Albania	Moldova	Turkey	Cyprus	EU
Slovenia	xxxx	71	6	15	614	77	136	210	6	2	19	2	4,667
Hungary	176	xxxx	25	176	74	117	13	78	10	17	45	18	11,606
Bulgaria	3	19	xxxx	57	10	-	114	2	33	7	294	8	2,083
Romania	14	128	53	xxxx	15	60	7	2	18	73	306	29	4,424
Croatia	488	44	4	5	xxxx	-	47	438	10	-	10	51	1,776
Yug./Serb	26	23	-	14	-	xxxx	-	-	-	1	7	4	1,028
FYR Mac	56	4	25	2	27	80	xxxx	1	23	1	49	1	489
Bosnia	12	1	-	-	51	-	-	xxxx	-	-	2	-	161
Albania	2	1	-	9	2	-	-	-	xxxx	6	5	-	190
Moldova	-	3	7	39	-	1	1	-	1	Xxxx	21	9	100
Turkey	26	45	73	130	22	6	66	11	47	11	xxxx	143	11,855
Cyprus	3	5	2	12	1	13	2	1	3	8	12	xxxx	373
EU	6,315	13,587	1,844	5,010	4,782	1,760	847	763	596	289	22,322	1,953	EU

*EU data: year 1997; otherwise, year 1996; exports from countries in rows; imports to countries in columns.

Source: Eurostat, IMF. All figures in millions euro. 1996 data in USD converted using end of period exchange rate (1.2530 euro per \$1).

Table 2a
Values and Shares of EU Imports/Exports to and from CCs, SEE, for Selected
Agricultural Sectors, 1997 (million euro)

EU Imports	Pigmeat	Cereals	Sugar	Oilseeds	Bovine	Poultry	Milk	Total
SEE								
Croatia	:	1.87	0.00	0.69	5.52	0.19	0.48	8.73
Bosnia-Herzegovina	:	:	:	:	0.00	0.01	0.01	0.02
FR Yugoslavia	:	0.41	:	0.47	0.02	0.11	0.01	1.02
FYR Macedonia	:	0.00	:	0.00	:	0.02	:	0.02
Albania	:	0.01	:	1.17	:	:	:	1.18
Total SEE	0.00	2.28	0.00	2.34	5.54	0.32	0.49	10.97
<i>% of EU production</i>	<i>0.00%</i>	<i>0.01%</i>	<i>0.00%</i>	<i>0.08%</i>	<i>0.03%</i>	<i>0.00%</i>	<i>0.00%</i>	<i>0.01%</i>
CEECs								
Bulgaria	0.05	0.29	1.35	13.95	:	17.80	2.09	35.52
Romania	:	3.38	0.26	5.67	0.69	2.32	0.23	12.54
Hungary	75.90	46.31	0.95	59.08	14.59	203.28	1.20	401.31
Slovakia	:	0.90	0.44	9.80	1.16	0.07	3.48	15.85
Slovenia	0.11	0.08	0.06	0.43	7.26	3.03	4.76	15.73
Czech Rep.	3.55	0.76	3.39	26.89	2.42	5.51	4.81	47.32
Poland	:	0.59	4.17	1.68	7.10	69.42	6.26	89.22
BALTICS (3 Countries)		1.34		9.74			18.87	29.98
Total CC	79.60	52.31	10.61	117.51	33.22	301.42	22.82	617.49
<i>% of EU production</i>	<i>0.30%</i>	<i>0.26%</i>	<i>0.19%</i>	<i>3.86%</i>	<i>0.16%</i>	<i>2.52%</i>	<i>0.06%</i>	<i>0.49%</i>
ROW	36.00	1581.84	966.36	4395.79	749.87	273.26	603.05	8606.17
<i>% of EU production</i>	<i>0.14%</i>	<i>7.82%</i>	<i>17.09%</i>	<i>144.34%</i>	<i>3.52%</i>	<i>2.28%</i>	<i>1.58%</i>	<i>6.77%</i>

EU Exports	Pigmeat	Cereals	Sugar	Oilseeds	Bovine	Poultry	Milk	Total
SEE								
Croatia	13.51	8.66	13.47	0.80	7.74	2.85	27.15	74.18
Bosnia-Herzegovina	2.89	0.69	8.05	0.02	9.80	9.38	12.16	42.99
FR Yugoslavia	0.14	22.67	1.05	0.31	10.05	7.44	2.23	43.88
FYR Macedonia	1.01	6.23	1.21	0.42	6.61	2.06	2.87	20.40
Albania	0.35	11.75	11.45	0.23	1.60	4.94	1.60	31.92
Total SEE	17.89	50.00	35.23	1.78	35.80	26.67	46.01	213.38

<i>% of EU production</i>	<i>0.07%</i>	<i>0.25%</i>	<i>0.62%</i>	<i>0.06%</i>	<i>0.17%</i>	<i>0.22%</i>	<i>0.12%</i>	<i>0.17%</i>
CEECs								
Bulgaria	1.42	16.02	0.63	0.15	6.18	5.65	3.00	33.06
Romania	0.15	5.29	13.97	0.72	0.92	0.40	6.46	27.91
Hungary	20.18	13.11	0.75	3.96	13.39	2.02	5.43	58.84
Slovakia	0.30	17.10	8.17	1.32	0.75	0.43	2.99	31.05
Slovenia	15.69	17.65	6.37	1.10	0.84	1.01	4.56	47.22
Czech Rep.	2.69	60.34	1.61	3.86	1.29	4.34	18.15	92.27
Poland	38.48	104.81	3.99	23.53	3.92	15.57	30.61	220.91
Baltics (Countries)	6.20	15.93	40.00	0.92	1.31	22.19	27.82	114.36
Total CCs	78.92	234.31	35.49	34.64	27.28	29.42	71.20	511.26
<i>% of EU production</i>	<i>0.30%</i>	<i>1.16%</i>	<i>0.63%</i>	<i>1.14%</i>	<i>0.13%</i>	<i>0.25%</i>	<i>0.19%</i>	<i>0.40%</i>
ROW	1235.25	1799.28	1404.03	151.07	938.71	863.54	2090.01	8481.89
<i>% of EU production</i>	<i>4.65%</i>	<i>8.89%</i>	<i>24.82%</i>	<i>4.96%</i>	<i>4.40%</i>	<i>7.22%</i>	<i>5.46%</i>	<i>6.68%</i>
EU15 production	26539.64	20231.03	5655.99	3045.53	21318.72	11964.59	38286.69	127042.19

Table 2b
Values and Shares of EU Imports/Exports to and from Ccs and SEE, for Selected
Agriculture Sectors, 1997
(million tonnes)

EU imports	Pig meat	Cereals	Sugar	Oilseeds	Bovine	Poultry	Milk	Total
SEE								
Croatia	:	1633	1	700	1167	60	151	3712
Bosnia-Herzegovina	:	:	:	:	1	9	3	13
FR Yugoslavia	:	881	:	3334	19	120	3	4357
FYR Macedonia	:	5	:	:	:	20	:	25
Albania	:	17	:	5112	:	:	:	5129
Total SEE	0.00	2536.00	1.00	9146.00	1187.00	209.00	157.00	13236
<i>% of EU production</i>	<i>0.00%</i>	<i>0.00%</i>	<i>0.00%</i>	<i>0.06%</i>	<i>0.02%</i>	<i>0.00%</i>	<i>0.00%</i>	<i>0.00%</i>
CEECs								
Bulgaria	39	1283	3288	51759	:	2665	960	59994
Romania	:	10841	653	20257	153	801	83	32788
Hungary	32130	226650	2200	166412	5953	62055	415	495815
Slovakia	:	4752	755	40534	159	24	1720	47944
Slovenia	73	228	136	219	2370	1195	13512	17733
Czech Rep.	1639	2722	8679	106785	874	2563	2481	125743
Poland	:	1479	12948	5792	1630	20744	2913	45506
Baltics (3 countries)		8567		43094			8980	60703
Total CCs	33881	247955	28659	391758	11139	90047	22084	825523
<i>% of EU production</i>	<i>0.21%</i>	<i>0.12%</i>	<i>0.15%</i>	<i>2.74%</i>	<i>0.14%</i>	<i>1.05%</i>	<i>0.06%</i>	<i>0.27%</i>
ROW	12316	6946396	1818656	16063673	189560	119836	191394	25341831
<i>% of EU production</i>	<i>0.08%</i>	<i>3.37%</i>	<i>9.79%</i>	<i>112.28%</i>	<i>2.40%</i>	<i>1.40%</i>	<i>0.49%</i>	<i>8.16%</i>
EU exports								
SEE								
Croatia	6866	45469	47414	586	4731	3091	38152	146309
Bosnia Herzegovina	931	3414	30363	11	5742	10238	6996	57695
FR. Yugoslavia	105	144496	3320	278	6536	7653	822	163210
FYR Macedonia	468	44382	4416	428	4468	2289	1412	57863
Albania	283	71706	39488	765	1344	6328	1080	120994
Total SEE	8653	309467	125001	2068	22821	29599	48462	546071
<i>% of EU production</i>	<i>0.05%</i>	<i>0.15%</i>	<i>0.67%</i>	<i>0.01%</i>	<i>0.29%</i>	<i>0.35%</i>	<i>0.12%</i>	<i>0.18%</i>

CCs								
Bulgaria	993	94820	2467	158	4203	6956	2241	111838
Romania	110	19905	44169	312	540	563	2777	68376
Hungary	13889	46785	2256	5253	10454	3108	2354	84099
Slovakia	248	69024	29279	1195	404	234	1175	101559
Slovenia	7857	86966	19818	3308	439	1041	2231	121660
Czech Rep.	1827	413025	6738	11025	904	3366	6952	443837
Poland	21644	657917	14076	73025	3271	22272	15247	807452
Baltics (countries)	4811	107739	118615	859	984	25998	16717	275723
Total CCs	46568	1388442	118803	94276	20215	37540	32977	1738821
<i>% of EU production</i>	<i>0.29%</i>	<i>0.67%</i>	<i>0.64%</i>	<i>0.66%</i>	<i>0.26%</i>	<i>0.44%</i>	<i>0.08%</i>	<i>0.56%</i>
ROW	425740	12909386	4688435	541087	696110	847609	887807	20996174
<i>% of EU production</i>	<i>2.62%</i>	<i>6.27%</i>	<i>25.23%</i>	<i>3.78%</i>	<i>8.82%</i>	<i>9.93%</i>	<i>2.28%</i>	<i>6.76%</i>
EU15 production	16249000	205900000	18583000	14307000	7888000	8536000	39020000	310483000

Annex 1

The Strength of Institutions and the Choice of the Exchange Rate Regime

In thinking about the exchange rate arrangements between the euro and the rest of the (non-EU) Europe, three groups of countries should be distinguished, according to their relative strength:

- fiscally and institutionally very strong countries with Maastricht-conforming policies;
- countries that are not yet at the Maastricht level, but are heading in that direction; and
- countries in states of acute financial crisis, with very weak institutions.

i) *The very strong countries*, i.e. those that could become members of the EU at any time and that fulfil the Maastricht criteria most of the time (e.g. Switzerland and Norway) would gain from pegging to the euro because the EU is their major trading partner in any event. They would thus experience considerable savings in transaction costs. Moreover, pegging to the euro gives financial markets an anchor for longer-term expectations, thus reducing the impact of financial shocks. For these countries, the classic criteria of the Optimum Currency Area approach are close to being fulfilled as their economic structures are close to that of the EU. Nevertheless, even if they have a strictly economic interest in joining the euro area, these countries can afford the luxury of waiting see. Given their strengths, they can comfortably survive outside.

ii) *The middling countries*, with moderate inflation rates (now usually below double digit) and fiscal deficits, for example the countries of Central Europe. But with rather large current account deficits, they are vulnerable to speculative attacks. These countries are also experiencing an intense process of structural change whose outcome is difficult to foresee. They might therefore need some flexibility in their real exchange rate for some time. But the cost of retaining some flexibility in the exchange rate is that the economy is left open to the threat of speculative attacks, as the example of the Czech Republic has recently shown. Their experience also suggests however that the cost of such an attack is limited, and does not result in outright catastrophe as in the case of Russia. The costs and benefits of different exchange rate regimes are thus often finely balanced and must be considered on a case-by-case basis.

iii) *The very weak cases*, namely countries that are very far from fulfilling any of the requirements for EU membership in general (and the Maastricht criteria in particular). These countries usually have large fiscal deficits and high inflation, their currencies are often under pressure and real interest rates are highly variable, often patently unsustainably high when the government tries to stabilise the economy. These countries would gain from being able to enter the euroarea, because that would be a way to import sensible macroeconomic policies and decisively gain the confidence of financial markets. Since the alternatives are hyper-inflation and/or enormous risk premia on foreign debt, the benefits of this confidence effect and of a stable currency can far outweigh any potential costs of not being able to react to asymmetric shocks with exchange rate changes.

One way for non-EU countries to enter the euro area is to opt for a currency board, as already done by Bosnia, Bulgaria, Estonia and Lithuania. The first three chose the DM as the anchor and are now de facto members of the euro area. A currency board can deliver the benefits of credibility with financial markets and low inflation. As the experiences of Argentina and Hong Kong also show, however, even currency boards that are run in a very conservative manner can come under attack. Although the mechanism of the currency board itself is usually technically unassailable, these attacks are costly because they lead to increases in domestic interest rates, which have a negative effect on demand. Defending a currency board is thus technically easy, but can have a high price in terms of unemployment. Financial markets know this and this is

why a currency board is never 100% credible. This weakness of currency boards has recently prompted the Argentine government to consider plans to switch totally to the US dollar.

The economic benefits of full dollarisation or euro-isation are similar to those resulting from a currency board, but they are more certain. They can be reaped even by countries whose institutional and political weakness would leave doubts in the market that it could follow the rules of the game of a currency board (e.g. Russia and Ukraine). Under a currency board regime, the country still has a domestic monetary authority which might cede to government pressure and violate the rules of the currency board, e.g. by giving credit to the government.

Therefore, the radical solution of unilateral, total adoption of the euro (or dollar) as the domestic currency offers even more benefits, compared to the currency board, for countries with very weak institutions. The case of Argentina suggests that the idea is one of practical, and not just theoretical interest. But it is not to be thought of as something more for advanced emerging markets such as Argentina. On the contrary, in the case of Central and Eastern Europe, euro-isation meets the objection that the national authorities would still be quite free to abandon their commitment to the monetary rule of the currency board, which in present circumstances would mean costly interest rate risk premia. Abandonment of the euro would be much more costly in political terms. Total euro-isation should thus result in a more credible regime.

Annex 2

Details of Cost Calculations

Most of the data necessary to make a reasonable estimate of the potential costs are available for the established countries in the region, i.e. Albania, Bulgaria, Croatia and FYROM. For the remainder (Bosnia-Herzegovina and rump-Yugoslavia), one has to rely on older data and statistics concerning the republics of Yugoslavia before the break-up. A key variable, GDP per capita, had thus to be estimated on the basis of 1979 data for Serbia, Kosovo and Montenegro. This problem cannot be avoided. For Bosnia-Herzegovina only some variables are available, from the EBRD.

The main purpose of all calculations was to provide an upper bound. The implicit dollar/euro exchange rate was set at 1:1 to avoid complications that in any event would be minor compared to other sources of uncertainty.

Compensation for Lost Tariff Revenue

The EBRD gives tariff revenues as a percentage of imports for most countries in the region. This can be combined with the available information on GDP in dollars and the share of trade in GDP to obtain the corresponding dollar amounts. The assumption implicitly used here is that the EU's support would be at most equal to this amount. In reality, it would be considerably lower because the EU should provide compensation only for the tariff revenue on trade with the EU. Trade with the EU is a large and growing proportion of the overall trade of countries in the region, but in some cases the proportion is closer to 50% than to 100%. In reality, therefore, the amounts required might be only about one-half of the sums mentioned here.

Moreover, for a country that aspires to full EU membership (e.g. Bulgaria), tariff revenue would disappear anyway. The part based on trade with the EU is scheduled to disappear soon under the Europe Agreements and the part based on trade with the rest of the world will shrink considerably when the country adopts the common external tariff, whose rates in most cases are close to zero.

For countries for which tariff revenue data are not available, the potential for compensation was set at 3% of GDP, which is somewhat higher than the average for the other countries; this appeared justified on the grounds that this group is generally poorer. The dollar amounts were then calculated as 3% of GDP in dollars.

Capital needs for 100% backing for currency board (=cash needs for euro-isation)

For the countries for which financial data are available, one can simply use the latest figures on currency in circulation converted into euro at the latest available exchange rate. This was done for Albania and Bulgaria. For the other countries it was assumed that the ratio of cash to GDP is 10%. This high figure was used on purpose because the countries for which no financial data are available no longer have a functioning banking system.

The initial endowment in euro that is needed can then be easily calculated as 10% of GDP measured in dollars (or euros). The burden for the EU budget was then set equal to 5% of this sum. As interest rates are at present somewhat lower, this is again meant to be a ceiling rather than an accurate estimate.

In the case of full euro-isation, the country concerned would use the same type of loan as for the currency board backing to buy the initial stock of cash from the Eurosystem (in reality from any of the national central banks in the euro area). The national central banks that provide the euro cash should immediately transfer the euros they obtain from the South-East European

country/region to the ECB who would then invest these funds.¹³ The interest income of the ECB would thus increase by approximately the same amount that the EU institutions would have to pay to service their own borrowings. As the profits of the ECB are distributed each year to national governments, the net cost to the EU as a whole (national governments and EU institutions consolidated) would thus be close to zero. (Not exactly zero if the interest the EU institutions pay on their borrowings is higher than the return the ECB obtains from its investments. Another complication is that all 15 governments contribute to the EU budget, but only the 11 euro area governments would receive a share of the revenues of the ECB. However, as the sums involved are minuscule, this issue will not be taken up here.)

The net cost of the operation would be essentially zero for the EU. But the budget of the EU institutions would have to carry the interest cost, which would be the same as for the backing of the currency board.

While it is straightforward to account for the initial endowment of cash, it is more difficult to deal with subsequent developments from an economic point of view. If a euroised economy grows, its demand for cash should also grow. Unless the EU makes further loans of its currency, the country in question would have to run a balance-of-payments (either current account or capital account) surplus. However, the magnitudes would again be so small that this is not an important issue.

Comment [A2]:

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Annex 3

Euro-isation: Any Lessons from the Panamian Experience?¹⁴

The main example of a country that has adopted a foreign currency is Panama. A brief review of the experience of that country is therefore instructive. Panama uses the US dollar, has no central bank and no official foreign exchange reserves (they are not needed). This arrangement has worked without technical problems for almost a century. The Balboa is mainly used for accounting purposes and exists only in the form of silver coins. (Guatemala had a similar fixed rate regime against the dollar until the mid-1980s, but this ended with its civil war in which over 10% of the population were killed.)

In the following we will address three key issues that arise when discussing euro-isation for South-East Europe: 1) Is Panama a useful example for South-East Europe (SEE)? 2) Are perfect labour markets a prerequisite for the adoption of a foreign currency? 3) Can euro-isation protect against financial shocks? The answers, in short, are: yes, no and yes.

1. Is Panama a useful example for South-East Europe (SEE)?

Panama is often perceived as a special case which has no relevance for other situations. Even a superficial examination reveals, however, that in three key areas there are close parallels to the countries in SEE.

i) *Size.* Panama has a population of about 2.7 million, larger than Kosovo or Macedonia and only slightly smaller than Albania. Its total GDP, around \$ 900 billion, is much larger than that of these countries, and in the same order of magnitude as that of Bulgaria.

ii) *Weakness of its institutions.* Panama also resembles the countries of SEE in that it has rather weak administrative structures and democratic institutions (as can be seen from the coup d'état of the 1980s.)

iii) *Importance of transfers from abroad.* Panama is often perceived as an artificial country which lives off the canal but which has no significant economic activities of its own. But this impression is wrong. The country does have a sizeable industry, and its exports of goods are at the same level, per capita, as in its larger neighbour, Colombia. Agriculture also employs a similar share of the population.

Moreover, the transit fees from the Canal make Panama actually more comparable to the countries in SEE for which the euro-isation option should be considered because these countries will also receive substantial transfers from abroad. These transfers will be reduced sooner or later, which will require substantial changes in relative prices, but it is not insurmountable problem. Panama had to deal with large swings in the revenues from the canal, but there was never any question that the country would need a flexible exchange rate to deal with them. The importance of the revenues from the canal should also not be exaggerated. In 1998 total revenues from the canal amounted to about \$ 650 million, equivalent to about 7% of GDP. But the canal is not a free lunch: operating costs were of a similar magnitude (with about one-half for labour). The (net) rent the country perceives from the canal is thus probably only around 3% of GDP, which is less than what the countries in SEE can expect over next few years (and much less than what Bosnia-Herzegovina receives at present).

The canal is more important for public finances. The Canal authorities and users contributed about \$ 150 million to an overall budget of about \$ 1.1 billion. It is interesting to note that, even after a reduction in rates, import tariffs still amount to about \$ 250 million, or slightly less than the 3% of GDP used as a benchmark.

¹⁴ This section is based on information from the IMF and Moreno-Villalaz (1997).

2. Are perfect labour markets a prerequisite for the adoption of a foreign currency?

It is often argued that a national currency is needed as a safety valve in the event that domestic price and wage pressures mount. Many opponents to EMU implicitly argued that poorer countries with weak institutions especially would run this danger. This concern is not borne out in the case of Panama. There has been no long-term price pressure on the dollar/balboa link. On the contrary, over the last 30 years prices have actually increased less in Panama than in the US, on average by 1.7% less each year. Over the entire period (between 1967 and 1997), the US consumer price index (CPI) increased by about 370%, whereas in Panama the increase was only 170%. There is also absolutely no indication that Panamanian labour priced itself out of the market. Unemployment in Panama presently hovers around 13%, but this compares well with other Latin American countries, and is much below the 20-40% unemployment rates that currently plague some of the countries in SEE. The data from overall employment is even stronger. Despite its young population, the overall employment rate (employment/population) is 33%, which is much higher than its Latin American neighbours (Colombia 15%, Guatemala 8%) and the countries in SEE with their much older population (the employment rate in Macedonia is 17%, and in Bulgaria, 22%).

This is not to say that the labour market in Panama is perfect. On the contrary, it was actually the model for the Harris-Todaro model of a dual labour market in which there are two sectors: a modern international one and a traditional rural one. The first sector pays above-market clearing wages to reduce the incentive to shirk. (High transactions costs make it impossible to enforce contractual behaviour by labour.) The second, traditional sector absorbs surplus labour at a wage rate that is determined informally through household and other non-market activities (subsistence agriculture, small-scale commerce, etc.). In equilibrium there is substantial unemployment in the cities until the cost of moving there just equals the expected wage differential (which in turn depends on the probability of finding a job, i.e. the unemployment rate). This is exactly what is likely to happen in SEE (and was already the norm in pre-war Kosovo). A different monetary regime does not change the fundamental reasons for this dual economic structure, which characterises many Central American countries. But the experience of Panama shows that a stable currency regime does not increase the problems that result from such a dual labour market. On the contrary, each time Panama had to face a major political or economic crisis (e.g. US embargo, oil price increase), the informal sector was able to absorb the surplus labour liberated by the formal sector without causing excessive unemployment problems in the cities.

The countries in SEE are likely to have imperfect labour markets whether or not they adopt the euro quickly. Their problems are likely to be similar to the ones faced by other countries, (such as Panama, with a similar income per capita (and weak institutions) but different from the ones facing EU members with their highly developed social systems. The experience of Panama suggests that the absence of a national monetary policy does not exacerbate the unavoidable problems that arise from dualistic labour market structures.

3. Can euro-isation protect against financial shocks?

The clear answer here is yes. Adopting the dollar has protected Panama against most financial problems and allowed it to survive the recent global financial crisis much better than other countries in the region. The latest IMF report notes that its economy was affected by the fall in demand in the rest of the region, but that there were no signs of financial instability in Panama itself. Deposit and lending rates remained essentially at the average of the five preceding years (around 7 and 10%, respectively) whereas dollar equivalent rates in other Latin American countries were often 20 percentage points above Libor. Dollarisation thus protects the domestic economy against external financial shocks.

A key issue for many countries with large external debts is to what extent could euro-isation lower the risk premium paid on foreign debt. For a country with an external debt to GDP ratio

of 100% (e.g. Bulgaria), a risk premium of 10% (not unreasonable under current circumstances) implies an additional annual transfer of 10% of GDP to foreign creditors. The experience of Panama shows that euro-isation could be a big help in this area as well. The public external debt of Panama is also substantial, now around 60% of GDP (after a peak of 75% in 1995), but the government never had to pay a large risk premium on its indebtedness. Why should dollarisation lead to radically lower risk premia also on external debt? Per se, the monetary regime does not cure the chronic difficulties of the public sector in countries with weak institutions to raise tax revenues (and limit pressures for more expenditure). But euro-isation has several consequences.

First of all, it eliminates the difference between external and internal debt. This in turn has two consequences: the government cannot discriminate against foreign creditors and it cannot rely on a captive domestic market to finance deficits.

Secondly, it eliminates a key source of uncertainty about the capacity of the government to service external debt because with euro-isation the wide swings in the real exchange rate that result from the large sudden depreciations which often arise during currency crisis are no longer possible. Russia is a case in point. When the exchange rate of the ruble quadrupled last year (going from 6 to 24 rubles per dollar), the capacity of the Russian government to service its foreign debt was cut to one-quarter (and the price of Russian eurobonds went to 25% of their face value). After a year domestic prices have doubled so that the real devaluation is only 50%, but this still implies that the dollar value of Russian tax revenues has been halved (and the price of Russian eurobonds went back to 50%). With euro-isation swings of the real exchange – and the price of foreign debt – of this order of magnitude will not happen.

Euro-isation thus improves debt service capacity in a number of ways, and much lower country risk premium is therefore entirely appropriate.

Annex 4

Associated Territory: Any Lessons from the Puerto Rican Experience?¹⁵

The main empirical example of a territory that is fully integrated in the economic space of a large country is Puerto Rico. A brief review of its experience is therefor instructive.

1. The Basic Facts

Puerto Rico has a population of about 3.5 million (similar to that of Panama or Albania) with a GDP per capita of over \$ 12,000, more than twice that of the richest country in Latin America (Argentina) and a multiple of that of its immediate neighbours, Haiti, the Dominican Republic and Jamaica. Its total GDP of over \$ 40 billion is larger than that of the entire South-East Europe an region. Puerto Rico is thus a shining example in Latin America, not only in terms of its current level of income, but also in terms of per capita growth, which has been the highest in the hemisphere over the last decades (3.9%) per annum. In 1960 Puerto Rico was not much better off than the rest of Latin America. It then had a GDP per capita below that of Argentina (about level with Chile), but it is now between two and three times richer than these two countries. PR is also by far the most open of all Latin American economies and its exports per capita (about \$ 6,000) are five to ten times higher than those of other Latin American economies of similar size.

The basis for Puerto Rico's links with the US is a Commonwealth Agreement (ratified by a referendum in 1951) whose key elements are:

- full trade integration with guaranteed market access
- use of US dollar plus an integrated financial system, overseen by the US Federal Reserve
- integrated labour market
- official transfers to the Puerto Rico government and to individuals
- integrated legal and judicial system
- non-voting representation in the US House of Representatives.

The first three points define the Economic and Monetary Union of Puerto Rico with the US and could be replicated in SEE (although labour mobility would take time). The one element that could not be replicated in Europe would be the *application of (US) minimum wage laws*. This is the key to the understanding of Puerto Rico's unemployment problem. Employers in Puerto Rico have to pay the full US minimum wage. On the mainland the minimum wage affects only a small proportion of the work force, but this is totally different in Puerto Rico where it is estimated that 60% of the employed are paid the minimum wage.

2. The Main Problem: Unemployment

The excellent growth performance of Puerto Rico suggests that full integration into a large economic space with a stable currency and a stable regulatory framework brings enormous benefits. These benefits do not seem to flow primarily from the mere access to capital since Puerto Rico has grown much faster than the rest of Latin America, although its investment rate (about 20% of GDP) is only average. But most investment in Puerto Rico has come from abroad and thus embodies technology and know-how that would otherwise not have been available to the country.

¹⁵ This section is based mainly on Hausman (1995).

The only really important problem that remains for Puerto Rico concerns labour markets. Labour mobility should be part of economic integration and is also part of established EU norms, even if it will not be quickly acceptable for the EU side in the case of SEE. The problem in the case of Puerto Rico is that its integration with the US goes beyond labour mobility in one critical area: the US minimum wage applies in Puerto Rico although the average income is less than one-half that of the US mainland. As this wage norm is binding for 60% of the employed on the island, it has led to an unemployment rate around 18%. Massive transfers from the US federal budget cannot cure this problem.

That wage equalisation leads to problems does not come as a surprise to a European observer. In economic terms the problems of Puerto Rico are those of East Germany. The only difference is that in Puerto Rico the US minimum wage norms are imposed by law, whereas in Germany the high East German wages are the result of agreements between employers and trade unions. The political economy is, however, the same. In both cases labour representatives in the richer part of the country press for higher wages in the less productive region in order to protect their own interests. The low-skilled workers who became unemployed as a result of this wage equalisation are usually not represented in the wage bargaining process. The same happens in many countries with regional problems, e.g. southern Italy (where unemployment is even higher than in Puerto Rico) or Wallonia in Belgium. In the case of Puerto Rico, the difference in size (50:1 in favour of the richer mainland) also explains why the fiscal burden has been bearable so far.

Fortunately nothing suggests that integration into the EU (including adoption of the euro) should lead to wage equalisation. In richer countries, labour movements push for wage equalisation within their own jurisdiction, but have so far shown much less interest in wage rates abroad. This relative lack of interest has two reasons: labour mobility is much lower across national (and linguistic) frontiers and the transfers that would be required to back up minimum wages in poorer areas are not feasible outside a political union.

3. Lessons for SEE?

The experience of Puerto Rico suggests that adopting the euro and taking over the regulatory framework of the EU internal market would bring large economic benefits for Southeast Europe. The only danger, namely premature wage equalisation, should be easy to avoid given that trade unions are still organised along national lines and operate within national political frameworks.

Part III

CEPS Special Brainstorming Session on a System for Post-War South-East Europe

Summary of Discussion, 28 April 1999

1. Premise: A “Realistic” European Solution

In general there was agreement that it was necessary to find some way of combining the unilateral and bilateral approaches to the region. There was much discussion of what was “realistic”. On one side, voices from the European institutions warned that the CEPS paper was simply not realistic, and would upset Romania/Bulgaria, Turkey, Ukraine/Moldova, Russia and the US. On the other, voices with direct experience of working in the region warned that a strong, credible, and above all European approach was necessary. Participants commented that “this is not foreign policy for the EU. There are no exit lines. The core reality is that this is Europe.” “We need a highly committed, ambitious project with a real impact, not PHARE/TACIS-style tinkering at the edges.” “If we do not shift the attention of the region’s political culture from the past to the future, they will continue to re-fight the past.” A participant who lives in the region stated that the CEPS paper was the first time, from his point of view, he had seen a realistic proposal.

A couple of participants wanted to see a time scale included in the paper. We should not underestimate the amount of time needed even to conclude a free trade agreement.

2. Hard core of Solution: Seven EU Innovations of Policy or System

i. Market regime: a multilateral, zero-tariff free-trade area for all, with budget compensation for loss of customs revenues. Most participants agreed. Some went further and urged that the free-trade regime, unlike other parts of the package, should be applied without conditionality. The new Bosnia-Herzegovina customs regime, which will introduce tariff barriers with Croatia and FR Yugoslavia, was deplored.

ii. Euro-isation. No disagreement, since much of the area is informally euro-ised (or at least DM-ised) already.

iii. Security (civilian). Little discussion, other than agreement that the current approach is not sufficient and that it is within the EU’s competence and experience to help run customs services and border crossings.

iv. Security (military). There was a great deal of scepticism that the ESDI would become a meaningful concept in time. A number of participants were conscious of NATO/US interests and obligations.

v. Institutions. There was considerable scepticism about the details of the CEPS proposals but there was sympathy for the general direction. One suggestion was that the five states should be linked with the Council and Commission for work on specific programmes that included their countries. Also some kind of screening process would have immediate and important educational significance. A participant from the region urged the EU to “multiply contacts on every level” with the region. This was the area where the most disquiet about the Western Balkan countries possibly “leapfrogging” Romania and Bulgaria was expressed, but it was also clear that symbolically it is of great importance for the people of the region.

vi. Management capacity. The amount of money required for both reconstruction and reintegration is huge. The total repair bill for the region has been estimated at \$50 billion. How

can it be administered? A number of interesting ideas were put forward. There could be a Balkan Reconstruction Agency, with the European Commission making policy but not executing it, let alone micro-managing. A related proposal was that there could be a reconstruction agency or authority, with the EU and the region's states represented, and that ownership and licensing rights in infrastructure, telecoms, roads, and/or power be vested in this authority. The EIB is useful here. As one participant commented, "The aim is not post-war reconstruction but the Europeanisation of the region." There was scepticism about the need for a single High Representative for the region, or for re-running the EBRD.

On a related topic, the administrative/absorptive capacity of the region is currently very low. The Office of the High Representative in Bosnia, with its large numbers of international staff, may not be a good example.

vii. New Associate Member States. There was talk of "stability agreements" from some quarters; others suggested "European Partnership Agreements". Apart from the free trade issue, there was consensus on the requirement for democracy (as measured by the standards of Copenhagen) as a basic condition and a demand for more detail from CEPS on the democratisation and civil society issues.

3. Individual Countries

Surprisingly few remarks were made about individual countries. One participant commented that Croatia has isolated itself from the region so as to escape being identified as a Balkan country. Another asked why the concern for returning Albanian refugees to Kosovo was not matched by an urge to return Serbs to Croatia. The continuing isolation of Yugoslavia under Milosevic is a huge problem at the centre of any stability pact for the region. The Kosovo war is seen as another failure of European policy.

4. The Wider Europe

As noted above, concerns were expressed about "leapfrogging" of Romania and Bulgaria by the countries of the Western Balkans. One participant suggested that as a consequence of CEPS' proposals, Romania and Bulgaria would have to be promoted to the fast track of accession.

5. Stability Pact

There seemed to be two views on the German Presidency's idea of a new stability pact, with one side feeling that it could be thrown together from the existing elements of regional aid and experience from the first stability pact, and the other fearing that this simply would not be enough. There was considerable concern expressed that the OSCE might try to take over the whole region, and several participants felt that the OSCE's ambitions were not matched by its ability. This dimension was seen as potentially very explosive.

Another explosive issue was the possible redrawing of borders. Considerable dismay was expressed that the US promise at Rambouillet of a referendum in Kosovo had opened this Pandora's box. Several participants urged that it should be firmly shut again.

List of Participants

Carl Bildt (former High Representative in Bosnia-Herzegovina)
Joachim Bitterlich (German Ambassador to NATO)
Günter Burghardt (European Commission, DG1A)
Costas Carras (Association for Democracy in the Balkans)
Poul Christofferson (Danish Ambassador to the EU)
Brian Crowe (Council of Ministers Secretariat)
Nikos Efthymiadis (Association for Democracy in the Balkans)
Wilfried Gruber (German Ambassador to FR Yugoslavia)
Ferit Hoxha (Albanian Ambassador to the EU)

Danuta Hübner (UNECE)
Mladen Ivanic (Banja Luka)
Richard O'Toole (ABB Zürich)
Romano Prodi (President-designate of the European Commission)
Panagiotis Roumeliotis (Royaumont Process)
Gerhard Sabathil (European Commission, DG1A)
Tom Spencer MEP

Peter Ludlow (CEPS)
Michael Emerson (CEPS)
Nicholas Whyte (CEPS)

CEPS Conference on a System for Post-War South-East Europe

Proceedings, 19 May 1999

**Chairman: Romano Prodi
President Designate European Commission**

Introduction

Peter Ludlow, Director CEPS

Two earlier Commission Presidents had seized a big idea as the central theme of their presidencies. Roy Jenkins had chosen monetary integration which resulted in the creation of the European Monetary System (EMS). Jacques Delors had decided to go for the Internal Market from which much else had flowed. Neither of these Presidents, however, had decided on their “big idea” until the second half of their first year in office. European Security through integration is already emerging, however, as the focus to the Prodi presidency. It consists of at least five elements:

- The establishment of an area of Freedom, Security and Justice as set out in the Amsterdam Treaty which has just come into force;
- Enlargement of the EU;
- Relationship between the EU and the Wider Europe;
- European Security and Defence capability; and
- Post-war reconstruction.

The President-designate has already spoken of the last two and more particularly of the last, which is the subject of today’s conference. If the definition of a “big idea” is that it is relevant and feasible, it fits the bill.

- Not only is it relevant, it is urgent.
- The disintegration of Yugoslavia has undermined the credibility of the EU.
- Only the EU has the full range of instruments for a long-term solution to the problem.

Romano Prodi

This type of conference shows how much we need people with ideas. But ideas are no good if we do not translate them into actions. The EU is essential to the reconstruction process but we cannot have peace through an economic strategy alone. We need a political/economic strategy that is sensitive to the needs of the whole region. To say that the European Commission is the engine of the EU is not just rhetoric. It must play this role in relation to the Balkans, as in other areas like unemployment, and it needs to define the agenda and find the appropriate instruments to implement it.

Presentation of the CEPS Paper: “A System for Post-War South-East Europe”

Michael Emerson, Senior Research Fellow, CEPS

It is clear that the optimistic view of the post communist world converging towards democratic market economies, though at different speeds is not true. Instead we have two models, one of

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integration and the other of disintegration. Unfortunately, the dynamics of disintegration usually work faster than those of integration.

This perspective should motivate the EU to use its vast economic, human and political resources to extend the modern European order into the Western Balkans once and for all. Bulgaria could be seen as a role model for the Western Balkans. In the last few years it has consolidated democracy, stopped inflation, achieved reconciliation between its ethnic/cultural communities, attacked mafia and corruption and moved closer to the EU. All this in spite of having many of the historical qualifications for conflict and chaos. It has instead reconciled its Slavic, Orthodox culture with the modern European order.

CEPS' paper offers a template for a strong European solution to the Balkan tragedy. It consists of a ten-point plan which has been revised after much discussion. It proposes:

- New associate membership
- Emergency assistance as well as present humanitarian attempts to clear the tent cities before the winter and efforts to overcome blockages on the Danube (Pontoon bridges on the Bulgarian/Romanian frontier)
- Customs Union with the EU scrapping all tariffs immediately and compensating the governments concerned for their loss of revenue.
- Euro-isation
- Reconstruction agency (SERA- South East Europe Reconstruction Agency)
- Civil Society Foundations. Specialised agencies are proposed which would relieve the Commission of excessive micro-management
- Civilian Security- EU customs services with police/paramilitary support should maintain controls at the extended EU Customs Union frontiers
- Military Security- EU-led peace keeping forces
- Institutional integration in variable ways for New Associative Members
- Executive capacity of EU institutions- the spinning off of Commission functions to specialised agencies.

The Stability Pact being prepared by the German Presidency is a positive move. The CEPS plan is an attempt to give this official initiative substance and depth quickly. Under the CEPS plan Albania and Macedonia should open negotiations on 1.1.2000. Croatia could also begin soon if elections lead to a government committed to EU political norms. For Bosnia, some experience with the front runners should enable us to Europeanise the Dayton regime. The whole package would also be open to Yugoslavia once political conditions allowed.

It is important that these plans should not be carried out at the expense of the present applicant countries. Instead they should be mutually reinforcing with enlargement negotiations with Bulgaria and Romania and the others in the second group beginning on 1.1.2000.

All these developments could create a new context for EU relations with Turkey, Russia and Ukraine.

Political Strategy of the EU

Carl Bildt, Former EU High Representative for Bosnia and Herzegovina

In his two years exposure to Bosnia, every meeting had demonstrated that short-term local solutions were insufficient. Long term, regional solutions were necessary. The problems of the Balkans have to be seen as an internal not an external problem, central to the internal order of

Europe itself. Some of the causes of the present conflict are local but they are also the result of the failure of preventive diplomacy. Action must now be taken on four fronts:

- The carrying out of the G8 principles, which involves the development of a common platform for peace with the US and Russia;
- The development of mechanisms for contacts so that possibilities can be sounded out;
- Identifying the instruments for implementing the agreed strategy. And
- The development of long-term perspectives.

Carl Bildt welcomed Michael Emerson's paper and outlined three interrelated pillars which he felt were in line with Emerson's ideas.

- *Military/Security.* The commitment of long term military force will be necessary as a deterrent against the resumption of war and to guarantee internal borders. There must also be disarmament across the region. It is the most militarised region in Europe with over 40% of GDP being used for military purposes. Economic development will be hampered if this level of expenditure continues.
- *Framework for economic reconstruction and integration.* Before 1989, Yugoslavia was the most advanced economically of the CEECs. Since then it has been sliding down the scale in comparison with the other countries, adversely affected by sanctions and by war. It could take ten years for what remains of Yugoslavia to reach the same level of two decades ago. Trade is the key, though balance of payments support and help in rebuilding the infrastructure will also be needed. The aim should be integration into the EU's internal market.
- *Political Framework.* Full membership of the EU should be envisaged. Only this will provide firm international guarantees within which autonomy, cooperation across borders and multi-layered government can become possible.

As Europe campaigned for One Market, One Money now we should acknowledge that we need One Europe, One Peace.

Tom Spencer, Chairman of the Foreign Affairs, Security and Defence Policy Committee, European Parliament

The Kosovo crisis had been predicted for ten years but it had been impossible to mobilise the political will to do anything about it, largely because of a lack of empathy between Western Europe and South Eastern Europe. He fully endorsed the strategy of the CEPS' paper, which compared with the German-sponsored Stability Pact has more substance. All the organisations listed in the Stability Pact may have a part to play but only the EU can offer membership. An offer of membership is not just something for discussion in the long term. It could have an immediate affect on the negotiations of the warring parties. We need to export the Community method that had worked on the Rhine (reconciling Germany and France) to the countries of the Danube.

The underlying psychology and language when we discuss South Eastern Europe are important. Look at the way we use the term balkanisation as a metaphor for the dark and destructive forces within societies, as if they are not present in us too. We need to change our attitude towards South Eastern Europe, coloured as it is by the split between Catholic and Orthodox Christianity and the long years of Ottoman rule. Remember Byzantium and the long years of culture and civilisation when much of Western Europe was brutish and crude.

We should change our stance to South Eastern Europe from neglect to inclusion. However, in making the case for the EU's unique role in the region we are not setting up as competitors with the US and Russia. But democratic, peaceful integration into the EU is better than the creation of protectorates

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Tom Spencer said that he was sad that the CEPS' revised paper had backed away from the idea of autonomous regions of the EU. He did not believe that Kosovo would remain part of Serbia or that Montenegro would remain for long part of Yugoslavia. We need to devise a mechanism for cross border relationships and these are usually better managed within the EU.

Finally the Parliamentarian emphasised the need for public support. The one good thing that Milosevic had achieved was the growth in public support for the idea of a Common Foreign and Defence Policy. We should build on this and emphasise that the main driving force and *raison d'être* for the European Union is peace.

Comments

Commissioner Emma Bonino pointed out that even if the war is over soon, the humanitarian aspect will be with us for many years. We should, however, be thankful that, in spite of various criticisms of the relief effort, there have been no major epidemics or malnutrition. Of the 700,000 deportees more than 300,000 are living with families. We must provide support for these families and increase the numbers so that refugees are not left in tents for the winter. The provision of safe housing within Kosovo is also being considered.

Erhard Busek, Coordinator SECI described some of the difficulties in building up the economy of the region. It is not realistic to expect large investment. SECI tries to encourage private investment but there is an enormous difference between this region and the accession countries. He felt that the EBRD and the EIB could help by creating a better framework and by working with existing institutions so as to increase confidence.

Danuta Hübner, Deputy Executive Secretary, UN Economic Commission for Europe had three points to make. The EU had to extend the "island of happiness" they had created by enlargement to their Eastern and Southern neighbours. They should not, however, underestimate the heavy burden integration imposed on these countries which had great difficulties in creating the necessary institutions and training their people. She welcomed the ideas of free trade set out in the CEPS paper but the EU would need to open its market in all sectors, give some guarantees for investment and encourage public/private partnerships. She suggested that CEPS should continue its work with an implementation plan.

George Vassiliou, former President and present Chief Negotiator for Cyprus expressed some reservations about the New Association Membership scheme outlined in the CEPS' paper. There was a danger of Europe being divided into two divisions. If the EU treated the New Associate Members on the same time scale as the present applicant countries, it could be 2100 AD before they became members.

Economic Priorities

Göran Lindahl, President, ABB

ABB has extensive local presence in the region which it defines for economic purposes as Albania, Romania, Bosnia, Bulgaria and Yugoslavia. Even before the current conflict, economic and infrastructure needs in the region were large. The influx of refugees, the contraction of regional trade, the disruption of traffic through Serbia, bomb damage to the infrastructure and increased political instability have all had an adverse effect on the economy. Tourism, direct investment and the ability to raise loans have all suffered.

Estimates of the costs of the conflict range from £25-50 billion. Commission estimates for the reconstruction of Kosovo alone stretches from \$3-7 billion over the first three years. Public sector finance must be augmented by private investment.

Göran Lindahl endorsed the approach in the CEPS paper and advanced a proposal of his own to address the problem of infrastructure development. He suggested that the EU together with countries of the region should create a Regional Infrastructural Authority. Each state would vest

all licensing and regulatory powers over infrastructure development to the Authority (cf. original European Coal and Steel Community). It would cover power, transport, water and sanitation and telecommunications.

Its remit would be to promote regional infrastructure within a competitive, market based framework creating an environment that would be able to attract private sector investment. It would produce common standards on key issues such as rates of return, tariffs and user charges and regulatory conditions. The advantages of such an Authority would be:

- coherent, regional public/private partnership approach in the context of a long-term relationships within the EU;
- EU institutions involvement would guarantee European standards of governance and remove constraints on availability of finance;
- elimination of wasteful duplication and destructive rivalries;
- simplified and faster decision-taking;
- openness and transparency reducing risks of corruption;
- swifter mobilisation of private investment capital; and
- better integration with neighbouring regional networks.

The EIB should be given a new, special mandate in the region with expanded financial and staff resources. To implement such a plan we do not need to wait until the conflict is over. Immediate action could be taken to:

- list actions needed to repair war damage;
- map priority infrastructure needs;
- identify opportunities for immediate action;
- draw up clear regulatory principles;
- EIB and IFIs to draw up plans to mobilise finance rapidly; and
- enlist expertise.

Göran Lindahl listed a number of potential projects in the energy sector that could be tackled and pointed out the great needs in the water sector. He concluded by calling for “ambitious, concrete and determined” EU action now.

Sir Brian Unwin, President, European Investment Bank

Brian Unwin divided his presentation into three sections:

- What the EIB is already doing
- The needs of the region
- The role the EIB can and should play

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The EIB's role to date. The EIB is well qualified to contribute to the reconstruction of South-East Europe. It is already a major player in the creation of pan-European corridors. It operates in over 100 countries and has already disbursed over 600 million euro in South Eastern Europe. It is used to acting swiftly in response to political demands. In Central and Eastern Europe it has concentrated on infrastructural projects, especially those which have a regional rather than a national value alone.

Needs of the Region. It is difficult to estimate the needs and the effect of the war. The EIB divides the countries of the region into three circles:

- Yugoslavia, Albania, Macedonia
- Bosnia, Croatia, Bulgaria, Romania
- Hungary, Slovenia, Czech Republic, Slovakia and Poland.

For the first circle the conflict is likely to have long-lasting economic consequences. The destruction of the infrastructure following years of economic decline could reduce GDP by a third and exports by 50%. In Albania income from trade has collapsed and there is no public investment. In Macedonia it is only slightly better. All the countries will need substantial foreign help. \$25 billion over five years, excluding humanitarian and emergency aid. (cf. however \$70 billion from West to East Germany).

The main problem for the second group is the disruption to trade in countries that are already economically weak. Tourism is threatened and they fear that foreign investment will desert them. The overriding priority is support by the international financial institutions to encourage the continuance of private investment.

The third stronger group of countries should weather the storm without help, though they will probably have to pay more to borrow on international markets. Acceleration of the accession negotiations would be beneficial.

Role of the EIB. The EIB is ready to play a full part in the reconstruction. It is already involved in all the meetings of the Council of Ministers where these issues are discussed and is well placed to make an important contribution. It can play a significant role in planning now and later implementing the reconstruction. The Bank has already set up a special task force. It is ready to consider Michael Emerson's template and perhaps there is a role for a Regional Infrastructural Authority. Duplication of institutions, however, should be avoided.

Daniel Gros, Deputy Director, CEPS

The ambition should be to promote sustainable economic development in the region not a dependency culture. Radically open economies should encourage the former and avoid the latter. In building up the economy of the region five points needed emphasising:

- The new policies should not be "regional policies" in the classic EU sense, nor bilateral arrangements.
- The gradual approach should be abandoned; the new structure should be set up by the end of the year.
- There should be no reconstruction of industrial dinosaurs.
- No micro-management from Western Europe.
- Though FDI is important it is bound to be limited and it is more important to build up the domestic market.

The two main proposals on the economic front in the CEPS' paper are for the establishment of multilateral, pan-European, zero-tariff free trade and the setting up of currency boards, or even better full euro-isation.

Free Trade. This would encourage trade within the region as well as trade with Western Europe. The opening up of barriers and the abolition of tariffs should eliminate smuggling and considerably reduce corruption. The loss in income from customs duties could be compensated for by EU grants. These would amount to no more than 1.5 billion euro.

Monetary Regime. A stable currency is a prerequisite for economic growth. Already Bosnia and Bulgaria have adopted a DM/euro-linked Currency Board. Full euro-isation would be even more advantageous. Countries could continue with their own “money” as the present Eurozone does until 2002 and then move directly to the euro. The loss of seigniorage revenues could be covered by a modest EU grant of approximately 200-300 million euro.

The EU should adopt a market led approach. Funds for refugees should be given as per diem grants which would be used to purchase accommodation and food locally. This measure would stimulate local economies and avoid the situation of funds passing through the region without any beneficial effect on the local market.

Strategic Views from South-East Europe

Mladen Ivanic, Economics Professor, Banja Luka

All sides share a responsibility for the break-up of the former Yugoslavia. Several mistakes had been made:

- The too hasty recognition of Croatia and Slovenia;
- The unbalanced attitude to different parts of Yugoslavia even though in fact all lacked democracy and all were interdependent;
- The way nationalism and ethnic minorities were treated differently; and
- The lack of a clear strategy.

It was difficult to see a swift solution to the Kosovo crisis but Mladen Ivanic felt that a serious approach was now being considered. The EU needed courage, decisiveness and a readiness to take risks. Help from the EU was needed because of the lack of democracy, the low level of economic activity and the social pressure created by unemployment. Local politicians needed to take responsibility but they should be put under strong pressure from the EU. Real stability can only be reached when all the countries accept EU standards.

Ferit Hoxha, Ambassador of Albania to the EU

All the countries of the region, except Serbia under its current leadership, aspire to EU membership. The EU could shorten the path to that goal, which is also in its own interests by:

- Sparing no efforts to strengthen democracy and civil society;
- Helping to build a competitive market economy. CEPS’ ideas need careful study;
- Building up the regional infrastructure;
- Creating stronger links with the EU at all levels – expert meetings, more frequent high level meetings;
- Strengthening local operators- agencies, local authorities not replacing them with western experts but extending training programmes; and
- The EIB should take a lead role in investment.

Assen Agov, Chairman of Foreign Affairs Committee, Bulgarian Parliament

Assen Agov had discussed the CEPS’ paper with his Prime Minister and Foreign Minister who expressed their appreciation of the effort. The environment is now more favourable for the

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proposals since most of the countries in the region are already re-orientating their policies towards the EU. However the kind words Michael Emerson had said about Bulgaria had only come true after ten years of pain. Bulgaria too had been guilty of ethnic cleansing, and though it had taken only six months to drive out the government which had caused 400,000 ethnic Turks to flee, it had taken many years to undo the damage.

Assen Agov agreed that entrance to the EU should be offered once the countries became democratic but he had a few words of caution and advice:

- Even when regimes change the bureaucracy will need help to rid itself of cronyism and corruption. Public service reform and training will be needed.
- The free trade idea would threaten some economies. It might be better to start first with domestic liberalisation.
- The Currency Board solution was strongly recommended but each case should be negotiated individually and in cooperation with the IMF.
- There should be strict conditionality for direct financing. Private investment could be stimulated by guarantees.
- Though all the countries should start negotiations together they should go at their own speed.
- Bulgaria and Romania should be invited at Helsinki in December '99 to start accession negotiations.

Comments

Jovan Tegovski, Ambassador of the Republic of Macedonia to the EU

The ambassador would like to have seen all five countries of the region represented on the platform. It was important to differentiate between the countries and not treat them too much as a group. He supported many of the ideas in the CEPS' paper, especially on the economic front but he suspected the ideas about the region were along the same lines as the present EU policies which are not effective.

Brian Crowe, Director General, Council Secretariat

Michael Emerson had stated that a new policy should be made towards Turkey. In plans to assimilate new countries we should not neglect existing applicants for EU membership. The EU has a policy towards Turkey, which we regard as an applicant country. It is in that context that we should examine Turkey and not as part of the Balkans problem.

Rory O'Sullivan, Resident Representative in Bosnia-Herzegovina, World Bank

Mr. O'Sullivan pointed out that the World Bank has established a joint office with the Commission to deal with reconstruction problems and was eager to play an active role.

Corrado Pirzio Birolli, Chef de Cabinet, Commissioner Fischler

It is necessary to capture the imagination of the general public. One of the ways would be to estimate the costs of non-action in the region. (e.g. the migration of the more dynamic people in the region).

Anna-Maria Bildt

Experience in Bosnia shows how important it is to work for the independence of the press. A Democracy Foundation has been created in Bosnia and the European Commission has been working with local institutions in order to build up civil society.

Chris Bennett, Institute for War and Peace Reportage

We now have some experiences that we can evaluate, especially the educational experiments in Bosnia and the recent political and economic turn around in Bulgaria.

Panagiotis Gennimatas, Vice President, European Investment Bank

Before the imposition of sanctions and the war, Serbia was one of the most developed parts of the region. Now its development level is comparable with the poorest countries and it will not be able to be one of the engines of the region.

Romano Prodi

Mr. Prodi began by saying that he endorsed much that had been said, particularly the ten points set out in the template. He was not, therefore going to repeat what had already been expressed but would highlight one or two points on the basis of his own experience. In expressing his gratitude to CEPS for the paper and for organising this conference, Romano Prodi pointed out how impossible it is to make the right decisions unless one sees the complexities and understands the interrelatedness of the region. Economic reconstruction is important but institutional integration and democracy building is even more important. How can we do this? We have to work with the fifteen EU governments who must themselves be involved in the mental shift necessary in order to view these problems as internal ones. The EU, however, has its own experience and must play a key role.

The reason that the Italian-led effort to stabilise Albania had been successful had been two-fold:

- It was a coordinated action. Spain, France, Bulgaria, Romania, Turkey and Greece had all contributed to it. We need to extend this kind of cooperative effort to the whole of Europe. We need to work towards porous or irrelevant borders within the umbrella of the EU.
- It was carefully implemented. The goals were modest but the timetable was kept. This gave a firm, coherent message.

From this experience Mr. Prodi concluded that Europe needed clear rules and the will to deliver.

Carole Ludlow, 26 May 1999

New European Body Needed For Rebuilding Southeast Europe – Now

*Göran Lindahl*¹⁶

It would be hard to exaggerate the cost of the war in Yugoslavia, above all the cost in human suffering. The television images we see every day bring this appalling tragedy home to us all. It is even more painful for us as Europeans. Our continent has seen hatred rage before in this century and we have tried so hard to ensure that this sort of conflict would never be unleashed again.

The human damage can never be repaired, but if the people of this troubled region are to see a return to prosperity, then we must begin today to plan for economic rebuilding. If we move boldly to build on the growing partnerships between the public and private sectors in Europe, I believe we can help relieve some of the pain in South-Eastern Europe and, more importantly, drive forward the kind of economic development that is perhaps our best means for really making sure it doesn't happen again.

I have proposed to the European Commission that the European Union, together with the countries in South-East Europe, immediately establish a Regional Infrastructural Authority to map the damage to infrastructure in the war-torn region and pave the way for rebuilding once the guns fall silent. This will also go a long way to bringing private foreign investment back into the region.

The EU's own history provides an example of nations overcoming deep-seated conflict and achieving stability and economic progress through shared institutions and economic integration. The model of the original European Coal and Steel Community can be the basis for the Authority I am proposing. Each state in the region would vest all licensing and regulatory powers over infrastructure development in the Authority, including power, transport, water and sanitation and telecommunications.

Sceptics may ask what yet another official institution would bring in a complicated situation. Based on my company's many years of public-private partnership in the infrastructure sector in many parts of Central and Eastern Europe, I believe it can bring a lot.

Before I elaborate in detail, just consider the damage that has been wrought. It is impossible to put an exact figure on the costs of the conflict, but estimates range from \$25 to \$50 billion. The European Commission estimates that the rehabilitation of Kosovo alone might cost from \$3 to

¹⁶ Göran Lindahl is President and CEO of ABB Asea Brown Boveri Ltd, a globalised engineering and technology firm. This article is adapted from a presentation he made on 19 May 1999 at the CEPS Conference on A System for Post-War South-East Europe, chaired by EU President-designate Romano Prodi. Proceedings of the conference are reproduced earlier in the section.

\$7 billion over the first three years. And this in one of Europe's poorest areas. I wouldn't rule out the possibility that these numbers double before long.

Public sector finance alone will clearly be insufficient to tackle the task of rebuilding. Perceived governance and credit problems have limited regional access to finance and many private investors are reluctant to assume what they see as excessive risk. Unless action is taken, they will wait a long time for stabilisation before they commit new investments.

To attract private sector involvement, a bold framework to encourage infrastructure development and to mitigate risks must be implemented. The Authority I propose would be charged with promoting regional infrastructure within a market-based framework and creating an environment to attract private sector investment and involvement in reconstruction.

Furthermore, common standards are necessary on key issues such as rates of return, tariffs and user charges, and regulatory conditions to avoid competition between countries and to attract private sector investors and developers. This can be made a condition of providing EU and European Investment Bank (EIB) finance.

The advantages of such an Authority would include:

- A coherent, regional public-private partnership approach to infrastructural development in the context of long-term relationships within the EU;
- Involvement of EU institutions and the EIB would assure that European standards of governance would apply and remove constraints on availability of finance;
- Elimination of wasteful duplication and destructive rivalries to secure an advantage over neighbours;
- Simplified and faster decision-taking;
- Open and transparent processes, reducing risks of corruption and bribery;
- Swifter mobilisation of investment capital from private sector sources and
- Better integration with neighbouring regional networks.

Provided the countries of the region are ready to develop infrastructure jointly through the Authority on the basis of common standards, the EIB should be granted a special mandate in the region to raise a target capital sum to be devoted to reconstruction in the region. Apart from financial capital that could be contributed directly by the EU public sector, the EIB should be able to raise additional long-term funding from capital markets and to put in place risk mitigation instruments to promote further foreign investment and lending from the commercial sector, including overseas participation.

Much can be done now already. In the water sector, many utilities need funds to maintain and operate their damaged systems and to carry out urgent repairs. Industrial water pollution, long service interruptions, low pressures and high leakage from distribution networks are increasing. The poor suffer the most from deteriorating water supply and the attendant public health risks.

The CEPS Plan for the Balkans

In the natural gas area, links from Greece to Albania, Bulgaria or former Yugoslavia, or trade with Russia and CIS would already help. There are other short-term priority areas in power generation and power transmission where upgrading existing systems would build a foundation for future progress throughout the region.

I believe a Regional Infrastructure Authority to establish a road map for reconstruction is a necessary and urgent requirement, which would send strong signals to business and governments alike. The demand for infrastructure is pressing and its construction is itself important to accelerating economic development and creating confidence in a regional future. Not the least important are the many local jobs that would be created by an infrastructure rebuilding program. Moreover, infrastructure can play an important role in creating greater interdependence between South-East Europe and its neighbouring regions.

We must not wait until after the war ends – the Balkan winter begins in six months. We must act now, in the interests of human rights, and to demonstrate to the much-tried people of South-East Europe that we wish to contribute to their return to prosperity and to long-term stability.