



OESTERREICHISCHE NATIONALBANK
CONFERENCE ON EUROPEAN
ECONOMIC INTEGRATION

November 28 to 30, 2004, Vienna

THE WESTERN BALKANS EUROPEAN PERSPECTIVE
(unabridged version)

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The Western Balkans European perspective

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Vienna, 29 November 2004

Ladies and Gentlemen,

Thank you for inviting me to this conference and for giving me the opportunity to discuss with you two of the key challenges facing the countries of the Western Balkans today – their economic development and their integration into the European Union.

There can be no doubt about the European perspective of the five Western Balkan countries, Albania, Bosnia and Herzegovina, Croatia, the former Yugoslav Republic of Macedonia and Serbia and Montenegro (including Kosovo). We want them to become members of the EU one day, and they want it. The fact that accession negotiations are about to start with Croatia is a proof of that. And we hope that this will inject some new energy into the reform processes in the other countries of the region. Our policy framework to lead the countries to EU-membership is the Stabilisation and Association Process. The integration into European structures needs to be preceded by significant reforms in most policy areas. The economic revitalisation is one of the major challenges the countries of the Western Balkans are facing today and perhaps the most difficult one.

Economic development in the region – a mixed picture

The Western Balkans can take credit for some major achievements, in relatively short time, in terms of reform and economic recovery.

Economic stabilisation has been continuous over the last year. Economic growth in the region will reach about 4.7% of GDP in 2004. There are differences between the countries, of course. Albania, Bosnia and Herzegovina, Croatia and Serbia and Montenegro have a comparatively high growth level while it is weak in the former Yugoslav Republic of Macedonia and sluggish in Kosovo.

Across the region, inflation is decreasing and exchange rates remain stable due to their cautious monetary and exchange rate policies, which are supported by IMF arrangements.

Fiscal consolidation has improved for several consecutive years, but has stalled in 2004. The average government deficit is expected to remain at about 3.5% this year, the same as in 2003. Until recently, these countries have relied on external grants to cover a large share of their public expenditures, so the inevitable decline in donor assistance will put additional pressure on public finances. Further consolidation will be necessary and will need to be accompanied by an improvement in public administration efficiency, including in the collection of taxes and other revenues.

Progress has been achieved in terms of market-oriented reforms. The privatisation of SMEs is practically complete in most countries. This process started later in Serbia and Montenegro but is now progressing at a good pace. Privatisation, restructuring and, where needed, the liquidation of *large* enterprises are a more lengthy process, however, and until the obstacles to bringing this forward have been removed – issues like clarity on liabilities, ownership rights and settlement of debt claims – large loss making public enterprises will continue to put a strain on public finances, with implications for jobs. Given that job losses in this area in most cases are inevitable, procrastination may only delay structural change and increase public deficits.

Considering the size of the individual countries and their national markets, intra-regional trade is instrumental to economic recovery. Under the auspices of the Stability Pact, the countries of South East Europe have signed free trade agreements with one another. To date, intra-regional trade has been rather limited but the new network of free trade agreements, as well as the rehabilitation of regional infrastructure networks in areas like transport and energy, should stimulate an increase in intra-regional trade. We are currently looking into the possibility of promoting a real free trade zone across the region. It seems that there is not yet a real understanding of the benefits of free trade.

The region's main trading partner is the EU. Supporting their economies by facilitating trade has been a key element of our policy. We therefore introduced autonomous trade measures in 2000. This means that the countries of the Western Balkans can export almost all their goods – including most agricultural products – to the EU market without duties or quotas. The countries clearly have a problem reaping the full benefits of this preferential treatment. There are several reasons for this: a lack of productive capacity and insufficient ability to comply with EU quality and health standards are major obstacles to increasing exports. Despite these

problems, results are encouraging. Exports are slowly increasing. The countries' exports to the EU are increasing at a faster pace than their exports to other parts of the world. We envisage extending the Autonomous Trade Measures beyond 2005. They will gradually be replaced by bilateral trade agreements.

Nevertheless, the trade deficit of the Western Balkan countries remains high and this represents a major challenge for them. We try to focus some of our assistance on sectors with potential for export (for example the agro-industry) and help with developing their laboratories and other systems to enable exports to meet European standards. The large trade deficits also reflect a growing demand for imports for domestic consumption and investment, a common feature of transition economies.

We support WTO membership of all countries in the region since this is a powerful driving force for wider economic and sectoral reforms.

While noting substantial progress in economic reform and recovery, huge challenges still remain.

Economic growth in this region is higher than the world average, but considering the starting level it is still too low. With the exception of Albania, the countries have not reached the GDP levels they had in the early 1990's. By European standards, the countries are poor, living standards are low and unemployment generally very high with social deprivation as a consequence. They need to attract a higher level of investment – particularly foreign direct investments. The high current account deficits need to be watched carefully. The existence of large informal economies deprives governments of much needed tax revenues. The countries therefore need to pursue their structural reform agenda vigorously. More attention needs to be paid to local development in the countries. In the *medium-longer term* they also need to, progressively, incorporate the EU acquis.

Widespread corruption and organised crime negatively affect the countries development, not only in economic terms. These problems are also holding back their political and institutional development. Unfortunately, most countries have so far failed to get sufficiently to grips with these problems.

Overcoming these issues and setting the countries firmly on the track towards full economic recovery and future EU membership poses major institutional challenges.

Strong administrative capacity will be crucial to deal with these challenges. Public administration reform should therefore be one of the main priorities ahead. For example: having fully functioning, competent, independent and sufficiently equipped judicial systems that can guarantee the rule of law is essential. Foreign investors need to know that they can obtain legal redress if contracts are not honoured; they need to know that their property rights will be clear and sufficiently protected; banks need their collateral rights to be enforced. Progress has been made in these areas but more needs to be done. The establishment of cadastres to ensure land ownership is important – this is currently a bottleneck in the whole region. I would also like to highlight the need for sustainable social security systems and the need to reform the pension schemes.

The perspective of future EU membership serves as an incentive to reform. EU rapprochement and reform implementation go hand in hand. It is important that the countries understand that they have to carry out wide-ranging reforms not because the EU asks them to do so, but because *they* have to do so to address the needs of *their* citizens, to raise *their* living standards. Therefore, the countries need to *internalise the reform agenda*.

The countries need to ensure that reforms are not only EU compatible but also that, at the same time, they address their particular needs, that legislation is enforceable, that they have the institutions required to implement reforms. There is sometimes a tendency to push through legislation and reform initiatives to satisfy EU criteria but without in-depth reflection on what the reforms mean. The whole integration process must be used to achieve *genuine change*. Profound structural and institutional reforms are required to cope with the challenges of EU membership and, even more importantly, the countries must associate themselves to the underlying European values, such as respect of human and minority rights, individual rights, democratic principles.

Integrating the Western Balkans into Europe – the Stabilisation and Association Process

As I mentioned earlier, the Stabilisation and Association Process is the EU's policy frame to lead the Western Balkan countries to EU-membership one day. Trade liberalisation, financial assistance and the Stabilisation and Association Agreements are the three pillars of this process.

- (1) I already dealt with the trade relations.
- (2) The EU has invested a tremendous amount of resources in helping the region. The currently running assistance programme amounts to almost 5 billion Euro (for 2000-2006). The Western Balkan countries receive some of the highest per capita assistance in the world. It is tailored to their needs, i.e. from emergency post-conflict reconstruction to institution-building and economic development. In addition, the EC provides macro-financial assistance which finances exceptional balance of payment needs and supports reforms in the context of the IMF programmes; since 1992 we have committed about €1 billion in macro-financial assistance. Our Member States, as bilateral donors, also are heavily engaged in the Western Balkans.

The main aim of our assistance today – as the reconstruction phase is more or less over – is to address many of the challenges I already mentioned. We are helping the countries with their structural problems. A large part of the CARDS programme for 2005 and 2006 is dedicated to economic and social development. We have projects aimed at improving the business climate, at supporting SME's and the privatisation of large state-owned enterprises. Where relevant, we still have infrastructure projects as well as projects in the areas of transport, energy and education. Since we are seeking to open up the countries' economies through our trade measures we are helping them in areas like standards and legislation so that they can take better advantage of the preferential treatment we grant them, improve their productivity and competitiveness.

Justice and Home Affairs and Institution Building are priorities for our assistance which are important in their own right and also in the light of economic regeneration. Building institutions and administrative capacity, developing the skills of civil servants and supporting the institutions guaranteeing the rule of law and accountability

– to put it simply: ensuring good governance – is essential for the countries to fulfil the political, economic and acquis related criteria for EU membership. It is also the basis for economic and social development.

- (3) By the Stabilisation and Association Agreements (SAA), we want to engage the countries in a wide ranging contractual relationship. These are demanding agreements, agreements which oblige the countries to gradually align their legislation with that of the EU, to progressively introduce the four freedoms and to cooperate closely with the EU on a number of issues at the heart of the internal market. Through the institutional framework which is set up under an SAA, they will also be exposed to all parts of the acquis. Implementing an SAA is thereby an important preparation for future membership.

Progress by the countries in the SAP - Political overview

Let me give you a quick overview on where the countries stand in the Stabilisation and Association Process

Starting with **Albania**: We are currently negotiating a SAA with Albania. The negotiations may be concluded next year. Our concerns at the moment are related to Albania's capacity to properly implement such an SAA. Albania needs to work harder to combat organised crime, corruption and the sizeable grey economy, and they need to ensure that the judicial system and public administration function properly. Furthermore, the customs services and tax administration need to perform better – customs collection here is the lowest in the region. The Parliamentary elections in June 2005 have to be carried out in accordance with international standards.

On **Bosnia and Herzegovina** the Commission last year presented a report on the feasibility of Bosnia negotiating, concluding and implementing an SAA. We then identified 16 priority reform areas where we need to see significant progress before it would make any sense to recommend to the Council the opening of negotiations. Progress has been made in terms of legislation. However, this needs to be backed up with solid implementation and there are still shortcomings. The Commission supports the introduction of VAT in Bosnia. This, combined with customs reform, should make a significant contribution to meeting the state's financial

requirements. Bosnia and Herzegovina must become a viable, administrable and, last but not least, an affordable state. Constitutional reforms beyond Dayton are necessary for the country to be able to manage closer relations with the EU.

We have concluded an SAA with **Croatia**. Croatia was granted status as a candidate country in June of this year. A few weeks ago, the Commission therefore presented a proposal for a pre-accession strategy for Croatia. This means that we will start issuing Regular Reports on Croatia next year, that Croatia should benefit from all three pre-accession financial instruments from 2005 and be able to participate in Community programmes. The same criteria apply to Croatia as to all other candidates – the 1993 Copenhagen criteria. If we can start accession negotiations in early 2005, as scheduled, will depend on Croatia's readiness to fully cooperate with the Hague Tribunal. Croatia will remain in the Stabilisation and Association Process and must also fulfil its obligations under the SAA, for example in terms of regional cooperation and other international obligations (such as cooperation with ICTY). The functioning of the judiciary is one of our main concerns as regards Croatia; it negatively affects the country's economic development. Property restitution is another issue which needs to be resolved.

After the entry into force of an SAA last spring, the next step for the **former Yugoslav Republic of Macedonia** on the ladder towards membership is the Commission's Opinion on its application for membership. Before we can express our Opinion, we need fYRoM's replies to the Commission's Questionnaire, which we expect to get sometime early next year. The timetable will depend on political and economic reforms and overall developments in the country. Reform of the public administration, reducing the number of municipalities and transferring various competences from State to local level is one essential element in this context and is a key part of the Ohrid Framework Agreement. It is absolutely essential that the Framework Agreement is implemented and thus internal stability is maintained. As far as economic development is concerned, the privatisation process and the elimination of loss making companies are almost completed. The crisis in 2001 interrupted economic development. The perception of instability, corruption and red tape is negatively affecting much needed Foreign Direct Investment. A protectionist attitude – as illustrated in the petroleum industry (OKTA case) – has been another problem. It led to an early infringement by the country of the Interim Agreement on trade between EU and fYRoM – a good lesson that signed agreements must be respected.

For **Serbia and Montenegro** the Commission recently proposed a new approach, the so called “twin track approach” as a way to re-energise our relations with the state. We need to press this country to move forward. The new approach will in time lead to a single Stabilisation and Association Agreement with Serbia and Montenegro, with two annexes negotiated with the republics covering those policy areas which fall under republican competence. The issues for the state level are political cooperation, compliance with international obligations (in particular cooperation with ICTY), respect for human and minority rights and regional cooperation and the issues to be negotiated with the constituent republics would be trade and customs, economic issues and sectoral policies like agriculture, the police and judiciary. All within the framework of one single SAA for the state. Since all our interlocutors have explicitly agreed on this approach, the Commission has re-launched the Feasibility Study for an SAA with Serbia and Montenegro. We hope to publish it early next year. This should bring the country out of its isolation.

2005 will be a crucial year for **Kosovo**. The new Provisional Institutions of Self-Government (PISG) elected last month will begin work, more competencies and responsibilities will be transferred to them from the United Nations Mission in Kosovo (UNMIK). Progress in Standards implementation will be reviewed with a view to a decision on whether the process to define Kosovo’s future status could start and UNMIK will probably be restructured as a result of all these developments. Particular economic problems include privatisation, which is made even more difficult by the unclear status, and the need for UNMIK/PISG to develop a comprehensive economic strategy.

Could we do more, should we do things differently or do different things?

Despite the enormous challenges still remaining for the region, I believe we have got things right and we can take some credit for progress achieved to date. The enlargement methodology has proven to be the right approach. The reorganisation of the new Commission with my own Directorate moving to DG Enlargement will allow us better to deal with the region of South East Europe as a whole rather than dividing it between candidate countries, and the Western Balkans. This is particularly appropriate when we deal with economic issues.

Our funds are significant but, as with all donors, nevertheless limited and we do have to focus on what we do best.

We are not the only economic players in the region – the World Bank, the IMF, the Stability Pact, our Member States and the USA are also active there, to mention only some of them. We need to further enhance coordination to avoid conflicting advice and work on a consistent strategy.

We all want the same for the Western Balkans - we want to see them as prosperous, democratic, fully functioning countries and market economies, on the road towards EU membership. Therefore, we carefully listen to the many ideas which are put forward to us, for example by excellent think tanks. We particularly welcome concrete and realistic proposals on what more we could do for the economic development of the region.

Help us get this right. Help us find appropriate answers to the following questions:

- Why do the countries not manage to fully benefit from our trade concessions? How can we help the countries to better understand the concepts of free trade and single economic space in the region?
- The countries all being very small, how could we increase their attractiveness to potential foreign investors? How can we help them think not in terms of their own markets, but rather as part of a region and a regional market?
- What is the basic level of security and stabilisation needed to make the economies “take off”?
- What is the required level of “good governance” needed for domestic stability as a basis for sound economic development?
- What do the grey economy, organised crime and corruption negatively affect the region’s economic development and what can we do against it?

Today, we still talk too much about minimum standards and requirements. As the countries make progress towards the EU, this will not be enough; the rationale will become one of preparing them to be able to function successfully as future Member States of the EU – to be able to apply its laws, to implement and to benefit from its policies.