# Business in the Balkans

**Reconstruction policies and private sector investment**

Conference Report

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by

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## Introduction

More than 200 participants attended the second one-day international conference dedicated to stimulating much-needed economic activity and fighting the investment battle in the Balkans. The conference, **Business in the Balkans: Reconstruction policies and private sector investment**, was presented by the Konrad-Adenauer-Stiftung, the Stability Pact, the World Bank, the Business Humanitarian Forum, EurActiv.com and *Humanitarian Affairs Review* and organised by Forum Europe.

The conference took place against the backdrop of potential war in Macedonia and the June 27$^{th}$ signing of the milestone Memorandum of Understanding for the Balkans, an agreement that commits countries in the region to liberalise and facilitate trade as well as work together to build a secure and promising environment for investment.

The post conflict rehabilitation phase in the region has been difficult and fraught with disappointment. Many participants pointed out that the Stability Pact had not lived up to expectations. However, others dismissed the notion of quick fix solutions and pointed to the building blocks of stability that are slowly being put into place. Several participants noted that peace and economic prosperity go hand in hand and one is unachievable without the other.

The spectre of conflict in Macedonia underscored the need for the international community to move quickly to rebuild the economy in the region. Luring business interest to the region is no easy task, despite the success stories of companies such as Solvay and Puratos. Corruption is rife, and as several participants pointed out, the rule of law is still being established. The banking system is questionable and there are myriad barriers to FDI.

At the same time, the success stories bespeak of local business people who are resourceful and energetic and a hardworking, skilled labour force. There are abundant resources in mining, manufacturing and agriculture. Commerzbank and Deutsche Bank emphasise they are committed to the long term in the Balkans.

In his welcoming address, **Franz-Josef Reuter**, Director of the Konrad-Adenauer-Stiftung European Office, Brussels, urged participants to roll up their sleeves and get down to work to determine what policy measures are needed to stimulate private investment and accelerate reconstruction.

“You represent an important cross-section of decision makers in both the public and private sectors,” he said. “It is time to figure out what will stimulate investment now, not tomorrow.”

The 26 June date of the conference was deliberately chosen, he added, so that participants could prepare their recommendation in time for the regional conference taking place in Bucharest 25 and 26 October.

“We must also follow up and update our progress since last year,” he concluded. “There has been a lot of progress made in the region, but there is still much work to do.”

Participants discussed and debated how best to regain investors’ confidence, attract corporate newcomers and kick-start intra-Balkan trade. A wide range of radical and instant changes was discussed. However, at the end of the day, participants agreed that an approach balancing ambition and realism is the way forward and that governments must seriously tackle red tape and corruption in addition to providing incentives. They agreed that Europe has a particular responsibility to ensure the Balkan countries find a path towards reform that will also lead them to create the economic and political conditions necessary for EU membership.

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## Opening addresses

### “Time to mobilise private investment”

**Donald Kursch**, Deputy Special Coordinator, Stability Pact for South Eastern Europe

The international community’s goal over the next few months must be to encourage private sector investment in the Balkans. There can be no peace without economic stability and no economic stability without peace, Donald Kursch told participants.

“Our task is to advance stability through promoting development and reform, which will in turn strengthen democracy,” he said.

Experience has shown that because public resources have limited impact, it is time to encourage and protect private investment in the region. First, private investment must be mobilised.

“Our intent is to lobby business to take a very close look at the possibilities,” Kursch added.

Two years after the establishment of the Stability Pact, much has been accomplished – there has been measurable economic growth, foreign direct investment is rising and confidence is building as the governments try to fight crime and corruption.

Regional cooperation is strengthening and the signing of the Memorandum of Understanding on Free Trade in the Balkans, which took place in Brussels the day following the conference, is a “very positive achievement” that sends a clear signal that the governments are committed to building an environment to promote free trade and investment. The Stability Pact is working and the reconstruction of the Balkans is on track.

At the same time, there have been “truly remarkable” political changes in the region. For example, Croatia has elected a pro-European government and today, Yugoslavia is “one of the Pact's closest and most enthusiastic” partners.

“We can be optimistic, despite the serious problems we are facing, such as current events in Macedonia, that demonstrate the fragility of the region’s institutions,” Kursch told participants. “But we must be careful. Quick fix solutions cannot resolve long standing problems.”

The Stability Pact is a case in point, with many actors believing it would bring “instant prosperity out of the sky”, however, this is not a realistic expectation. Nonetheless, 201 out of 244 or about 81% of the “quick start” projects funded by the first regional donors conference in March 2000 have begun. This in itself is a promising sign.

The regional conference planned for October 25 and 26 in Bucharest is a key event. In addition to demonstrating the continued commitment of the donor community to the region we also hope it will promote private investment by highlighting best practices. Investment in the region is up, but the overall levels are still far too low.

“These gaps must be closed,” he concluded. “Much has been accomplished, but much more needs to be done.”

## "We cannot escape our collective responsibility"

Ambassador **Jacques Klein**, Special Representative of the Secretary General & Coordinator of the UN operations in Bosnia and Herzegovina

The last decade was a time of great turbulence in the region, characterised by conflict, civil war and external aggression. Globally, the IT revolution has swept the economic landscape, opening greater avenues for prosperity, although they are uneven. During this time, the international community has focused on peace building, the results of which have been realised in the former Yugoslavia. The new century is opening with peaceful settlements in the region.

"The Former Yugoslavia has been a major testing ground and finally, the ultra-nationalist regimes have been effectively dismembered," Ambassador Klein told participants. "In five years of war the economy was decimated. If it were not for Milosevic, Yugoslavia would have been first in line for EU accession."

New states are like orphans growing up on an "ideological and religious fault line", which is why they need a welcoming European home. If they are left outside, they risk becoming victims of nationalist leaders.

"Just as we cannot escape our collective responsibility, neither can we escape their need for economic tools," he said.

Countries in the region are undergoing a double transition – from war to durable peace and from centrally planned to market economies. The prognosis is clear in that they are near the bottom rung of development. It is up to the business and investment communities to provide the economic underpinning for success. In this way, they can share in the peace dividend.

There is much cause for optimism. Klein pointed to the following developments:

?? There has been a "quantum leap" in inter-regional relations.
?? Constructive bilateral relations are ongoing.
?? Regional security cooperation is reinforcing efforts to maintain stability.
?? Regional law enforcement cooperation is developing.
?? An Interpol office has been opened.
?? Bosnia Herzegovina, Croatia and Yugoslavia have signed an agreement that establishes measures to deal with cross border crimes.
?? The healing process has begun with the process of establishing truth and reconciliation commissions in Sarajevo and Belgrade.

These are "encouraging signs" of a return to normalcy and a strong indication that the people of the region want to live peacefully within Europe.

"We must persevere with our efforts," he said. "If we fail, it will sound the death knell and the rest of the Balkans will fail. A piecemeal approach will not work. A credible vision is needed."

It is time to move the region from the "yugo to the euro", which means, "We must articulate what we want the region to look like and how we can present a credible path for integration into Europe. There has been too much diffusion of this vision on the ground." Klein urged participants to reconsider the roles of the Stability Pact and of the European Union.

"It is critical to establish rule of law," he concluded. "Social progress will follow and give the people better standard of living within a larger freedom. We need to give them hope and the home in Europe they so much deserve."

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## Session I: What will regain investor's confidence?

The Balkan region still desperately lacks the substantial inflows of private capital needed to lay the foundation for economic reconstruction. Participants discussed how to create the economic and political stability needed to attract foreign investment as well as short- and longer-term measures. Fighting the investment battle is no easy task as governments and investors struggle to implement the radical – and instant – changes needed to spark investor confidence.

The Moderator, former US Ambassador **John Maresca**, who is the President of the Business Humanitarian Forum, urged participants to focus on how to create incentives because "investment is critical to economic reconstruction”. This will be no easy task as continuing instability and the possibility of recurring conflict plague the region. Dramatic events are unfolding in the Balkans, some with more positive effects than others.

"The success of economic reconstruction depends almost entirely on individual decisions made by the investors themselves," he emphasised.

**Besnik Fetai**, the Minister of Economy of the Republic of Macedonia, agreed there is much to be done. Progress requires a vision realised through a planned approach and permanence through undertaking concrete activities. The most immediate needs include stabilising economic trends and resolving humanitarian problems.

"These countries must soon find their path to a better future that will in turn bring new possibilities for integration in EU political and economic flows," he added.

Introducing "modernisation" to the Balkans and then helping move its citizens closer to Europe is exactly what international institutions are trying to accomplish, observed **Rory O'Sullivan**, the Special Representative of the Joint World Bank Group for South East Europe Reconstruction: "We want to move from the 'yugo' to the euro."

This is already happening, he told participants. Exciting changes are unfolding in Yugoslavia, which saw exports increase by 30 per cent last year. Trade with Croatia is now a possibility with the free movement of business people across the region. The basics are now in place.

Experience has shown that in the aftermath of war, people reflect about what they have done wrong. This experience of mankind is set out in the first sentence of the International Labour Organisation's (ILO) constitution, commented **Heribert Scharrenbroich**, the former ILO Regional Director for Europe and Central Asia.

"Universal and lasting peace can only be successful if it is based on social justice," he said. "This principle was tested during the Asian crises. The government's of the region did not invest in social conditions such as employment security and as a result the economies – and people – are still trying to recover."

Patience is what is needed, observed **Piet Steel**, the Public Affairs Director of Solvay and a Member of the Business Advisory Council, South East European Cooperative Initiative (SECI). The buccaneers seek to get rich quick while serious investors plan for a longer-term return. This could lead to conflict with shareholders. However, in business "contradiction is the norm" and this tension must be accepted.

"It is certainly not all smooth sailing in South East Europe at the moment," he added. "There are trouble spots that need to be watched, particularly Macedonia, Kosovo and Montenegro. But positive political changes such as the democratic toppling of Milosevic and the recent election in Bulgaria bode well for the future."

Serbia is the last country to enter the reform process, observed **Dusan Zivkovic**, the Director of the Investment and Export Promotion Agency, Republic of Serbia. But despite the "unfortunate loss of the past ten years" Serbia is fortunate in that it can learn from the reforms taking place in neighbouring countries.

Zivkovic, introduced by Maresca as "an example of the younger generation taking charge in Serbia", said the key elements for attracting investment can be identified through exploring the interlinkages between private investment and bilateral as well as multilateral assistance.

### Focus on immediate, short-term needs

The pace of change is accelerating across the region and while the long-term perspective must always remain in focus, participants agreed that there are immediate, short-term needs that must be attended to if the momentum is to continue in a positive direction.

Basic business relationships in the area are changing on a daily basis, O'Sullivan reported. This is stimulating movement of goods within the region, which is extremely important. The “get rich quick phase” is coming to an end, particularly with the abolition of the licensing system in Yugoslavia that made many people rich. (At one point, more than 700 different commodities required licenses to be traded.)

"We are seeing a positive move away from the buccaneer economy," he said. "People with enormous power are no longer taking from the system. The next phase of long-term investment is beginning."

Fetai added that "radical and instant changes" need to be made to the region's economic situation. The Stability Pact should be viewed as a challenge to investors to become a respected partner for reconstruction of the Balkans. Macedonia is prepared to become a platform for the region for investment from around the world.

"In the short to medium term, regional integration will provide a foundation for economic, technological, energy producing, cultural and other kinds of cooperation supported by multilateral programmes and agreements," he told participants. "This in turn will foster easier integration into European structures."

Also important is the emphasis on donor conferences, which provide a stimulus and accelerator for economic stability and regional development. Equally important is to focus on immediate, short-term needs if true development is to take root and grow.

Solvay's experience in Bulgaria has been a positive one, Steel pointed out. The company invested heavily in 1997 when the country was on the brink of major upheaval. Since then, "there have been big changes, particularly in the attitude of people and their willingness to open the economy". This experience underscores the need to work with local people at the outset to lay the foundation for long-term success.

Short-term measures must include creating an investment friendly environment through a Balkan Investment Charter whereby countries agree on concrete steps to attract national investment. A mix of policies
needs to be put in place to secure corporate governance, which will encourage joint ventures.

In Serbia, the government has in seven to eight months put into place measures to restore investor confidence to the detriment of the standard of living of the population, Zivkovic told participants. It is crucial to find the right balance between creating the right economic and institutional conditions and the discontent of the local population, which could in the medium term affect economic reform.

“Before moving from the yugo to the euro Serbia needs a car; we cannot walk to Brussels,” he said. " We need help in social areas and with our privatisation programme, which is one of the most ambitious seen in Europe over the past ten years."

Zivkovic agreed that Serbia and the Balkans must move very quickly with their reform systems: "In Serbia, the cornerstone of this reform process is privatisation. In four years, all companies must be privatised."

Investor confidence could be rebuilt if Serbia's debt burden is alleviated. What the region needs are a few key high-profile investors willing to come in now and grow their businesses. "This sends a clear signal that the region is ready for serious business," he added. "Repatriation of flight capital is also an important issue. People who moved funds abroad and then back to invest in their countries send a positive sign that reforms are on course."

Scharrenbroich emphasised that every effort should be made to minimise the trade off between economic and social investments. The ILO completed a study last year that showed why some OECD countries fared better than others in the area of unemployment; the successful countries are those that implemented social protection instruments built into sound macroeconomic and labour market policies strengthened by a mechanism for social dialogue.

"Employers and workers organisation should be strengthened and a mechanism put in place for such a dialogue," he said.

**Laying the foundation for stability**

Political and economic instability has been the common denominator of the region for more than a decade. The headline "Trouble in the Balkans" has become commonplace. This situation makes for confusing times as the prospect for peace and prosperity seems to dim every time there is a clash somewhere in the region. Despite the spectre of renewed ethnic slaughter and a new war in Macedonia, participants remained optimistic about the future.

Reaching a state of stability and economic viability will be no easy task, nonetheless, creating a stable macroeconomic environment with a low inflation rate and stabilisation of national currencies are goals being pursued in Macedonia and elsewhere in the region, Fetai told participants.

In this regard, Macedonia is an example of "successful reformation", which has admittedly deteriorated under the current war. From March until June, military expenditures have reached DM700 million, including direct and indirect damages. This inflicts long-term damage with the loss of confidence of foreign partners and the diminishing possibility to protect foreign investments.

Instability creates a vicious circle whereby business withholds investment until the situation becomes more stable, resulting in more problems for the Macedonian economy – "illiquidity" coupled by creditors postponing or cancelling payment. At the same time, obstacles are further created for domestic entrepreneurs, who face a military tax of .05 per cent on transactions from 1 July to the end of the year.

"The aim of the tax is to reduce the budget deficit resulting from increased costs of maintaining state security, but it is a hardship," he explained.

O'Sullivan said it is "striking to see what a terrible legacy has been left and what an enormous undertaking it is to turn around the economy and get it right". At the same time, however, the World Bank Group for South East Europe Reconstruction feels confident that with a certain amount of donor support, this situation can be turned around. Figures already show a positive trend.

Steel emphasised that without stability, there could be no investor confidence. Investors are not averse to assuming economic and financial risk, but political risks are "unpredictable and uncontrollable". Business and politics are two different worlds but they must interact and cooperate because they imply mutual obligations. Political stability cannot be decreed, it must result from the "right mix of policies" that must take place at the following levels:

?? *International*: it is important that Balkan countries have closer links and adhere to NATO to give them a sense of purpose and security.

?? *EU*: a rapprochement to the EU will instil respect for the rule of law. To this end, the EU has become a "major magnet" for democracy and economic reform in South East European countries.

?? *WTO*: membership will integrate the region into the global economy and the multilateral rule of law.

?? *Regional*: regional cooperation is extremely important. A "Balkans Without Borders" similar to the EU's Schengen Agreement must be implemented gradually.

Zivkovic pointed out that FDI in its most productive form will not come until major infrastructure projects and banking systems are in place. Many construction companies will only participate in tenders for projects if there are guaranteed funds from international organisations.

"Serbia needs donor assistance to provide an enabling environment with infrastructure and a basic standard of living for people," he added.

The key role of business in social policy was eliminated from the Stability Pact, Scharrenbroich reminded participants. However, the more recent Initiative for Social Cohesion "must be realised or the Stability Pact will lose a great opportunity". Sound economic growth goes hand in hand with social development.

O'Sullivan agreed and added that indicators for health and social security are still very good. In fact, it is "a miracle" that they have stood up - pensions are on track but the system is weak in social security. The challenge is the budget crunch as countries struggle to maintain current social expenditures while dealing with economic reforms.

"There is no golden bullet here," he added. "It is a horrible mess from an economic point of view. One third of our funds now go into the budget for social payments."

Participants discussed the issue of political conditionality as a pre-requisite to creating a stable investment climate. Steel pointed out that investors want profit and return on investment, which entails taking the long-term view. First considered is the strategic context for investment. Scharrenbroich argued that "the international community must take a firm stand; for example, war criminals must be brought to justice".

**Longer-term objectives**

Despite the need for immediate, short-term initiatives, the longer term must be kept in perspective if the region is to recover and not fall into war and chaos. The West is present and active in the region, cognisant of its failed efforts in the past. Peace-brokers are working at political level and NGOs, although their numbers are dwindling, are still present and active.

Steel pointed out that creating a "common economic space" for the region would constitute another important stepping stone towards the noble objective launched after the fall of the Berlin Wall – a Europe whole and free.

Zivkovic agreed but warned that there is a "long road ahead" before moving into these advanced policies. Tackling crime and corruption is particularly difficult and although steps can be taken in the short-term, it is a long-term objective.

Fetai said that the Memorandum of Understanding for the Balkans to be signed in Brussels the day after the conference is a positive step towards trade liberalisation and an important "move towards unifying the Balkans". Next steps include further liberalisation of legislation and harmonisation to EU regulations, removing trade barriers, putting into place mechanisms to guarantee equal treatment of investors, developing bilateral and multilateral agreements to protect foreign investors and recognition of international arbitrage.

"These measures will bring back peace and create internal stability," he concluded.

Steel added that it is important now to begin the longer-term task of strengthening the institutional and administrative capacity of the countries in the region.

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## Session II: What will attract corporate newcomers?

Participants discussed a wide range of options to attract corporate newcomers to the Balkans including incentives such as tax holidays capable of attracting Foreign Direct Investment, ambitious privatisation programmes, the potential of IT in the region and the role of micro-finance banking. They generally agreed that an approach balancing ambition and realism is the way forward and that governments must seriously tackle red tape and corruption in addition to providing incentives.

Moderator and Forum Europe President **Giles Merritt** asked participants to consider sectors and individual markets rather than talking about generalisations. He also asked whether CEE countries have a common investment strategy or is it "a set of dog eat dog beggar thy neighbour tactics". It is time to draw conclusion from what works and what does not.

Thousands of books, articles and consultancy reports have been written on the issue of supporting private investment and FDI in emerging markets and the transition economies, said **Reinhard Cluse**, an Economist with the Economic Research Department's Emerging Markets Unit at Commerzbank. Research shows the crucial ingredients of a good FDI policy include:

- ?? Peace and political stability.
- ?? A reliable legal and administrative framework and the effective implementation of laws and regulations into practice.
- ?? Privatisation and the quick clarification of unsolved property rights issues.
- ?? Stable macroeconomic conditions.
- ?? The absence of regulatory barriers to FDI.

"For export-oriented investors, additional factors of special importance are a liberal trade regime and good infrastructure," he told participants.

From the point of view of a commercial bank, the private ownership of land and the existence of cadastral offices that document the ownership of real estate in a reliable way are absolutely crucial. This is important because small and medium-sized enterprises often have no meaningful credit collateral to offer other than real estate.

In addition, strong and efficient banking supervision and transparent accounting principles are also crucial for commercial banking activities. "Where this is not in place, we, the foreign banks, have problems in assessing the credit-worthiness of our corresponding banks and corporate borrowers in the region. This greatly increases our risks," Cluse added.

**Boris Divjak**, the President of Transparency International, Bosnia Herzegovina, agreed that corruption is a "very serious" issue. There is a lack of transparency in too many areas. A World Bank study in Bosnia Herzegovina, the results of which generally apply across the region, showed that 98 per cent of respondents see corruption as a serious problem, 60 per cent believe that as a result the rich get richer and the poor get even poorer and that public trust in government is very low.

Another study by the Centre for the Study of Democracy found that corruption is a bigger problem than poverty. Respondents in Bosnia Herzegovina and Macedonia said it was a bigger problem than ethnic tensions and political instability.

"Corruption leads to poverty and not the other way around as many argue," he told participants.

Divjak added that the region has a weak business environment plagued by lack of financing, a poor fiscal system, monopolies caused by the state sector, corruption and an inefficient judiciary.

"These are the areas where action needs to be taken," he said. "By addressing these barriers simultaneously, the region will be able to move forward."

**Dumitru-Dan Ifrim**, the Head of Partinvest and Match Making Office at the Chamber of Commerce and Industry in Bucharest, Romania, said incentives for foreign investment and support for foreign investors are "critical", issues that Romania is dealing with by reducing red tape and providing investor information regarding the business environment and legislation. Other actions include legislation regarding repatriation of capital gains, direct investments and special incentives for SMEs.

Lessons can be learned from Bulgaria, commented **Bojidar Danev**, the Chairman and Executive President of the Bulgarian Industrial Association. Danev, who is also the Executive Director of Interlease and the Co-chairman of the EU-Bulgaria Joint Economic and Social Committee, pointed out that Bulgaria is "one of the more successful market economies in Eastern Europe."

It is a small country with political stability where banking reform is complete, resulting in a very healthy banking system. Inflation has been under control for four years. Bulgaria's WTO membership builds confidence and 87 per cent of products will be duty free to the EU until 2003.

"This is a brick for both economic and political stability," he said. "With free trade agreements with CEE countries, there is a potential market of 500 million consumers."

**Robert Cronin**, the Director of Partnerships and Training Division at the Washington D.C.-based International Research & Exchanges Board, pointed out that the complexity of the issues at macro level is "enormous":

?? The region is in the throes of transition from a socialist to capitalist market.
?? It is in transition to democratic government structures.
?? It is in the process of post-conflict stabilisation and nationalist tensions.
?? Infrastructure is being rebuilt.

"Information technologies is one of the sectors with the greatest potential for quick economic growth and benefits to democratisation and the development of civil society," he said. "Governments must create an enabling structure."

Governments must also work towards taking clear and practical steps to make legal and regulatory frameworks transparent so competition can take place.

"Regional linkages have been destroyed and the technology is not the most modern, but overall, the regional infrastructure for IT technologies is not in poor shape compared to other infrastructures damaged by fighting," Cronin noted. “The phone system and wiring, while not great overall, works and in some cases it is quite good.”

**Neven Mimica**, the Chief Negotiator of the Republic of Croatia for the Stabilisation and Association Agreement with the European Union, said FDI is critical to enabling sustainable growth because the region is in "double trouble" – transitional troubles and troubles of war. Special attention must be paid to encouraging FDI, but it would be preferable in the export sector.

"Horizontal measures should be used to achieve horizontal goals of sustainable development," he said. "It is proven that in transitional countries the most positive correlation exists between FDI and export growth."

In addition, yearly growth is proportionate to privatisation programmes. Mimica noted that when developing incentives it is important to focus on the three key factors that potential investors have in mind when determining credibility:

?? Political and environmental stability.
?? A satisfactory level of investment incentives.
?? Few administrative barriers.

**What can governments do?**

Participants discussed a wide range of incentives, including accelerating privatisation, reforming the banking sector and tightening up regulation of the commercial and legislative framework.

The Republic of Croatia has fast-tracked reform. Profit tax level has been reduced to 20 per cent, income tax has been reduced and improvements made to the pension system. Customs tariffs have been cut in half, there are 30 free trade agreements in place and the country is a member of the WTO and a NATO partner for peace. An association agreement has been negotiated with the EU and there are 50 investment promotion and protection agreements with other countries.

"Countries should be cautious with incentives, but most important is non-discrimination against foreigners," Mimica added. "A new state of mind is required regarding the real nature of foreign capital."

Dijvak said corrupt tax authorities and customs officials are "at the top of list" followed by local authorities and state and socially owned enterprises and banks. In some countries, inspection visits frequently consumed an estimated 36 per cent of managers' time. Bribes are commonplace; more than 89 per cent of companies are thought to pay bribes to get access to services they are legally entitled to. He added that governments should be careful with tax incentives, citing Bosnia Herzegovina grant to Volkswagen of tax incentives that all other foreign investors are now clamouring for.

Cluse noted that special foreign direct investment incentives have never had an influence on Commerzbank's activity in the region: "We regard our presence in Central and Eastern Europe as a long-term commitment. Our decisions are guided by strategic and fundamental considerations and we therefore do not shop around for special tax incentives."

"Government processes must be streamlined," Dijvak noted. "The co-registration process takes months. In Bosnia Herzegovina, there are some 11,000 laws governing the business environment. All reform must be transparent."

In addition, the IMF is not giving enough support to much needed fiscal reform and banking reform needs to take place. There is an urgent need for a public-private sector dialogue. "This is an important option so government can hear the voice of the business community to learn what needs to be done," he added.

Danev pointed out that Bulgaria has privatised its banking sector and telecommunications is underway. The different categories of investors require a different approach, but all investors require stability.

"Economic stability flows from political stability," he said. "There must also be stability in the overall legal framework as well as the country's taxation and accounting system."

Romania has also made considerable progress in investment incentives, Ifrim told participants. Foreign and local investment is treated equally and there is no restriction on the amount being invested. Government approval is only needed in projects dealing with national security or defence. The government recently passed a law on direct investment of amounts exceeding US$1 million:

?? Funds can be transferred abroad after the taxes are paid.
?? A percentage of the investment value is tax deductible.
?? Recovery of fiscal loss is possible over five years.
?? There are no custom duties on installation investment or raw materials.
?? There are no taxes on land.

A government policy to support SMEs includes special incentives such as a tax exception for creating new jobs and VAT and customs duties exemptions on installation equipment and costs. Free trade zones are being created and there is a five-year exemption on industrial parks. Local taxes have also been decreased.

"An important move forward is a new regulation that makes it possible to set up a business in 15 days using one registration form," he said.

Experience shows that putting the principles of a good FDI policy into practice is very difficult, warned Cluse. Above all, progress is often hampered by a lack of administrative and judicial capacities as well as powerful vested interests or corruption.

**Leveraging the potential of IT**

With a relatively solid infrastructure and cheap yet highly qualified labour forces, Balkan countries are well positioned to leverage this sector for quick progressive economic growth, Cronin told participants. Foreign companies have already demonstrated interest, including Cisco, Intel and Microsoft, that are offering training programmes and establishing their brand on the market.

To answer the question of what the government can do to facilitate FDI in IT, it is necessary to assume that IT penetration (of usage) and e-commerce follows GDP and general economic growth. FDI will come when there are real economic opportunities and when Balkan economies stabilise with fundamental economic growth. At the same time, there are a number of very basic very simple things that the government can do to promote growth in the IT sector, including:

?? Develop and promote a national strategy for development of the sector. This needs support at the highest levels.

- ?? Open up the markets to competition: privatisation does not equal competition. For example, it is easier to license and set up mobile phones, which is leading to networking growth.
- ?? The marketing of skilled labour to local and international firms is necessary to undercut the devastating potential for brain drain.
- ?? Eliminate or reduce local phone tariffs.
- ?? Transparency and simplicity of regulation and licensing procedures.
- ?? Legislation is needed to support e-signatures and electronic financial transactions.

"Governments have a pivotal role to play," he said. "Quick action will result in positive investment and economic growth. Without action, Balkans countries risk falling increasingly further behind. This is dangerous (and difficult to dig out of) in the ever-broadening international digital divide."

Danev agreed that IT is a promising sector. In Bulgaria, there were fewer than 100,000 cell phones in 1998 compared to 780,000 today. There were no Internet users in 1998 compared to 630,000 today and the government has adopted e-signature legislation, opening the door to e-commerce.

Mimica pointed out that countries showing the largest growth in exports are those that changed their focus to IT.

**Micro-finance banking – a solid business approach**

Cluse described Commerzbank's approach to the region, which began in 1990 with the establishment of closer contacts with local banks, mostly to increase trade-financing activities. In the second half of the 1990s, the bank opened representative offices, similar to the ones in Bucharest in 1997 and in Zagreb in 1998.

For a number of years, it has also increased cooperation with the International Financial Institutions active in the region. A good example of this is the founding of so-called micro-finance banks (in Kosovo, Bulgaria, Yugoslavia and Georgia) together with the EBRD, the IFC and the German Kreditanstalt für Wiederaufbau. The purpose of such banks is to extend credits to small and medium-sized enterprises in the region. The specific role of Commerzbank in this joint venture is to handle the international payments transactions arising from trade activities and the import of capital goods.

"We regard micro-finance banking as a very successful way of cooperating between the private and the public sector," he said. "In an environment such as the Balkans, where a stable and efficient banking sector is not yet fully established, micro-finance banking can make a very important contribution to the development of a vibrant private sector."

**The EU and "euro-isation"**

No doubt the introduction of the euro currency will have an impact on the region. The unilateral adoption of the DM in countries such as Bosnia has helped reduce inflation and supported the development of a payment system.

Cluse predicted that it will take several years for other countries to adopt the euro, but when they do, it will result in monetary stability and increased macroeconomic stability. There will be further convergence of interest rates and a concurrent positive signalling effect that will increase investor confidence and the level of FDI.

Danev pointed out that Bulgaria's currency is closely connected to the DM and the euro, which makes the economy more sensitive – 56 per cent of all exports go to EU countries. However, it would make sense to adopt the euro in the future.

Speaking from the floor, **Rory O'Sullivan** of the Joint World Bank Group noted that private banks are moving into the region to take advantage of opportunities about to appear because of the euro.

**Guenther Fehlinger**, General Secretary of the SME Union, European Parliament, observed that the EU has acted "too slowly and has not supported the positive signs" in the region. The fact that Croatia is not yet a candidate for enlargement "is a bad signal". In addition, there has not been enough investment in SMEs.

Danev added that the way forward for Balkan countries is to start negotiations now for full EU membership.

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## Session III: How can we kick-start intra-Balkan trade?

A fundamental problem that dissuades many would-be investors in the region is the absence of trading opportunities, political and economic instability and pervasive corruption. A very positive political achievement is the signing of the Memorandum of Understanding (MOU) for the Balkans, which took place in Brussels the day following the conference.

MOU signatories committed to liberalising and facilitating trade in the region, which sends a clear signal to the rest of the world that it is ready to work together to build a secure and promising environment for investment. Just one year ago, in Zagreb, the signatories together with the Heads of EU member states, European Commission President Romano Prodi and Secretary General Javier Solana, drew up a roadmap to define EU priorities for reconstruction of the democracies and the economies of the Western Balkans.

Trade is a decisive dimension of this policy with intra-Balkan trade liberalisation and free trade between the region and the EU identified as key elements. Participants agreed that regional cooperation is paramount if peace and prosperity are finally to take root and grow.

On one level, there is certainly no problem with intra-Balkan trade, commented Moderator **Susan Woodward**, Professor of Political Science at The Graduate Center of the City University of New York and Senior Visiting Fellow at the Institute of Strategic Studies in London. There are initiatives on trafficking in human beings, small arms, light weapons and drugs. Networks exist across and between countries and among people with various national backgrounds.

"The issue today is how to create legitimate trade and how to use it as a spur to economic growth," she said.

Woodward noted that all speakers were pessimistic that a kick-start is possible. However, many "interesting and practical" ideas were put forward during the debate, including the possibility of war if the borders are opened too quickly, the MOU, the importance of finding capital investment to take advantage of trade opportunities and the need to take advantage of existing trade preferences as well as to focus on regional issues by paying particular attention to the "mesa" level.

Differences arose over whether reform should take place within individual countries before pushing for intra-Balkan trade. Participants argued for both. **Serge Ameye**, Area General Manager of Puratos and the President of the Belgian Business Club for the Balkans, argued that "if we were to suddenly open all borders without restrictions, we might just create another nightmare leading to chaos, social distress, massive migrations, political instability and potentially another conflict".

Non restricted inter-Balkan trade as a mid-term objective will add greatly to the potential of the whole region, but it is not a panacea, he warned. First, local economies must solve their most basic problem before they can move into second gear: "Opening the markets alone will not do the trick. One has first to clean up the mess in each country and then inter-Balkan trading will be the icing on the cake."

At the same, Ameye encouraged companies to invest in the region, despite the challenges.

**Mike Gonzalez**, the Deputy Editor of *The Wall Street Journal Europe*, disagreed: "The answer is not to building a *cordon sanitaire* around the Balkans before they can join the rest of Europe. The thing to do is embrace them now."

In the "chicken and egg situation of what comes first, peace or economic revival, the priority is the cessation of hostilities for there will be no peace without economic activity and until society revives," he said. Without economic revival the forces of nationalism will recur again and again. The escalating tension in Macedonia wakes up memories of the early 1990s.

"It is really unfortunate that this is happening just after we thought we'd hammered the last nail in the coffin of Balkan strife with the fall of the Milosevic regime," Gonzales added. "This situation makes talk of trade and economic revival in the Balkans even more urgent."

**Andy Bearpark**, the Deputy Special Representative of the Secretary General, United Nations Mission in Kosovo-EU Pillar, remarked that conference participants repeatedly referred to the need for peace and stability. In Kosovo, "we don't know about the long-term future or security", nevertheless, the area does attract private sector investment.

"Peace and security are important but they are not insuperable," he argued. "This is still an attractive area for investment."

It is important to distinguish between investors and non-investors, Bearpark added. The latter are people who want their share of the aid pie, and while there is nothing wrong with this, building a bridge is not the same as investment.

"Investment requires a different skill set and is about economic growth," he said. "At the end of the day, what is required is a lot more imagination. International aid officials are not known for imagination and boldness. We do not want to turn the clock back ten years."

Two years following the launch of the Stability Pact, "some achievements are visible and a lot of momentum has been gained", said **Ermelinda Meksi**, the Minister for Economic Cooperation and Trade, Republic of Albania. It is positive that the Former Republic of Yugoslavia has become a full and active partner in the region, but unfortunately, the events unfolding in Macedonia show that "the region as a whole needs sustained attention and support".

The stabilisation and association process is drawing a roadmap for integration with the European political and economic mainstream. Recent events, such as the MOU and Albania's WTO membership create "room for optimism" and sends signals to the business community that the region is moving in the right direction.

"The focus must now be on regional cooperation and the most important aspect is trade," she said. "It is an area where meaningful change can take place quickly. Balkan countries are rapidly moving towards full trade integration and the opening of markets."

Banking systems across the region are a relatively recent phenomenon, observed **Wolfgang Walter**, the Director of the Corporate and Investment Banking Division at Deutsche Bank. Foreign capital is needed if these systems are to become sustainable, as well as financing and securing payments. Countries need tradable goods, which

means they must be competitive. Capital investments are needed to produce the goods, which harks back to the need for financing and international investors.
"It is a circle that must be broken " he said. "I can only encourage governments, politicians and all other players to really take the necessary steps forward."

Walter compared the European Union's involvement in the area to a lighthouse showing the right direction. Western governments, companies and banks must act as a beacon, but there is still "a very important role to be played by the people of the region".

**Moving beyond the challenges**

The Balkans consists of a dozen or more states with small populations earning low incomes. This situation is underscored by political instability and cultural complications. The disintegration and subsequent conflicts within the former Yugoslavia destroyed trade patterns and set the country back at least a decade.

Yugoslavia's GDP is about US$8.5 billion, compared to $US25.25 billion in 1990. This gap must be bridged, Walter told participants, for even to get back to 1990 levels by 2020, the country would need to achieve a growth rate of 3 per cent every year.

If the region were one market with 57 million inhabitants and easy cross border trading conditions, the area may indeed look more attractive to investors, Ameye pointed out, but today, "who really wants to invest zillions over there?"

Despite these conditions, Puratos has carved out a niche in the region and is enjoying remarkable returns on investment. The company built a margarine factory in the capital of Serbia in 1998 during the worst possible time. Local workers continued to build, despite the bombing and the operation is starting to make money. This was done without any government deals and can be attributed to hard working local staff.

"If we can do it, others can," he told participants.

But the challenges are myriad. To be able to trade, you need an offer, a demand and preferably the cash to finance the transaction; all three are missing in the Balkans. The situation is worse in Yugoslavia. "The nation has been cut off from the rest of the world which has made its equipment and products obsolete, there is no cash for transactions and investments," Ameye said. "Incomes are so low that the consumption potential is irrelevant. What was once the leading country of the region is now its pauper."

Companies must realise a decent return on investment if they are to convince shareholders to make more substantial investments in the region. However, recent elections in Romania, Moldova and Bulgaria indicate that the populations are tired of having their incomes reduced year by year since the fall of communism. The lowering of the standard of living also reduces to prospects for profitability of investments.

"There is no quick fix," he added. "We must follow the stepping stones in the right order. If we don't and we go too fast in inter-Balkan trading, we might go a bridge too far."

Bearpark noted that a relatively industrious trade block has been "brought down" by a dozen years of conflict, neglect and under investment in everything. The international community is doing all of the right things by pushing aid money in large quantities, yet infrastructure is not being rebuilt as quickly and effectively as it could. However, despite recent events in Macedonia, things are better than they were a few years ago. The

Stability Pact means different things to different people, but it is working towards the elimination of tariff barriers and the creation of free trade zones.

**Besim Beqaj**, the Director of International Cooperation for the Kosovo Chamber of Commerce, pointed out that basic regulations are in place to attract foreign investment, but it is still unclear how investors can take capital back to their home countries. NGO transparency is also needed in addition to government transparency. Another important issue is privatisation and commercialisation.

Bearpark acknowledged that privatisation has not gone as quickly as many had wished, but it must be borne in mind that while it is clearly the answer for transition economies, it must be done very carefully.

"It can have perverse and harmful effects if it is not done right," he said, "It is better to listen to voice of caution."

It must be remembered that the difference between Kosovo and anywhere else in the world is that UNMIK as a government is not accountable to Kosovo but to the international community. As a result of this relationship, UNMIK had to build a constituency of support outside the region, no easy task when dealing with the UN Security Council and New York based lawyers.

Bearpark agreed there is a "terrible lack of accountability" by governments of the international community.

**Alexander Dijckmeester**, representing the European Association of Small and Medium Sized Companies, pointed out that it is difficult to get involved in CEE countries because of the Stability Pact. What is needed is more involvement and discussion with the business community and the associations comprising the private sector. Table Two of the Stability Pact deals with economic issues, but it is dominated by international financial institutions and other large players.

"Local businesses and associations need to organise so their voice may be heard," he said. "We need to focus on the mesa level, between the political level and the private sector. This way we can start to bridge the gap. In addition, the regional private sector element must be recognised.

Meksi emphasised that the creation of a free trade area is critical to the region. In this regard, the EU has taken important steps to offer unilateral trade preferences, thereby giving nations the opportunity to decide and agree on specific actions to liberalise and facilitate trade.

"Even with EU support through bilateral trade arrangements with a number of Balkan countries, the location of economic activity will favour the EU if we do not have a free trade agreement among us," she said. "That is why the MOU is so critical. This is a very important step towards enhanced cooperation."

The region is suffering from its incapability to attract FDI, particularly in high tech industries, Meksi added. More focus on coordination on internal and regional reforms to improve the business climate are needed as well as support for initiatives of the Investment Compact and the Stability Pact. Trade flows can be reversed by inadequate infrastructure, which is why regional infrastructure development is "very high on our political agendas".

Walter pointed to Yugoslavia, where there are 81 banks with an aggregate balance sheet of US$10 billion in joint assets. These assets are likely quite poor and together with the GDP of US$8.5 billion drives the capital balance to minus US$3 billion. This represents a terrible burden for the country to carry.

"If there is not a sound banking system, you cannot develop trade or the economy," he said.

Without this, the payment flows from one country to another cannot be secured. In Yugoslavia this is further complicated by the fact that the foreign debt has not yet been restructured, resulting in an uncertain situation in which assets could become attached by third parties. This makes it extremely difficult for banks to manage their reserves or to transfer funds. This is "very basic banking" but it produces a lot of headache and makes it difficult for banks to make payments.

In addition, because the debt has not been restructured, there is no financing and no collateral to induce Western governments to issue guarantees. Traditionally banks take the view that to achieve this, a country must have an agreement with the IMF, the World Bank, the Paris Club and the London Club. This situation represents a "substantial hurdle" to developing trade.

"With these guarantees in place, banks will step in with facilities," Walter added. "But there is still a very long way to go before this happens. We must figure out how to speed up this process to open up sources to finance trade."

The international community is "too slow and too afraid of radical solutions", observed Gonzales. It was only in 1998 that Bosnia had free trade with Serbia. During the three post- Dayton years, 1995 to 1998, the Office of the EU High Representative spent billions of dollars trying to create the infrastructure of civil society, but it was too reluctant to push for the activity it was funding.

"The money spent on education and institution building is almost wasted unless there is free trade and economic activity," he said.

The West must come to terms with the fact that “the connection between poverty and the bad guys is stronger in the Balkans than other regions”. The bad guys are the nationalists and the gangsters, who are often the same people or very closely connected. They rely on patterns that obstruct free trade. In Bosnia, for example, nationalist parties have for too long relied on funding from central payment bureaux. They have had a stake all along in not seeing them replaced by a real banking system.

"These bureaux are creatures dating back from the age of Tito," Gonzales pointed out. "The fact that they were connected to the currency board gave them a modicum of stability."

In the rest of the Balkans, the way to get ahead in life is to work for the customs authorities. There is nothing new in this, this is a way of life in the rest of the third world, but "we will not get solutions until we solve these problems".

Ensuring that private sector investment in the Balkans does not produce another round of human rights violations in terms of people's economic and social rights is an issue that deserves attention, proposed **Sian Jones**, Campaigner, East Adriatic Team, Amnesty

International UK, International Section. For example, within Bosnia, returning minorities find it difficult to find employment because of mono-ethnic employment practices.

"Some of the companies practising this discrimination have outside investment," she said. "For this reason, investment should be done according to best practice and standards. EU companies should afford those working in companies they finance in the Balkans the same economic and social rights we aspire to."

Bearpark pointed out that avoidance of discrimination is an absolute right, but when considering relative rights, such as maternity leave, a balance must be struck between the extent to which one can protect and to the need for the economy to go forward. An issue such as maternity leave must be debated within the community rather than dealt with capriciously by bureaucrats.

**Stepping stones to stimulating trade**

The creation of a common market in the Balkans is a goal to be achieved over the next few years, Ameye commented. If the right stepping stones are used, the process will constitute an excellent preparation for the ultimate goal of EU integration. To achieve this, he proposed the following:

?? Honour our own promises. There is little evidence of the fabulous amounts of money that have been promised so many times by so many politicians. Maybe we should in this respect be a bit creative and if the donors for the promised help really cannot be found, perhaps EU bonds could be launched for reconstruction.

?? Hopefully an amount of these sums can serve to finance existing businesses. Many Yugoslav companies cannot find the cash to buy the raw materials they need to operate. In other countries the credits remain quite expensive even when expressed in hard currency.

?? Corruption and bureaucratic abuse continue to be high deterrents and form a huge economic handicap. When scouting for real estate in and around Bucharest, for example, prices are outrageous compared to the salaries paid to construction workers. It takes about 40 authorisations to finish a building and each authorisation may need the right amount of *baksheesh*. Successive Romanian governments have been notorious for ignoring these practises, which has deterred many investors. Industrial zones could solve this problem.

"If we can take care of the most urgent needs and decrease these excesses we can start by gradually integrating those economies," he concluded. "Clearly it would make sense to give priority to establishing a free trade zone (and free movement of persons) for the countries of the former Yugoslavia because their economies were totally integrated up to a few years ago. A gradual lowering of duties between all countries can be the next step."

A greater recognition of the interrelationship between economics and politics is needed, Bearpark observed. Far too often in the Balkans, local and international politicians act in ways that do not support long-term economic development. Similarly, long-term economic development experts refuse to accept that politicians have short-term imperatives, such as winning elections.

More linkages need to be created in the area. Serious wounds that only time can heal are leftover from the conflicts, but those affect the people of the region, not international actors who should engage more at regional level.

Public-private partnerships "are desperately needed", he urged, because the private sector cannot do it alone. Business does not have the ability to create the legal framework needed to regenerate economic activity and governments do not have the entrepreneurial skills required to make it happen.

The MOU will benefit 55 million consumers and create a trade area big enough to attract foreign investment, Meksi predicted. It is a complex and constructive package of domestic reforms that conform to EU regulations and comply with WTO regulations. Facilitating trade across the region will tie it together.

To this end, initiatives by various international institutions such as the EBRD can make a huge difference. The EBRD has recognised that trade in high-risk environments is often blocked by the high cost or unwillingness of foreign banks to accept exposures by local banks. As a result, it has initiated a regional trade facilitation programme that offers guarantees to approved local banks to support trade activities. In addition, regional initiatives focusing on the following areas are needed:

?? Promoting global free trade in South Eastern Europe through trade liberalisation and facilitation (already jumpstarted by the MOU).

?? A customs union.

?? Unification of trade tariffs, non-tariff barriers and introduction of an adjusted regional VAT.

?? Balkan countries must make use of EU trade preferences and trade preferences they grant to each other. The fact that this does not happen means there are not enough products to export nor are there effective institutions and structured channels to realise exports.

?? Attracting export oriented FDI could be an appropriate and fast way forward in orienting Balkan economies towards exports.

?? Developing export promotion institutions and related activities should complement attempts to attract FDI in export-oriented sectors.

The region needs tradable goods, which means it has to be competitive. However, to produce the goods there is a need for an investment of capital and "once again you are back on the financing scene or back on the side of international investors," Walter told participants. International investors need a comfort level that risk will be covered. Traditionally, governments cover such risk, but this is not yet possible. International capital markets are very flexible and finance can be structured in many ways, however, "the structures we propose are not picked up by governments”.

This is the only way for a government, country or company to access money to finance the import of capital goods. Internally, capital stock is limited and there is a need to access know-how. This is a necessary process to produce competitive goods. But it is not yet in place.

Gonzales pointed out that Montenegro and Bosnia are getting the euro because they use the DM. This is the right way to go because they will "have the efficiency of the single currency and avoid EU red tape and regulations."

He again called for the EU to embrace the Balkans and reminded participants of Bulgaria's role during the Kosovo conflict when it put its well being on the line and denied Russia the right to fly over its airspace. This created a "huge advantage" for NATO because it did not have to deal with a Russian presence in Kosovo.

"I do not think we can now turn around and tell them we are sorry but we are not going to let you in," Gonzales added.

**Moving towards EU membership**

Participants agreed that the Balkans must work hard towards meeting the criteria for EU membership. Ameye pointed out that because the region borders the EU, it is an investment Europe's future to invest in these countries.

"If we do not invest in the region and create social stability, we are heading for a great mess," he said. "We must keep our word and invest in what we have promised. If not, another conflict will erupt and it will be worse."

The process is underway and is accelerated in Kosovo, Bearpark observed. As a result, the area will have the euro next year. The exchange rate will be pegged to the DM, which is a positive step towards strengthening the economy.

There is a positive and a negative side to the Balkans being part of Europe in the 21st Century, Gonzales commented. The positive side is that the region will get the necessary attention from the West to avoid future tragedies. The negative side is that salaries in the Balkans are far too high compared to Asia and other regions where companies can invest. This will be a deterrent to companies wishing to do business there.

Meksi pointed out that upgrading trade contracting relations with the EU and having a joint strategy for harmonising legislation with the *acquis* in the areas of customs and standards is already taking place. The MOU will strengthen this process.

"We in the Balkans must do our work now," she said. "The Stability Pact used to be viewed as a sack of money. Now it is time to start thinking about what it represents and how to keep the region motivated."

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