Market Liberalization in the Countries of South-Eastern Europe

An Instrument of Security and Improvement of Investment Opportunities

Dr. Richard Temsch, OSCE Seminar on Economic Aspects of Security, Trieste, 2 October 2003

After going through a high intensity conflict and achieving piece, a country or province has to go through numerous steps to regain stability and rebuild its economy. Only after security for the people has been provided and the rule of law has been established, the economy can start to grow. Sustainable economic growth is a prerequisite for employment and subsequent poverty reduction. Poverty reduction is crucial for political stability. In certain regions of the Balkans over 50% of the population live in poverty and over 20% in extreme poverty, which means they have to survive on $2 per day or less. Prosperity is a vague dream for all but a very few.

The key ingredients of the recipe for creating a stable and prosperous democracy include institution building, infrastructure rebuilding, private sector development, vocational training and education, sustainable industrial development, along with social and political evolution.

The elements of a post-crisis society, who need urgent help, are people with no or low income, such as children, retirees, the unemployed, the homeless; small entrepreneurs, who start up or rebuild their businesses; schools, hospitals and the independent media; many public sector institutions, such as courts, police, tax and customs authorities.

The former communist countries of Eastern and South-eastern Europe were characterized by a command economy. The command economy of former Yugoslavia was more flexible than the economies of the USSR and the COMECON countries in general, but large parts of former Yugoslavia went to a lengthy war situation, which killed hundreds of thousands and destroyed most residential and industrial property in the afflicted areas. Refugees left their homes in large numbers and arable land was rendered useless by landmines. Tourism was annihilated as a source of income.

The Eastern European countries, which did not suffer from armed conflict, have been going through a difficult, but peaceful transition on their way towards market economy. Some of them have progressed remarkably fast and will access the European Union in less than a year from now. Bosnia and Herzegovina and the province of Kosovo passed through a war economy, then a post-war economy and are now transiting towards a peace economy that should eventually evolve into a functioning market economy, too.

A war economy is characterized by the collapse of production and services, extreme deficiency of basic supplies, destruction or seizure of property, severe market distortion and black markets, hyperinflation, breakdown of infrastructure, dysfunction of the legal system, usurpation and profiteering. The employment situation depends on the stage of the war. In the beginning there may be a labor shortage as a result of workers turning into fighters and increased military production. Later, when the industries do not produce any longer, unemployment rises fast.

When the war is over, the economy is in shambles. Before a functioning government is taking charge, political instability and legal and fiscal uncertainty deter investors. Black and gray markets, which have developed during the war or already earlier in the communist era, continue to flourish. Warlords and former political bigwigs, who still have the connections, become richer and the rest of the population suffers from poverty. The middle class has virtually vanished. Inflation soars and capital migrates to safer places.

A shadow economy unfolds in many facets: trade of goods (smuggling of cigarettes, alcohol and other merchandise, drug and human trafficking), services (moonlighting, unlicensed labor, selling illegal favors, abuse of office, prostitution), manufacturing (pirated CDs, DVDs and software, fake brand name items) and banking (usury, money laundering).

The shadow economy does contribute to economic growth, but it causes many problems: rise in crime, inequality, loss of tax and customs revenues, health threats, human suffering, deterrence of investment capital. Therefore, the government ought to curb the gray and black economy and create and enforce rules that would guarantee a level playing field for entrepreneurs, a transparent and accessible market for consumers and revenues for the treasury. This can be done best by liberalizing markets in order to eliminate or reduce the need for a shadow economy.

Market liberalization is not just liberalization of trade. Different types of markets, such as

- Goods - industrial, consumer, agricultural
- Money - currency, stocks, bonds
- Labor - manufacturing, trade, services
- Energy - electricity, heat, gasoline
- Information - Telecom, Internet, media

are subject to different liberalization options:

Domestically, deregulating/re-regulating

- Monopolies and competition
- Ownership of land and means of production
- Permits and licenses
- Banking and currency transactions
- Labor laws and business hours
- Collection and distribution of information

Internationally, granting free(r) movement across borders of

- Capital
- Goods
- People
- Information

Liberalizing the market for agricultural goods, e.g., is a most difficult endeavor and has caused fierce arguments over decades within the EU and between the EU and the US. Currency markets were strictly controlled by the Communists (and triggered black money changing at rates typically five times under the official rate). Now they are widely liberalized throughout the CEE and SEE area. Liberalization measures for labor markets are hot discussion items in all EU countries and certainly also in the transition economies, because the trade unions generally oppose them. In the former communist countries energy was commonly subsidized and therefore cheap for the consumer. Liberalizing electricity prices causes hardship for the poor and is politically hazardous. Totalitarian regimes have tried to control and minimize public access to information, while they were gathering as much information as possible on their citizens. Liberalization of access to and distribution of information has been at the core of political change in the former Communist part of Europe. The right to free migration across borders has been a key consideration in the EU's selection of accession candidates.

Since liberalization and deregulation of markets must be accomplished in an orderly manner to avoid failure and chaos, most command economies have followed this pattern:

Abolition of central planning ⇒ Corporatization of enterprises ⇒ Commercialization ⇒ Privatization ⇒ Protected competition ⇒ Open markets ⇒ Global integration

For the same reason, deregulation must be accompanied by harmonization of

- Standards for safety, compatibility, quality, environment, etc.
- Taxes, e.g., VAT, corporate income tax, personal income tax
- Laws (the EU's acquis communautaire is an example for this concept)

Economic integration is the objective of international trade liberalization and harmonization. Depending on the size of the economic space envisaged, there are different categories:

- Regional – EFTA, CEFTA, Stability Pact MOU, bilateral Free Trade Agreements (FTA)
- Continental - European Union, NAFTA
- Global - WTO

Some examples for economic integration efforts in SEE/CEE:

CEE

- Bulgaria, Romania and Slovenia are CEFTA members
- Croatia and Turkey have FTAs with CZ, SLO, H and PL
- S&M and Hungary have an FTA since 2002 (fully in force 2006)

CIS

- Moldova and S&M have FTAs with Russia

EFTA

- Bulgaria, Croatia, FYROM, Romania, Turkey have FTAs with EFTA

EU

- Greece is a EU member, Turkey has a customs union with the EU
- Bulgaria, Romania, Slovenia have Europe Agreements (EA)

  Includes duty free trade with industrial goods
- FYROM, Croatia have Stabilization & Association Agreements (SAA)
- Albania's industrial products are duty free in EU, SAA is planned
- BiH can export duty free to EU till 2005, no quantitative restrictions

WTO

- Albania, Bulgaria, Croatia, FYROM, Greece, Moldova, Romania, Slovenia, Turkey are WTO members

- BiH and S&M are observers

CEFTA, SECI and the Stability Pact MOU are three of the most important free trade initiatives in SEE and will be discussed here in some more detail.

CEFTA Central European Free Trade Association

One of the objectives for founding CEFTA was to prepare its members for EU accession. It has currently 8 member states, which joined in the following order:

1992	Hungary, Czech Republic, Slovakia, Poland
1996	Slovenia
1997	Romania
1999	Bulgaria
2003	Croatia

The admission of Serbia and Montenegro is envisaged under the precondition of trade liberalization.

Since 2001 the trade among members with almost all manufactured goods is duty free. CEFTA has been less successful in liberalizing the trade with agricultural produce. Most agricultural tariffs and quotas are still in place.

SECI Southeast European Cooperative Initiative

Based on the "Points of Common EU-US Understanding" SECI had its inaugural meeting in Geneva on 5 – 6 December, 1996. The following countries are currently members of SECI:

Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Greece, Hungary, Moldova, Romania, Slovenia, FYROM, Turkey, FRY (as of December 2000)

Some of SECI's guiding principles are

- Enhancing stability by economic and environmental cooperation
- Complementing, not duplicating, other initiatives in the region
- Leaving the initiative to the participating countries
- Participants select a high-level SECI coordinator
- IFIs, EU and U.S. may participate in SECI projects
- SECI is not a base for requesting additional EU or US funding

Dr. Erhard Busek, Coordinator of the Stability Pact for SEE, is also the Coordinator of SECI.

Stability Pact for SEE, Memorandum of Understanding of 27 June 2001

The highlights of the MOU are

- Forming a network of Free Trade Agreements for goods
- Complying with WTO and EU rules
- Abolishing export duties

- Abolishing import duties for at least 90% of trade
- Abolishing import and export quotas
- Simplifying customs procedures and harmonizing with the EU
- Harmonizing trade statistics
- Foreseeing future liberalization of trade in services
- Harmonizing standards, regulations, accreditation systems
- Enhancing quality control for production processes
- Harmonizing company law, taxes, banking law with EU
- Harmonizing competition law with EU
- Upgrading intellectual property protection to WTO standards
- Liberalizing trade with the rest of the world
- Progress review by Stability Pact Working Group
- Facilitating WTO accession of BIH, FRY (now S&M), FYROM
- Seeking international technical and financial support for the a.m. activities

MOU Implementation: FTA Network as of 4 March 2003

	BiH	Bulgaria	Croatia	FYROM	S&M	Rumania
Albania	initialed	signed	signed	signed	initialed	signed
BiH		initialed	signed	signed	signed	initialed
Bulgaria			CEFTA	signed	initialed	CEFTA
Croatia				signed	signed	CEFTA
FYROM					signed	signed
S&M						initialed

Source: Stability Pact

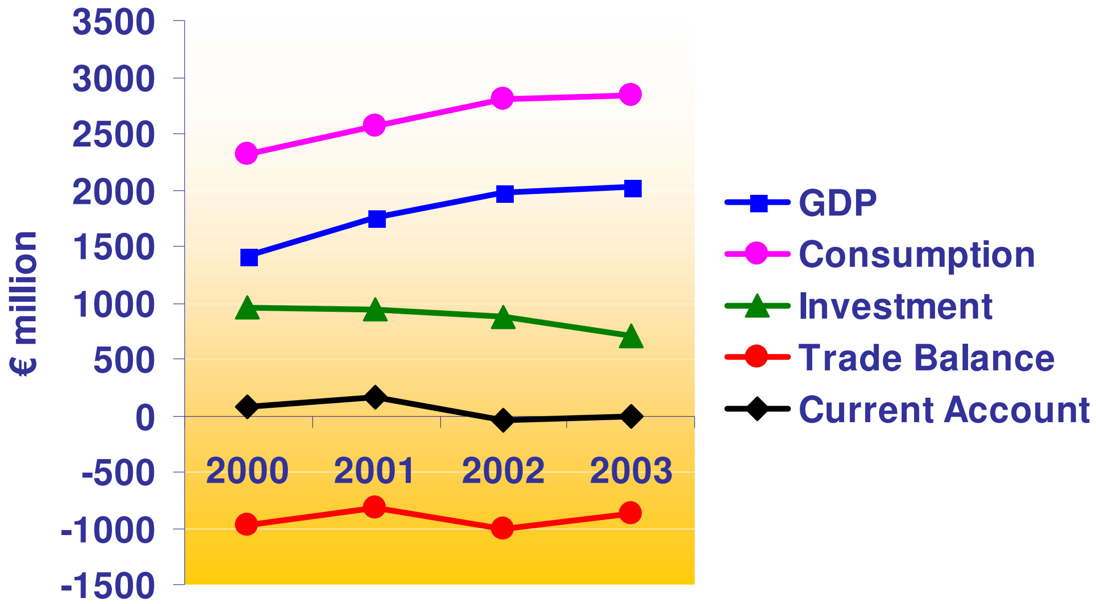
GDP in the Balkans

The per capita GDP in the Balkans varies strongly among the different countries, entities and provinces. Slovenia is at the top and the province of Kosovo at the bottom of this scale. The difference is in the order of one to ten.

	GDP € billion	GDP per capita	GDP pc ppp*
Slovenia	22.4	€11,208	$18,530
Croatia	23.8	€5,368	$10,030
BiH	5.6	€1,475	$6,400
FYROM	3.9	€1,925	$6,520
S&M	14.0	€1,679	$4,500
Kosovo	2.0	€900	$2,700

*per capita purchasing power parity *Source: WIIW Database, Figures for 2002*

It is surprising that in some areas of the Balkans private consumption is higher than GDP. This is the case in Bosnia, were private consumption was 110% of GDP in 2002, and in the province of Kosovo (see chart below). Countries outside of Europe with private consumption at 100% or more of GDP include Eritrea (132%), Haiti (100%) and Lesotho (101%). The world average is 61%, according to WDI 2002.



Source: WIIW 01/2003 Kosovo Selected Indicators

GDP is often described as the sum of private consumption C, private investment I, government spending G and net exports (exports X minus imports M) NX:

$$GDP = C + I + G + NX = C + I + G + X - M$$

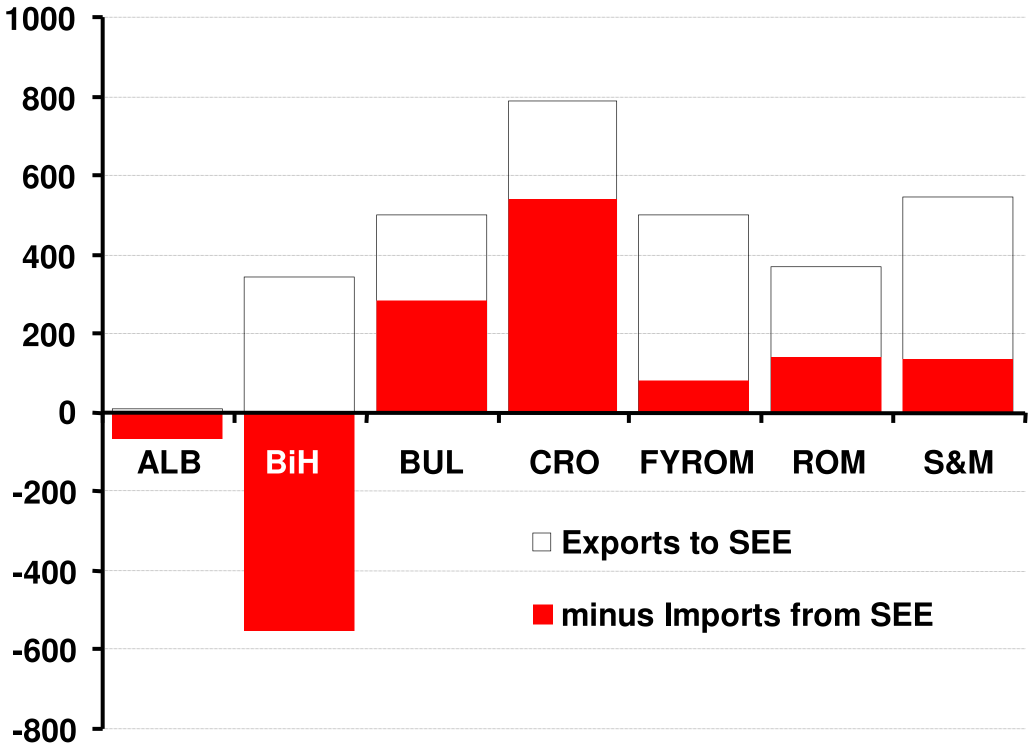
If C is greater than GDP, this means that imports M are greater than I, G and X combined. The result is a huge trade imbalance, which entails several adverse consequences. Firstly, imports are often more expensive than domestically manufactured goods. Secondly, there is no value added in the country and no employment created. Most critically, however, paying for imports depletes the country's currency reserves. They have to be either replenished by donations or by foreign loans, which cost interest and make the imports even more expensive. These effects can be typically observed in poor developing countries:

• Donations bounce back to donor countries as value creation in recipient countries is low

• Poor countries pay higher prices than rich countries for many goods and services

Does intra-regional trade contribute to GDPs?

Comparing the exports and imports of the SEE-7 within the region shows that five of them have a trade surplus and two (Albania and BiH) are net importers. While it is obvious that positive net exports add to the GDPs of the countries with a surplus, the countries with a negative trade balance suffer from the opposite effect.



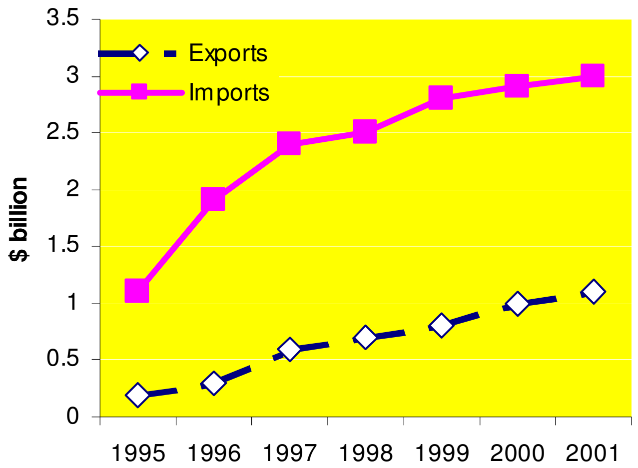
Source WIIW Database 2003 and national statistics

It has been stated by some analysts that intra-regional trade would have very little direct impact on the economic growth of the regional, but only significant indirect effects, such as harmonized regulations, increased security, better infrastructure and a larger economic space. This conclusion is derived from the fact that the total sum of net exports (NX) within the region is a very small number in comparison to the combined GDPs of the countries and therefore would not much augment the sum of GDPs.

This concept is misleading, because intra-regional trade is a zero-sum game. Exports and imports compensate one another, and it is only due to statistical imperfections that the combined NX is not zero. However, while the NX contribution to the gross regional product ($GRP = \Sigma\ GDP_n$) from trade within the region is nil, the contribution to the other GRP components C, G and I is significant. In other words, if the region is viewed as one economic space, then intra-regional trade becomes domestic trade, and increased domestic trade expands the economy without net exports involved.

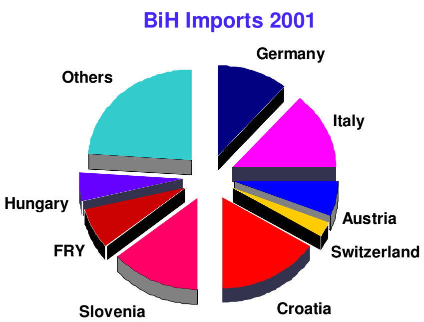
BiH Exports and Imports

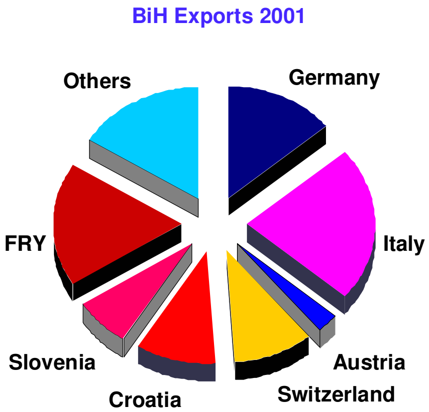
Both imports and exports of BiH have increased over the years after the end of the war, but the gap is narrowing too slowly. Presently, imports are still three times of exports in value.



Source: BiH Ministry of Foreign Trade and Economic Relations

It is remarkable that 42% of BiH's imports come from Croatia, Hungary, Serbia & Montenegro and Slovenia, while 35% of its exports go to Croatia, Serbia & Montenegro and Slovenia. This shows the importance of trade with other SEE countries. The significance of trade with the EU is characterized by 31% of the imports coming from Austria, Germany and Italy and 39% of the exports going to the same three countries. Italy and S&M are BiH's largest markets, accounting for 40% of its exports.





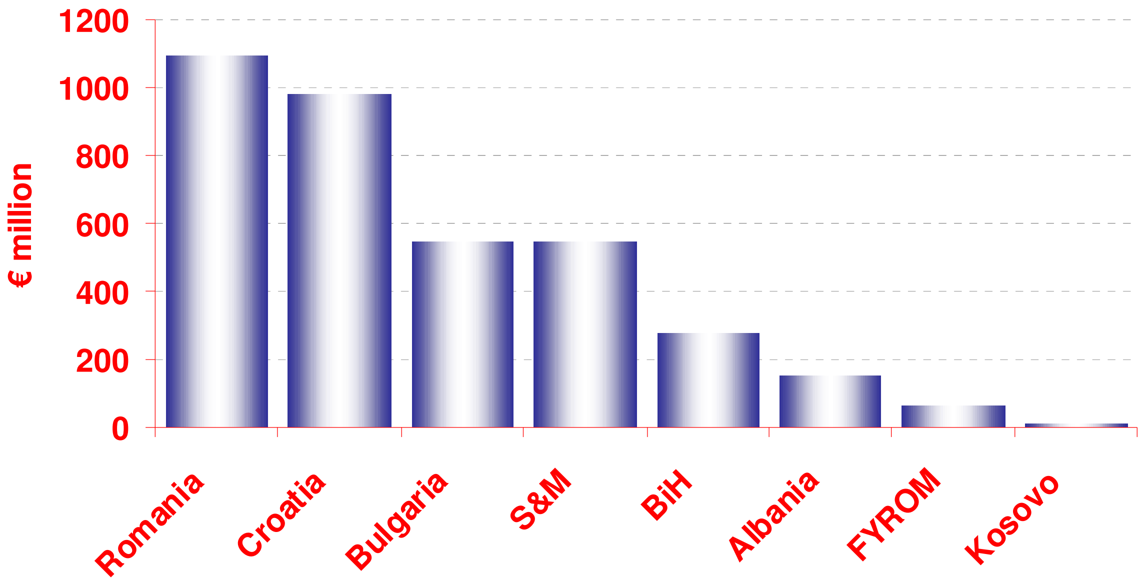
Source: BiH Ministry of Foreign Trade and Economic Relations

Foreign Direct Investment

Worldwide FDI rose sharply between 1996 from $400 billion to $1.5 trillion at its peak in 2000. In the following year its collapsed to about half of this value, namely $752 billion. However, this rise and fall took place mainly in the industrialized countries and hardly touched the developing countries, where it has been hovering at some $200 billion between 1996 and 2000 (up from less than $100 billion in 1993) and Central and Eastern Europe, which has shown a rather flat line over a decade approaching the $25 billion mark.

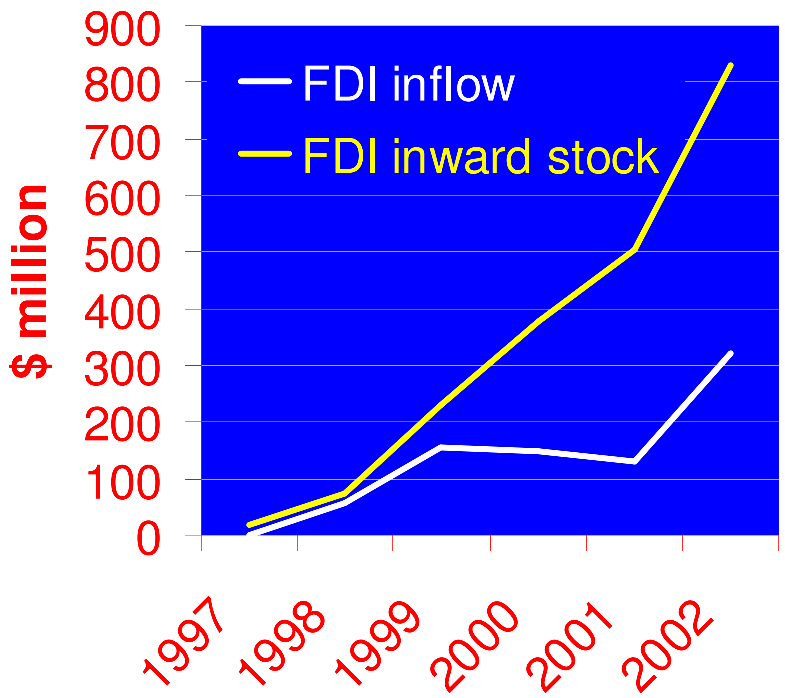
South-eastern Europe has received only about $3.6 billion FDI in 2001, out of which $2.6 billion went to Romania, Croatia and Bulgaria. The remaining $1 billion was shared between FRY, BiH, Albania, and FYROM. In this order, each of the latter three countries got about half of the amount the country mentioned before it received (from FRY with $550 million to FYROM with $67 million).

FDI Inflow 2002



Stability Pact Investment Compact and OECD, March 2003

Bosnia's FDI inflow has doubled within the year 2002 to over $300 million and the FDI inward stock has reached $800 million.



Source: UNCTAD Database

What Drives Investors?

Investment seekers are driven by many obvious motives, such as building manufacturing capacities to reduce imports and boost exports, augmenting their currency reserves, creating jobs, raising quality standards, acquiring new technologies, receiving vocational training, etc.

It is more challenging to explain what drives investors to risk their money in one country rather than in another. The international consulting firm KPMG conducted in 2002 a survey in Bulgaria among top management personnel of major foreign enterprises, asking them about the principal factors for approving current and future investments in Bulgaria. Ranked by the number of votes, the main factors were

59%	Stable political environment
47%	EU membership prospects
46%	Skilled labor
39%	Positive regulatory environment
38%	Tax incentives

The proven success of some CEE countries in attracting FDI confirms these results. The Czech Republic, Hungary, Poland and Slovenia are typical examples. They are stable and have a functioning and relatively supportive regulatory environment, a skilled workforce and will be EU members soon.

In a nutshell, these are the main preconditions for attraction investment:

Political stability	Peace and security Democracy

Rule of law	Protection from extortion and other abuse of office Protection from crime Independent law enforcement and judges
Clearly defined property rights	Investment protection Intellectual property rights Landownership
Fiscal accountability	Transparency Continuity Fairness Efficacy

Stability is the most important, because most investors are very cautious and not gamblers. They do not want to put their money at unreasonable risk, even not for high potential profits.

A positive regulatory environment provides protection from extortion by bureaucrats and mafia, and from fraud and other crimes. It ensures consistent laws and taxes, as well as transparency and cooperation of government authorities.

The high rating of EU membership prospects in the survey shows the importance of free trade to investors.

Tax incentives are always welcome, but without the other elements in place they will not attract substantial investment. In an unstable environment they can be revoked easily, and if the laws are not clear, they may encourage corruption of and extortion by the officials who approve the incentives. Experience suggests that among different types of incentives some work better than others, e.g., accelerated depreciation of investments has been generally more beneficial than tax holidays. Removing tax disincentives can be even more important than granting incentives: a high payroll tax may cause investors to employ fewer staff or avoid a country altogether.

The Investment Guide for SEE 2003 (www.seerope.net) compares tax regulations in different countries:

	Corporate Rate	VAT	Double Tax Treaties
Albania	25%	20%	16
BiH	FBH 30/RS 10%	n.a.	1
Bulgaria	23.5%	20%	51
Croatia	20%	22%	30
FYROM	15%	19/5%	23
Rumania	25%	19	67
S & M	20%	n.a.	20

Foreign Direct Investment and Transnational Corporations

TNCs are by far the biggest contributors of FDI worldwide. They take much blame from anti-globalization activists, but it is important to understand that they provide much more than investment capital to developing and transition economies:

- Innovation and technology transfer

- Higher quality and environmental standards
- Manufacturing and marketing skills
- Managerial know-how
- Access to new markets
- Information and communication infrastructure
- Participation in global production systems and value chains
- Integration in regional or global distribution networks

Without attracting FDI from TNCs it is hardly possible for a transition country to cut the learning curve and to find the money to advance its economy in a reasonably short period of time.

Summary - The Effects of Market Liberalization

South-eastern Europe is in every aspect a very diverse and heterogeneous territory. Every country has to be treated individually and there are no universal remedies, which will work the same way in every part of SEE. However, the SEE countries have also many features, traditions and challenges in common. Building on this common ground, market liberalization can bring economic growth and a better standard of living to all nations of South-eastern Europe:

- Accelerated economic growth in all SEE countries
- Increased regional security
- Harmonized standards, taxes and laws
- Higher quality of goods and services
- Improved transport and communications infrastructure
- Environmentally sustainable development across the region
- Better integration with EU and global economies
- Minimization of trade, manufacturing and financing costs
- Level playing field for competitors
- Better protection from organized crime and political cronyism
- More choice and transparency for consumers
- Single market of over 55 million people, attractive for foreign and domestic investors
- More and higher paying jobs, poverty reduction and a growing middle class

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