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This issue of the EBO brings excerpts of three papers from the Southeast European part of the global research project on Understanding Reform. There is also a brief note on some of the lessons learned.

The project has been carried out within the Global Development Network (GDN) and has brought together researchers from most Southeast European countries.

In the next issue of the EBO we will bring excerpts from the other country studies (Croatia, Serbia, Montenegro and Bulgaria).

All these papers can be found on the website of our Balkan Observatory at www.wiiw.ac.at/balkan/.

Edited versions of these papers together with some additional material have been submitted for publication.

In this issue there is also an announcement of the launch of the new project within the GDN on the influence of policies of developed countries on the developing ones. Detailed information on the project proposal can be found on the website of the Balkan Observatory where also additional information will be regularly posted.

We hope you enjoy this issue of the European Balkan Observer. As always, comments and contributions are welcome!

Vladimir Gligorov

Bosnia and Herzegovina: Problems, obstacles and outcome of the reforms

By Vesna Bojicic-Dželilovic, Fikret Caušević and Rajko Tomaš

1. Institutional problems and obstacles

During 1995-2000 institutional obstacles were a major barrier to the creation of a legal framework necessary for the implementation of reforms. Complicated procedure of harmonization and adoption of laws, which would serve the interests of all citizens, and delays in the adoption of the key laws, prevented BiH (Bosnia and Herzegovina) from becoming an economic community and from developing as a single economic space. This is best illustrated by the fact that The High Representative decreed the establishment of some of the key state institutions. In 2000 only, some 27 decisions were taken, including on basic laws such as state border service, on standardization, on travel documents, on meteorology and on BiH customs policy.

The imposed laws are applied on a temporary basis until adopted by the BiH Parliament. It took 6 to 10 months for the BiH Parliamentary Assembly to adopt even these laws, which represent the basic minimum for the functioning of any state. Establishment of the BiH Institute for Standards and Metrology may serve as an example of the lack of interest in establishing BiH state institutions. BiH obtained a special preferential treatment for exports to the EU without restrictions, provided that the goods and services meet the standards. The

fact that there was no state-level institution in charge of quality certification meant that companies could not make use of this preferential arrangement. Although there was an alleged interest in both entities, the BiH Institute for Standards and Metrology was eventually established only after the High Representative imposed the state level law.

Another example of institutional weaknesses being exploited by the national elites in the post-war period was "privatization" of the state border. The Dayton Peace Agreement allowed entity authorities to control the state border crossings, which enabled networks of criminal groups involved in smuggling and other forms of illegal trade to operate almost unchecked, thus depriving the budgets of millions of KM. Given the extent of grey and black markets of goods, labour and services it is estimated that BiH lost approximately one and a half of its GDP in 1995-2000 or some \$6 bn. Finally, the Law on State Border Service was adopted by the BiH Parliamentary Assembly following the decision by the High Representative.

2. Problems of the fiscal system

The concept and structure of fiscal federalism in BiH has showed serious shortcomings regarding the provision of public services. In

a relatively small space (BiH market), entrepreneurs are faced with a non-uniform fiscal regulations. Of course, tax competition is not necessarily bad in a developed market ambience. However, against the level of development of fiscal decentralization in BiH it would result in entities alternating losses and gains, which has a negative impact on the long-term business development. Thus, in this model harmonization rather than tax competition, which could lead to "tax war", is a more rational solution.

The existing model of fiscal decentralization is mainly intended to resolve potential political conflicts at the level of peoples and entities. This is important by way of creating initial conditions for political stability. However, fiscal division between entities and the state, or the Federation and cantons, does not mean that the problem of fiscal decentralization is fully or adequately solved. What it can quite well do is to reduce or change the level of centralization, while tax payers at the local level still might not see the link between the taxes they pay and the quality of public services at the local level. Therefore, greater concern for economic principles is of critical importance in further reforms of the fiscal system, a concern that was only marginally addressed in the course of initial reforms.

Fundamental weakness of BiH fiscal system in 1996-2000 was the possibility of tax competition between the entities stemming out of differences in tax rates (turnover tax and excise duty) and uneven application of the Unified Customs Policy in BiH. Fiscal system has been one of the main obstacles to business development:

– The fiscal system is complicated, it includes unforeseeable retroactive tax obligations and is characterized by insufficient harmonization of fiscal laws between the entities, which discourages inter-entity trade, and encourages uncontrolled import.

– Legal system is slow, inefficient and discouraging for development of business operations, while administrative procedures are lengthy and complicated.¹

The reforms to address some of these problems were stepped up in 1999-2000. The outcome was a significant narrowing down of the gap in tax rates, and the reduction of the number of taxes applied until mid 2000. The reduction in the number of taxes from 4 to 2 (2000), followed by a reduction in the tax rates in the FBiH (2001), significantly reduced the space for tax competition at inter-entity level. However, one of the fundamental problems of the tax system in

both entities, i.e. its complexity arising from the approach that the turnover tax is collected at the final stage of consumption, remained one of the main barriers to development of efficient and harmonized tax system.

Parallel to the reforms aimed at streamlining the tax system and improving revenue collection, reforms at the reduction and restructuring of public expenditures were also put in place focusing on cuts in military spending, overhaul of the disability and war veteran benefits and pension system. Public spending was reduced from 64.5% GDP in 1998 to 56.2% in 2002- still in excess of BiH's fiscal capacity. As a result, fiscal performance improved and consolidated budget deficit fell from around 5.1% of GDP in 1998 to 4.3% in 2002. However, efforts at fiscal consolidation were accompanied by an increase in public sector arrears, which were arrested in 2002. Escrow accounts, including privatization proceeds and assets allocated to BiH as part of SRF Yugoslavia succession process, were set up to deal with domestic debt settlement. Oversized public sector remains a major source of fiscal pressures and will require significant downsizing. Rationalization and restructuring of public spending would also have to address the balance between the capital and current expenditures, since for most of the post-war period majority of capital spending was met by external funding.

3. Problems, obstacles and failures in enterprise privatization

Privatization process in BiH in the post-Dayton period was complicated by the fact that it was implemented separately in two entities. Non-existence of unified legislation was the first important contradiction of one of the main requirements of regulated market economy - to have a clear and comprehensive legal system. Privatization was politically motivated and was not a part of a coherent reform programme. Another fundamental problem was to do with the predominant privatization model. Majority of state capital in both entities was privatized through public offering of shares, i.e. by exchange of certificates and vouchers for companies' shares (some 85% of the privatized assets excluding utilities). The basic weakness of mass privatization is that it does not solve any of the issues of crucial importance for the enterprise performance. It brings no profit either to the state or companies and therefore no possibility of creating funds to finance company restructuring or to resolve social issues.

The second problem arising from mass privatization is a very low concentration of necessary knowledge about market and market institutions, and in particular about different options of restructuring and market re-positioning of companies. In majority of cases, shareholders in companies are persons who do not have the relevant knowledge, and managers of privatized companies lack

¹ The World Bank, *Bosnia and Herzegovina-1996-1998 Lessons and Accomplishments - Review of the Priority Reconstruction Program and Looking Ahead Towards Sustainable Economic Development*, May 1999, Annex 11, page 3.

skills and knowledge of local, regional and global markets. Apart from a lack of knowledge on the part of shareholders and managers, the problem of privatized companies is further complicated by the fact that new owners do not have a contractual obligation to invest and restructure their companies. The third aggravating factor is surplus of workers. Solution to this problem is neglected within the privatization process, without developing adequate social programmes and financial sources to fund them. In BiH many smaller companies were acquired by management, employees and private investment funds, which provided no investment or know how.

Formal corporatization of companies in both entities was conducted after the mass privatization. Selection of models and implementation of corporatization in RS companies were subject to political interests in order to preserve the influence of the authorities on the companies as long as possible. The chosen model was particularly confusing to strategic investors, who were offered up to 30% of the state capital value, while they did not know about the number of shares they would get, total issue of shares, or dispersion of the remaining 70% of the shares. This was the main reason for moderately low interest of strategic investors in privatization in RS, especially foreign investors. Thus, privatization in RS turned into "hunting grounds" for different speculators who invested in other people's vouchers,

acquired them on someone else's behalf with 70% discount of the average nominal value, or invested other people's coupons for pre-war foreign currency savings, also bought with a high discount rate. On the other hand, the state retained an important role in managing the unsold state capital and the shares of investment funds. Although one of the privatization objectives was to attract foreign investments, this did not materialize to any significant extent. In the privatization process, foreign investors were discriminated against: they could not use any of the preferential schemes. Therefore, privatization in RS became a privilege of domestic speculators and the state.

Mass privatization in the FBiH was implemented in 2001/2002. Privatization funds also participated in the mass privatization, enabling linking up physical and legal persons on the basis of their mutual interest or on the basis of ethnic affiliation. As in RS, corporatization of companies in the territory of FBiH did not result in creating conditions conducive to efficient and fast restructuring. The idea to bridge the huge gap in the know-how on privatization and corporate governance with participation of privatization investment funds and fund management companies has so far proved not particularly successful.

Overall the results of privatization have been very modest. The share of private sector in GDP is esti-

mated at around 40-45%. Five years since the start of privatization many large enterprises have failed to restructure and privatize, while large number of privatized ones suffer from poor corporate governance. The participation of strategic investors on which the main economic impact of privatization hinged has been disappointing. Privatization in the way and at the pace at which it has progressed in BiH has failed to have a major impact on the development of market economy.

4. Problems of financial sector reforms

Two main problems of BiH's financial sector reforms are disproportionate focus on commercial banking reforms at the expense of institutions for financing restructuring and development of companies, and insufficient development of BiH financial market. Commercial banks reform in BiH has been one of the most successful among transition countries. However, strengthening control and supervision of banking operations, through the adoption of the Basle Standards, resulted in the restructuring of commercial banks assets. They shifted the focus of their operations away from the corporate sector towards households and maintained liquidity by keeping deposits abroad. This is important from the point of inter-linkage among various reforms in the process of transition. Because the banks continued to perceive lending to largely unstructured corporate sector as higher risk option, they favoured households in their lending

portfolio. Given the currency board arrangement, strong credit growth as a reflection of financial deepening produced by the reform became a threat to macroeconomic stability in 2002, by its upward pressure on the current account deficit. A set of monetary reforms was initiated to slow down the credit growth and further bank regulatory reforms enacted aimed at removing remaining deviations from international standards.

Beginning of financial liberalization in BiH resulted in an enormous increase in market interest rates. Gradually, as a result of new entry of foreign banks and an increase in the minimum capital requirement ratio, interest rates declined. However, one of the consequences of banks directing their activity to less risky portfolios led to the export of capital. As the reserves of the commercial banks with CBBiH are included in the CBBiH liabilities and have to be covered by foreign assets, the total amount of exported capital, intended as insurance of commercial banks against risk, amounted to KM2bn KM at the end of 2002. This amount is higher than the amount of loans that BiH received in the post-war period. These data clearly demonstrate that BiH economy will not be able to achieve significant growth rates without a strong support from development and export-import banks. Reliance on foreign direct investments, as the most important factor of balancing trade deficit and accumulation of foreign currency reserves, has so far

proved not an effective strategy. Out of US\$ 848 million of total foreign investment in BiH (1994-2002), relatively small share were greenfield direct investment.

As suggested above, financial deregulation in an environment lacking institutions for crisis management and development incentives, resulted in the banks shifting their lending portfolio away from the corporate sector into less risky sources of revenue. This leads to a paradoxical conclusion of BiH becoming an exporter of capital. The commercial banks, which dominate the banking sector structure their portfolios in compliance with the rules based on the existing international standards. In this environment, more than two fifths of assets of commercial banks have practically no impact on the development of BiH economy. Therefore, a radical shift toward establishment and/or attracting financial institutions for funding development projects, along with well-defined export-orientated strategy, are crucial for economic revival of BiH.

5. Problems of reforms of foreign trade relations

The logic behind BiH's free trade agreements with countries in the region was based on the assumption that removing customs barriers on products and services from BiH would result in substantial export expansion, accompanied by a reduction or at least a slow down in the growth of imports. Data on BiH trade with Croatia, Slovenia, and

Serbia and Montenegro suggest this has not happened. The key issue is that improvement in BiH trade performance is limited by its narrow export capacity as medium and large companies in the processing industry sector, the main potential exporters, were until recently state owned or are still undergoing privatization. In majority of these companies restructuring has not been completed, while in some of them it has not even started. Funds in support of continuous expansion of export activities either do not exist in BiH or they are available at interest rates twice as high as those in the neighbouring countries, which discourages potential exporters.

Much attention in analysing export performance in transition countries has focused on progress in trade liberalization. In BiH, the problem has not been in markets being closed; on the contrary, the World Bank data on tariff protection of domestic production indicate that BiH producers are the least protected in the entire SEE region. The weighted average tariff protection rate in Slovenia and Croatia is by 33% higher than in BiH. Similarly, weighted average tariff protection rates of Romania and Macedonia are twice as high. BiH has the largest trade deficit in the region; it stood at 31.4% of GDP in 2002.

Table 1

BiH Trade deficits with main trade partners
in millions of KM

	Trade deficit		
	2000	2001	2002
TRADE DEFICIT IN TOTAL	- 5,346	- 6,215	- 6,879
OF WHICH WITH:			
Croatia	- 779	- 857	- 1.017
Slovenia	- 848	- 770	- 732
Germany	- 543	- 444	- 736
Italy	- 189	- 544	- 541
Hungary	- 300	- 402	- 478
Austria	- 294	- 333	- 380
Serbia and Montenegro	+ 26	- 57	- 277

Source: Federation Statistical Office, Statistical data on economic and other trends, 2/2002, pp. 44-45;
Central bank BiH, Bulletin 2/2003

Table 2

BiH: Balance of payments, 1998 to 2002
in millions of KM

	1998	1999	2000	2001	2002
I CURRENT AC- COUNT	- 2,043	- 2,678	- 2,531	- 3,403	- 4,398
1. Goods	- 5,482	- 6,052	- 5,567	- 6,456	- 7,023
2. Services	257	192	221	241	144
3. Income	751	715	669	697	533
4. Current trans- fers	2,431	2,468	2,145	2,116	1,947
II CAPITAL AND FINANCIAL AC- COUNT	2,076	2,656	2,519	2,926	4,210
1. Capital account	766	946	862	803	711
2. Financial ac- count	1,310	1,710	1,657	2,122	3,499
- Direct investments	117	325	310	274	604
- Other investments	1,341	1,973	1,512	3,513	2,649
- Reserve assets	- 148	- 588	- 165	- 1,665	245
III NET ERRORS AND OMMIS- SIONS	- 33	22	12	477	188

Source: Central bank BiH, Bulletin 2/2003, page 139.

The main impediment to BiH benefiting from the opportunities created by the opening of the EU and neighbouring countries' markets and indeed to the development in general has been the lack of unified economic space. The lack of institutions supporting functional integration based on technological and resource compatibility and joint entry into foreign markets, along with the problems of financing, are some of the key obstacles for improvement in BiH's external position through the reduction in trade deficit. Although exports have grown steadily since 1996, they have been surpassed by strong growth in imports- a trend which was somewhat attenuated in 2000-2001 due to slow down in reconstruction-related activity as the main source of import demand. However, imports grew strongly again in 2002 propelled by the credit boom, driving the trade deficit up. Large trade deficit has been the main cause of current account deficit, which stood at some 22% of GDP in 2002.

6. Problems of labour market reforms

BiH labour market does not exist in the true sense of this word. Terms "employed" and "unemployed" represent formal categories rather than the actual supply and demand for work. This "formality" of labour market is a consequence of the still prevalent socialist-type legislation in this field, but also of the inertia evident in state owned companies and institutions. The main problems in the la-

bour market are the following:

- lack of competition for every vacant job and between the employed and the unemployed;
- lack of sectoral and regional mobility of workforce;
- wage determination which does not reflect the true costs of labour, but depends more on the position of a company or institution and the line of business, rather than on efficiency and situation at the labour market.

At the beginning of transition, deteriorating situation in the state sector, implementation of economic reforms and development of private sector necessitated changes in the approach to labour market regulation inherited from socialist times. Establishment of labour market has evolved through the conflict of socialist and market principles of the utilization of labour as a factor of production. The phenomenon of so called "wait-list" workers discussed earlier was the side effects of the confrontation of these two concepts, and an indication of resistance of socialist principles. At the same time informalization of labour as an anarchic approach to establishing free market came to be one of the main characteristics of BiH labour market. The confluence of a range of factors i.e. heritage of pre-war legislation, aggravated by the specific problems related to war and post-war situation, restricted access to finance for the state owned enterprises and slow privatization opened the way for the creation of two labour mar-

kets in BiH. The formal one regulated by entity laws and collective agreements and an informal one, which offered opportunities for temporary and occasional work, as a source of income. By its nature, informal labour market was not regulated by the law. Contractual provisions and rules of collective agreements were not applied at this market either. Dual nature of labour market resulted in an enormous increase of obligations related to unpaid salaries to registered workers in the state or majority state owned companies that were subject to privatization. Direct consequence of this problem was reduction of the value of the state capital due to accumulated losses arising out of costs growing faster than revenues.

The emergence of the informal market was partly related to the high fiscal burden on labour. Aggregate rate of taxes and contributions on net salaries until August 2000 amounted to 81% (average rate for both entities), and was subsequently reduced twice to 68% (income tax rate has been reduced from 15% to only 5%). Compared with other countries, the total tax burden on net salaries does not exceed international average. However, the existence of dual ownership and uneven application of tax and labour legislation created a possibility for the development of a large informal market. Tax evasion and non-payment of social insurance contributions, as well as non-registration of workers, are particularly

evident in the small enterprise sector. Since these companies account for the

biggest share of the total of registered companies (over 75%), financial inspections

are not in a position to control it adequately.

Table 3

BiH: Employment and Unemployment, December 2001

	Bosnia and Herzegovina	Federation of Bosnia and Herzegovina	Republic of Srpska
- In thousands			
Working age population (15-64)	2,390.6	1,475.1	915.4
I Employment			
1. Total	999.5	551.3	448.2
2. Formal	627.0	407.0	220.0
- primary sectors*	21.0	11.0	10.0
- secondary sectors*	247.0	156.0	92.0
- tertiary sectors*	359.0	241.0	118.0
3. Informal	361.5	175.8	185.7
II Unemployment			
	190.7	111.0	79.7
III Activity rates (in %)			
1. Rate of employment	40.1	36.7	45.5
2. Rate of unemployment	16.4	16.9	15.8
3. Labour force participation	48.0	44.2	54.0

Note (*) - the number of persons employed in formal sector listed under "agriculture" covers agriculture, forestry and fishing industry; the manufacturing sector covers mining industry, processing industries, production and distribution of electrical power, gas supply, water supply and civil engineering; the service sector covers trade, catering, transport and telecommunications, financial services, business services, education, health, public administration and other services.

Source: Survey of living standard in BiH households, 2001, FBiH Statistical Yearbook, 2001, BiH Statistical Agency, Federation Statistical Office, RS Statistics Institute;

7. Current status of reforms

Since mid 2002 the office of the High Representative, in co-operation with local authorities and international experts, has stepped up efforts to deepen the reforms focusing on fiscal system, business environment and judicial reform. Reform of the tax system focuses on the elimination of tax competition between the entities, introduction of

value added tax and the establishment of a Unified Customs Administration for BiH. In mid 2003, a draft Law on Indirect Taxation was proposed, aimed at changing the fiscal structure, i.e. to grant considerably larger competencies to the state level authorities in collection and transfer of customs duties and value added tax. Given the fact that introduction of value added tax is foreseen for the beginning of 2005, as an interim measure for

addressing the weaknesses related to tax collection, the Law on Turnover Tax on Goods and Services was amended, thus enabling collection of turnover tax at the stage of import, or production, instead of collection at the stage of final consumption.

As far as the BiH fiscal system is concerned, preparations for the Law on Income Tax, which has not been applied during the entire post-war period, are also

underway. Adoption of this Law is foreseen for the beginning of 2004, and its application will introduce progressive taxation in accordance with the levels of generated income. Parallel to the preparation of this Law, Amendments to the Law on Corporate Tax are being prepared. They are aimed at reducing the existing 30% rate in FBiH to the RS level of profit tax rate of 10%. However, the announced amendments to this Law imply that tax exemptions will be far less frequent in comparison with the regulations that have been applied over the past 8 years.

A particular effort has been put towards reforms aimed at removing administrative barriers to business. A commission was established at the end of November 2002 charged with proposing measures, which would improve business environment such as the removal of unnecessary legal provisions that imply lengthy and complicated procedures delaying the registration of business. In the period between November 2002 and the end of February 2003, Parliaments of both entities received 50 requests for amendments to the laws that, according to the opinion of employers, represented a barrier to business development. These amendments were mainly adopted under the fast track procedure, and their result was a partial acceleration of the company registration process. Another important piece of legislation the Law on Bankruptcy finally came into force in the Federation in 2003, following strong

resistance by the local parties including the trade unions. The Trade unions demanded that privatization be reviewed in order to cushion the expected impact of the bankruptcy law.

As far as the financial sector is concerned, amendments to the Law on Banks made in both entities in 2003 reinforced financial supervision, i.e. introduced stricter procedures of classification of commercial banks' assets with the aim of improving risk management. The proposal by the CBBiH to place the entity banking agencies under the auspices of CBBiH, and to make them more resilient to fend off potential pressures by entity authorities, was not accepted. The proposal of CBBiH governor to have CBBiH as an issuer of certificates on deposit was not accepted either. This proposal was a logical step toward expanded role of this institution and a contribution to initial development of money market in BiH. Interest of commercial banks in investment in foreign securities, aimed at protection against risk, would be at least partly compensated by introduction of first-class domestic securities. This proposal remains as an option and, most probably, will soon be again put on the agenda.

Privatization of strategic enterprises is the most important issue in the area of privatization. International experts in cooperation with local experts employed in the entity privatization agencies have drawn a list of strategic enterprises awaiting privatization. During September and October 2003, tenders

were opened for several enterprises from this list. Another burning issue is that of the reform of corporate management in public enterprises, primarily in energy sector and telecommunications. There are three enterprises in each of these two sectors. As BiH is one of the rare countries in SEE region that has a positive energy balance, it makes investments in energy production and distribution sector more attractive, and, likewise, increases the interest of foreign investors. The situation is similar in the field of telecom-operators, which have significantly upgraded their technology in the last 8 years, primarily by re-investing the profit they have gained via the expansion in capacity.

Summary of a paper prepared for the GDN research area 'Understanding Reform'. The full version of the paper can be downloaded at: <http://www.wiiv.ac.at/balkan/2ndphase.html>

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Macedonia: Structural reforms

By Mihail Petkovski and Gligor Bishev

1. Privatization

The Macedonian privatization started in 1990, when the last federal government of former Yugoslavia introduced the Law on Social Capital. Under that law, enterprises could be corporatized and employees could purchase shares in their own firms ("internal shares") – usually at a substantial discount to their market value. By mid-1991, roughly 67 large and medium-sized enterprises in Macedonia had been fully privatized under the law and hundred more partially privatized (IMF, 1998). It is interesting to note that, compared to all other former Yugoslav republics, the process of distribution of these internal shares went furthest in Macedonia. As Slaveski (1997) points out, a small group of powerful managers of big socialist enterprises acted as a lobby and were capable of discouraging any moves towards a suspension of The Law on Social Capital, before 18, 1991, when its legal validity expired.

Not until June 1993 was the federal law replaced by the Law on the Transformation of Social Capital and only in late 1994 did the privatization process get started again. The new law was based upon the selling of enterprises on a case-by-case basis. Enterprises, i.e. the existing management were permitted to choose the method of privatization although their plan had to

be approved by the Privatization Agency.

The turning point in Macedonian privatization came when the authorities had realized that privatization of large enterprises might not be feasible, despite the generous concessions offered by the law (10 to 20 percent down payment and five year interest free credit). Since nobody showed interest in putting money on the table, authorities found an "original" solution: management teams from within enterprises were allowed to use their internal shares, obtained in the previous privatization, as a down-payment. Moreover, more internal shares might be used for securing the right to purchase the rest of the shares for up to at least 51 percent of the appraised value of the company in five annual interest-free instalments. This concession to insiders effectively blocked any outside party interested in offering an alternative development plan for a specific enterprise undergoing privatization (Slaveski, 1997). Even when shares were made available to both insiders and outsiders (the buyout model), insiders tended to purchase the majority of stake as they had more information on the company and could benefit from discounts and the chance to purchase shares in instalments.

By March 1998, roughly 87 percent (weighted by the number of employees) of privatized companies were purchased by insiders, including a number of different privatization forms. The low level of outsider, and particularly foreign, involvement in privatizations meant that privatized companies did not benefit from the injection of capital or know-how seen in many other transition economies. At 0.9 percent of GDP in 1997 Macedonia had the lowest level of foreign direct investment of any transition economy. The insider-dominated ownership had serious adverse implications for the corporate governance and restructuring, which are explained, in the next section.

Slaveski (1997) concludes that Macedonian insider dominated privatization has probably emerged as an unintentional product of the strategic mistake of not combining the sell-off method with some of variants of mass privatization. While that is partly true, it is at the same time very likely that politicians in charge tried to use privatization as a way of strengthening their own position. Implementing the insider method, at one hand, they gained support from the powerful business lobby, given the fact that managers became main winners of the privatization. At the other hand, they might have hoped that employees would, at least ex ante, support reforms, in

exchange for shares received in the privatization process.

It will be probably fair to say that the same privatization model applied in Macedonia would deliver better final results if the country had stronger institutions. The World Bank comments: "...the impact of privatization has been rather disappointing....most likely because of the dominance of insider buy-outs but also because improper procedures and substantial corruption during the process, discouraging new owners from investing in their new acquisitions because of uncertainty about property rights" (World Bank, 2003a, p. 4). But it is also quite interesting that international financial institutions were more or less passive during the creation of the privatization law and in the early phase of its implementation. It seems that

almost the only thing they were worried about was the speed of the process, obviously trying to secure the irreversibility of the ownership change. For example, the World Bank required privatization of 790 enterprises in 1995 alone, out of around 1,500 identified for privatization as one of conditions of the FESAK arrangement.

1.1. Enterprise restructuring and governance

Despite a large-scale privatization programme and significant foreign trade liberalization, Macedonia's track record in enterprise reforms has been weak. The persistence of payment and wage arrears and poor profitability in the enterprise sector suggest low corporate restructuring. This reflects first, a privatization process dominated by insider buyouts and second, unfavourable institu-

tional framework for investment and restructuring (tolerance of soft budget constraints, weak legal protection for creditors, relatively inefficient banking system, large informal sector etc.). Yet, cross-country comparisons of profitability indicators show that Macedonia significantly reduced the gap with other transition economies in 2000, although net profits remained the lowest among the group of countries presented in Table 6 (Zalduendo – 2003) (During the recovery period 1997-2000, many other indicators of corporate performance-productivity, turnover of firms, concentration of losses-also witnessed a strong positive reversal). The 2001 civil conflict certainly made aggregate profitability indicators worse, even though data for the years 2001 and 2002 are not available.

Table 1

Profit and losses in transition economies (in percent of GDP, before taxes)

	Gross profits			Gross losses			Net Profits/Losses		
	1994	1997	2000	1994	1997	2000	1994	1997	2000
Bulgaria	na	11.3	9.1	na	-5.4	-8.0	4.5	6.0	1.0
Czech Republic	13.7	na	na	-5.7	na	na	8.0	2.5	1.6
Macedonia	2.5	3.5	6.5	-14.5	-6.4	-5.9	-12.0	-2.9	0.7
Poland	10.0	8.8	7.4	-3.9	-2.9	-4.4	6.1	6.0	3.0
Slovak Republic	13.9	na	na	-7.2	na	na	6.7	na	8.8
Slovenia	4.5	na	na	-6.4	na	na	-1.9	na	na

1.2. Insider privatization

It is now well understood that privatization that results in widely dispersed ownership structures can work well only in countries with effective standards of corporate governance (IMF,

2000). Macedonia obviously lacks such standards and at the same time, as we previously explained, its privatization process resulted in highly fragmented ownership, which creates specific governance problems.

These are particularly acute in the case of employee buyouts because share ownership is diffuse and employees have a strong incentive to maintain employment. At the other hand, managers with rela-

tively small ownership stakes wield considerable power without being effectively controlled by shareholders, which provides incentives for asset stripping and self-dealing. Many managers (even of viable enterprises) found that generating profits was not the best way of increasing their income—instead, they did better by selling assets and products at below market rates to related persons.

The slow pace of enterprise restructuring in Macedonia is visible in statistical data on the work history of registered unemployment. Since early 1980s, the vast bulk of registered unemployed—between 73 and 84 percent—were young people leaving the education system with no work experience. Contrary to several countries in the region, there were no massive layoffs in Macedonia (World Bank, 2003a). The saying that the Macedonian labour market is a “heaven” for those that have a job and a “hell” for those that do not is not far from truth.

The disappointing performance of privatized enterprises is also evident from deeper analysis of the aggregate profitability indicators shown in the Table. Analyzing financial accounts of a sample of manufacturing firms, Zalduendo (2003) finds a profound difference between privatized old firms and nimbler new ones. In fact, privatized firms had a weak performance and the recent improvements in aggregate profitability were driven by new private firms. The privatized firms recorded a marked decline in operating

profits in 1994-1997 and only partial recovery in 1997-2000, which was insufficient to reverse that deterioration. Despite substantial labour shedding, their labour productivity in 2000 remained below 1994 levels. Zalduendo argues that the predominance of insider privatization is one reason for the poor performance of privatized firms.

1.3. Institutional framework

There is now growing recognition among economists that market-oriented policies may be inadequate without more serious institutional transformation, in areas ranging from the bureaucracy to labour markets (Rodrik, 2003). During transition, Macedonia has not been successful in creating efficient institutions, due to several reasons. Firstly, as a newly independent state, it had to build many basic institutions virtually from “scratch”. Secondly, it has traditionally been an underdeveloped region. Therefore, it is logical that its inhabitants do not possess any “institutional memory” on market based institutions (for example, stock exchanges) which existed in more developed parts of Yugoslavia and in advanced transitional economies between the two world wars. Thirdly, to date, Macedonian policy makers have paid relatively little attention to institution building process, which is typical for less successful transition strategies.

Therefore, privatization has failed to boost restructuring

and better performance of enterprises partly as a result of privatization method but also partly because of the institutional impediments that affect enterprise development and growth. The Macedonian experience also confirms that process of privatization risks producing perverse results in the absence of hard budget constraints and effective competition.

1.4. Hardening budget constraints

While direct budget subsidies to firms were drastically reduced during the 1990s, privatized firms continue to receive implicit support in the form of soft credits and wage, tax and social contributions arrears. As presented below the share of the non-performing loans in the Macedonian banking system has been one of the highest among transition economies. As regards wage, tax and social contributions arrears, analyzing a sample of manufacturing firms, Zalduendo (2003) finds that they remained high between 1994 and 2000 (in the range of 3 to 4 percent of GDP).

This tolerance of arrears mainly reflects slow progress in resolving the loss-making enterprises in Macedonia, especially the large ones. Macedonian reformers have started transition in the context of the already very high unemployment and that have been probably a main reason why they were reluctant to deal fast with the endless number of loss-makers. In 1990, the unemployment rate amounted

23.5 percent of labour force and in 1997 it was at its highest 36 percent.

Protection of creditor rights

Inefficiencies in the bankruptcy process and weak creditor rights have also undermined the imposition of hard budget constraints and slowed the process of restructuring. In October 2000 the government strengthened the bankruptcy, collateral and executive procedures laws. Nevertheless, financial discipline and liquidity of enterprises have not improved significantly.

It seems that main problem remains inefficient court enforcement of creditor rights. According to Business Survey conducted jointly by the EBRD and World Bank (BEEPS-2002) contract enforcement in Macedonian courts is slow, complicated and expensive. Among the eight South East European countries only Albania has higher costs proceedings and a heavier procedure than Macedonia (World Bank, 2003b).

Behaviour of the banks

The root cause of financial indiscipline among enterprises is probably the interlocking relationship between many of commercial banks and their shareholders-being mainly net debtor enterprises. Privatization of banks occurred through privatization of dozen of owner shareholders, resulting in fragmented ownership, dominated by net debtors, with a tendency to abuse credit rather than safeguard bank capital.

The case of by far the largest Macedonian bank at the start of transition is a good example. In 1995, the non-performing loans of the Bank, comprising two-thirds of the credit base have been replaced in the Bank's balance sheet by the government bonds. Dealing with the stock problem of a bank's credit portfolio, however, was not enough to prevent a resurgence of the flow problem of bad financing to nonviable enterprises. In 1999, when government sold the bank to foreign investors, it had to recapitalize the bank again, by issuing Euro-denominated bonds in exchange for the four largest borrower's bad debts amounting to EUR 120 million. Such behaviour of the banks was also a result of the government's failure to address the issue of loss-making enterprises.

1.5. Improving competition

As we have seen before, Macedonia has liberal foreign trade regime, domestic prices are generally free, and turnover (exit and entrance) of the firms is rather high. In other words, firms are exposed to strong competitive pressures, which is likely to improve their performance.

However, one important aspect of competition policy in Macedonia has been so far largely neglected-protection of small and growing private firms from the possible anti-competitive policies of large state or privatized enterprises (anti-monopolistic

policy). For that reason, until recently (end of 1999) Macedonia constantly received the lowest possible grade for its competition policy (score 1 according to the EBRD ranking of transition economies). After that, finally, The Law against limiting of competition was enacted and the Monopoly Office was established.

Despite these legislative changes, significant actions against monopolistic behaviour and abuse of market power have not been observed, although media and anecdotal evidence offer many examples of anti competitive behaviour. The most probable reasons are a combination of complicated legislation and inadequate enforcement mechanism. The Law is considered to be too extensive and complicated and the Monopoly Office is de facto and de jure dependent on the Ministry of Economy.

An important source of unfair competition is a big informal sector, which is estimated to be around 40 percent of official GDP. A large size of the informal sector reflects a weak institutional framework and high costs of doing business in Macedonia. Therefore, bringing the informal sector into the formal economy will require significant improvement of the quality of Macedonian institutions, which is likely to be a long-run process.

2. Financial sector reforms

In contrast to other command economies, Macedonia, within the former Yugoslav Federation, has had a two-tier banking system since 1964. Extending credit and collecting deposits were the main bank activities in pre-transition period. The features of the banking industry were in accordance to the main characteristics of the economic system based on associated labour. The main function of a bank was not to make profit by undertaking calculated risks, but to extend as much credit as possible to enterprises at the lowest possible interest rate. Borrowing from the banking industry at significantly negative real interest rates in the period of high inflation, with intention not to repay the loan has a treatment as subsidy. Banks were perceived as institutions for subsidizing enterprises. This was emphasized through the programme of selective credits supported by the Central Bank. In addition to banks, insurance companies were in existence, only.

A universal type banking system was inaugurated after the monetary independence (April 1992). Banks were defined as institutions that collect deposits and extend credits in order to make profit. However, it was stipulated that they had to be solvent and liquid, and other supervisory standards were prescribed for the first time. The Central Bank undertook the role of banking supervision. The low standards for entering banking industry had contributed to rapid

increase of the number of banks. From four banks before independence, in 1993 they increased to 19. The record was reached in 1998 – 24. The new established banks had the same defect function of performance as the old banks. They were established primarily from domestic non-financial companies that did not have any expertise in financial operations. In the most of cases, the main goal of the shareholders of newly established banks, were to attract funds for financing their own businesses. Thus, the newly established banks from the beginning had ill-corporate governance and distorted operation function.

The structure of the financial system remained simple even in the matured transition phase. The dominance of the banks within the financial system remained during the whole transition period. In 2002 they accounted for 96.5 percent of total financial transactions. Other bank like financial institutions consist of saving houses. They are small financial intermediaries that can collect deposits and extend loans to households. They account for 1.8 percent of total financial transaction. A compulsory deposit insurance scheme was established in 1996. The scheme is insuring only household deposits up to Euro 20,000. Apart from state own health insurance fund and pension fund, which have been functioning as pay as you go systems, private investment funds have not been established (see table 13 in the Appendix).

2.1. Financial restructuring of the banking sector

The restructuring of the banking system started in 1995 with big delay. Mainly, soft loans seeking groups (individuals and enterprises) through borrowing from state owned banks with intention not to repay loans, were prolonging financial sector reforms. Due to this financial reforms started only as financial restructuring of the banking system.¹ The operational restructuring² of the industry was put in halt.

¹ The main purpose of financial restructuring is the renewal of the bank's solvency (net worth). The bank could improve its balance sheet by inflow of new capital (from the present and new shareholders), by reducing the liabilities (for instance, some liabilities to be written off), or by increasing the value of the assets (for instance, by improving the collection of bad claims, by accelerating the realization of collateral for bad loans and so on). This phase of the bank's restructuring usually includes government intervention by: replacement of bad claims with government bonds, establishment of a government agency for the collection of bad claims undertaken from banks, liquidity support from the central bank, acceleration of the privatization process in banks and so on.

² Operational restructuring includes: audit of the business strategy of the bank; improvement of corporate governance; establishment of sound management and accounting systems; adoption of better techniques for risk evaluation and asset and liability management; efficient liquidity management; and implementation of an efficient internal control and audit system as a prevention against different kinds of risks. Operational costs in banks could be reduced by the implementation of new technologies, closing some branches, opening agencies, and reducing the number of employees. Usually this phase begins with a change of management of banks under the rehabilitation programme.

The main goal of financial restructuring of the banking system was to clean up the bad loans from the portfolio of the old banks. The costs of the rehabilitation were extremely high. Total costs reached 42.3 percent of GDP, out of which 12.1 percent refers to the cleaning of bad loans from the balance sheet of the banks, and 30.2 percent refer to the costs for payment of foreign currency deposits of households, deposited in the banking industry before 1992. Thus, soft loans from old banks that were playing a role of implicit government subsidy de facto be-

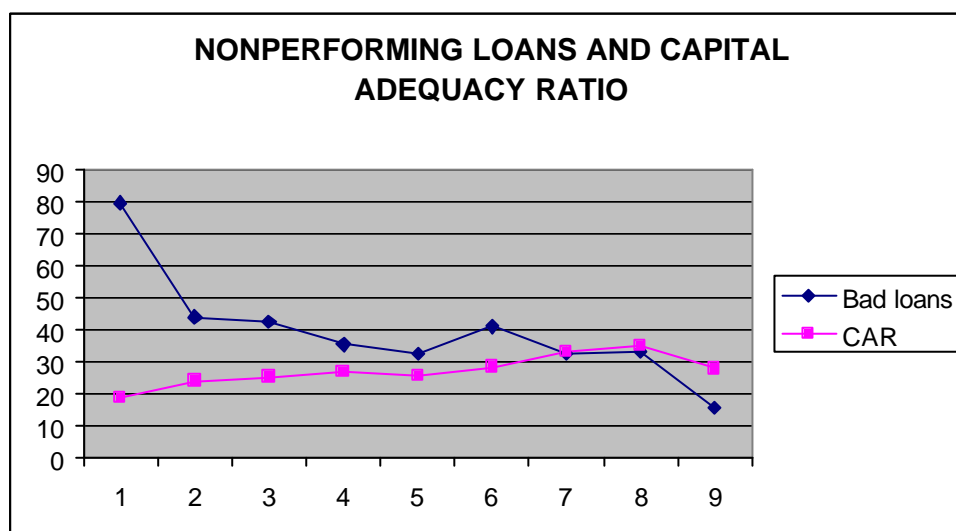
came explicit government subsidies. This was, worldwide, one of the most costly operations of bank restructuring³.

³ The financial restructuring of the banking system has considerable fiscal implications, with the costs being borne by taxpayers. There is empirical evidence that these costs range from 4 percent of GDP in the case of bank restructuring in Philippines to 45 percent of GDP in the case of restructuring of the banking system in Kuwait. The average costs for restructuring of the banking systems in transition economies were about 8 percent of GDP (the Czech Republic in 1993: 7.8 percent of GDP; Hungary in 1993: 12.2 percent of GDP; Poland in 1993: 5.7 percent of GDP).

There was no special programme for privatization of the old banks which were owned by socially owned enterprises. Banks were automatically privatized along with privatization of enterprises. Thus, the root cause of financial indiscipline among enterprises is probably the interlocking relationship between many of commercial banks and their owners – enterprises that were interested to get soft loans from the banks instead to maximize the shareholders value.

Graph 1

Non-performing loans and capital adequacy ratio



The misallocation of funds continued, although the share of bad loans in total loan portfolio was decreasing. Non-performing loans level remained high until 2000. Kosovo crisis has its contribution in worsening the loan portfolio of banks also. Thus, competition in the financial sector re-

mained weak, resulting in low efficiency.

2.2. Operational restructuring

Inflow of foreign capital and presence of the reputable foreign banks started after almost a decade of transition. This was big disadvan-

tage for the financial sector. The entrance of the first foreign reputable bank was in 2000. This initiated process of operational restructuring of the banking industry. The largest bank – Stopanska Banka Skopje, was sold to three foreign reputable institutional investors: National Bank of Greece S.A. Athens, Euro-

pean Bank for Restructuring and Development and International Finance Corporation. Actually, Stopanska Banka Skopje, became subsidiary of National Bank of Greece, having in mind that it has had share stake of 74 percent. The precondition for this development was a second financial restructuring of the bank, which occurred at the end of 1999 with the replacement of EUR 125 million of bad loans by government bonds. This created additional costs of 3.5 percent of GDP for rehabilitation of banking industry. Another small bank was undertaken by Alfa Bank from Greece, and the third largest bank by Nova Ljubljanska Banka Ljubljana. Simultaneously, at the end of 2002, Bank of Austria opened representative office in Macedonia. Thus, at the end of 2002 more than half of the banking industry was in the hands of reputable financial institutions that has had expertise and experience to manage a bank.

The link between enterprises - shareholders searching for soft loans and banks was broken. Corporate governance of banks was normalized. Competition and efficiency has been increased through the comprehensive reorganization and restructuring, that was dictated by Stopanska Banka Skopje. All these measures had increased the soundness, efficiency and credibility of the banks, which was reflected into reduction of the bad loan portfolio, lower interest rate margins and high capital adequacy ratio, resulting with grade 3 in classification of banking reform in

the EBRD Transition Report for 2002 (EBRD, Transition Report, p. 20). However, the inter-mediation and depth of the financial market remained low, and from this respect Macedonia was lagging behind to other transition economies (see table 14 in the Appendix).

Increasing profitability and efficiency, together with introducing higher transparency and larger market discipline are remaining main short-term goals of the banking industry and supervisory authorities. Securitization of the economy remains as medium term goal. The role of the banks is remaining crucial for promoting high economic growth. Efficient allocation of domestic and foreign savings is precondition for sustainable economic development and increasing of employment. The challenge for supervisory authorities would be small weak banks (about ten almost half of the total number) that do not account more than 20 percent of total banks assets. These banks were created as banks with ill-corporate governance, to attract funds for financing activities of their shareholders. The shareholders of these banks do not have expertise and experience to transform them from weak to sound banks. Their phasing out from the market seems inevitable.

3. Conclusions

The Macedonian economic transition has been implemented under unpleasant external and internal environment. However, due to the small size of economy

and unstable regional situation, the country was exposed to the variety of external shocks. Due to this, the country reformers did not enjoy any "honeymoon period". The main internal shock was the security crisis in 2001, which undercut business prospects and investment activity. The size and frequency of external and internal disturbances did not allow the policy makers to fully concentrate on the comprehensive long-term economic reforms. The short-term attempts for overcoming unexpected unfavourable shocks dominated their decisions.

Despite this, the first generation reforms: stabilization, foreign trade liberalization and small-scale privatization were successfully implemented until 1995. The effectiveness of initial economic reforms was especially increased with arrangements concluded with the IMF and the World Bank. In addition, domestic team of economic advisors contributed to the efficiency of the reform process, as well.

The second generation reforms, which are focused on large scale privatization, microeconomic restructuring and institution building obviously have tended to advance more slowly than initial phase reforms. The reasons for weak results lie in the facts that they are considerably more complex, require significant implementation capabilities from the state and broader social consensus in order to overcome the resistance coming from different interest

groups in this advanced stage of transition.

During the transition period, the permanent IMF arrangements along with its dominant leadership enabled authoritarian approach to policy making. The IMF and World Bank arrangements partially substituted for the lack of broad based consensus for the transition reforms. Due to the falling output and increasing unemployment and poverty, the authorities were not able to create compensating mechanisms for the transition losers.

All these factors together with unfavourable structure of fiscal expenditures tied the hands of policy makers to promote more energetically the capital accumulation and economic growth. A major weakness remains the weak institutional framework and especially the lack of the firm rule of law. Despite considerable support of the reforms by the international financial institutions, the inflows of private capital and foreign direct investment were low, while export growth was anemic and stagnant. Due to the delayed transition and high social costs there is widespread public feeling of "reform fatigue".

Continuous institution building, energetic reforms in the financial and real sectors and the continuation of sound macroeconomic policies are the only ways for bringing more dynamism into the economy. In this regard, the entrance of the reputable foreign banks has increased

the industry's efficiency and represents a solid background for promotion of other sectors' restructuring and for acceleration of the economic growth. The process of EU accession would give additional impetus for accelerating and finalizing the transformation into the modern market economy.

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Specifics in Slovenia's transition process

By Mojmir Mrak, Peter Stanovnik and Franjo Štiblar

Slovenia's success in economic and social transition during recent 13 years of independence was to a significant extent a consequence of special conditions under which the transition was made. Only recently, the appropriateness of the country's *sui generis* approach was widely recognized by various international institutions, including most important international financial institutions.

Here, two issues will be briefly presented. First, specific framework that enabled Slovenia to design and implement special approach (procedure) to the transition process. Second, special solutions in some key areas of economic reform (substance).

Specific framework of Slovenian transition

There have been several particularities that enabled *sui generis* approach of Slovenia to transition. This approach was frequently in defiance of advises and statements of major international financial institutions and foreign advisors.

At the beginning of the 1990s, i.e., at the starting

point of the transition process, Slovenia was faced with the following facts:

– After its declaration of independence in June 1991, Slovenia was not politically recognized for several months. The country became a UN member only in May 1992, and a member of international financial institutions later on in 1992 and in early 1993. Slovenia had no need to enter into an IMF sponsored arrangement that would impose its views on the overall transition process through conditionality clauses. Taking into account a complete cut of links with Belgrade, the newly independent Slovenia had practically no foreign exchange reserves at the time of introduction of its currency. It is for this reason that floating exchange rate regime was the only possible solution to generate foreign exchange reserves.

– The following underlying pattern of Slovenia's transition is related to the fact that it is one of many countries where the transition from a socialist to a market economy has

been accompanied by a transition from a regional economy to a national economy. When Slovenia became independent, its first tasks were not related exclusively to economic transition issues, but also included issues of key importance for creating a sovereign state. One of these tasks was the creation of the institutions of a sovereign state, which had not existed before independence, such as a central bank and a national currency, customs system, and a worldwide diplomatic network under the direction of the ministry for foreign affairs. Another was the creation of economic conditions conducive to compensating the loss of the larger part of the internal market of the former SFR Yugoslavia.

– Legacy of the pre-transition period, including much stronger market orientation and democracy in comparison to other transition economies, has strongly influenced the concept of transition in Slovenia. On the one hand, this legacy bequeathed some important benefits to Slovenia as it embarked on its transition. The country inherited a

strong tradition of a quasi-market system with relatively independent enterprise management structures. On the other hand, the legacy of the former SFR Yugoslavia's economic system also had some strong negative effects. Two issues deserve special mention here. First, the tradition of self-management system influenced the approach that Slovenia took to privatization, in which a very important role was assigned to workers. Second, Slovenia inherited huge internal and external imbalances from the former Yugoslavia.

Slovenia was characterized with a relatively high level of economic development in comparison to other transition countries. Higher volume of domestic financial resources has enabled the country to embark on a different path of the transition process than most of other transition countries and to adopt different sequencing of the transformation activities. Its main characteristic has been a strong preference of the gradualist approach over shock therapy. Slovenia opted for a gradualist approach in its transition from a planned to a market economy for several reasons, of which the following are some of the most important. One was the endogenous origin of Slovenia's transition, in which the old elites not only anticipated the transition but, by introducing important changes already in the pre-transition period, also influenced their own future position in the society and economy in the aftermath of transi-

tion. Another reason was the already mentioned relatively high level of development, which allowed a more cautious approach to the transition and which introduced into the cost-benefit analysis the consideration that it was important not to undermine some of the positive developments that had preceded the transition. A third reason was the generally cautious attitude of Slovenians toward economic reform, accompanied by a tradition of consensus building in the face of any major collective decision. Finally, the shock to the economy caused by the loss of the Yugoslav market, together with the unstable political situation in Slovenia itself during the early independence period, argued against a "big bang" approach to the transition.

The main argument in favour of a gradualist approach to transition has been articulated as a counterargument against the big bang approach. Big bang reforms in other countries have typically been accompanied by large shocks to the economy, leading many times to temporary but severe losses of output and growing unemployment, and consequently to the threat of social instability and ultimately reversal of the reforms. A more gradualist approach gives economic agents more room to adapt, although it can also lead to a halt in the reform process. Gradualists believe that their approach is better because it allows some economic activity and some jobs to be reallocated between firms or

industries rather than lost altogether.

Strong political consensus and a tradition of economic and political reform were the main reasons why it was natural to choose a gradual approach in the early stage of transition. This approach was, however, not without its drawbacks, one of which was a stalemate between interest groups, leading to postponed decisions and less-than-optimal compromises, which delayed some crucial structural reforms. Recent developments have warned that the continuation of the gradualist approach might seriously hamper economic competitiveness and even backfire on a macroeconomic performance that has so far been remarkably stable.

Specific solutions applied in the Slovenian transition

Three strongholds of Slovenia's successful transformation in financial and fiscal sector (thus supporting transition of enterprise sector) were (i) independent central bank and prudent monetary policy with strong supervision of banks, (ii) successful bank rehabilitation with domestic financial resources (similar to this exercise in developed countries), and (iii) prudent fiscal policy with budget close to equilibrium during the past period.

In the following paragraphs, these specific features are explained in some more details.

– Managed floating exchange rate regime was introduced from the early beginning. It enabled accumulation of foreign reserves in the early post-independence. An important vehicle for generating foreign exchange reserve was selling – for foreign exchange – of socially owned apartments to population for foreign exchange. The selling was made at highly discounted value around 17% of market price.

– Quickly liberalized trade of goods accompanied by slower liberalization of trade of services. Capital flows were liberalized gradually, more intensively from 1999 on, what protected Slovenia from financial crises in many emerging economies in 1997 and 1998.

– Creation of fully independent central bank responsible only to Parliament, which led successful monetary policy: (i) introduction of new domestic currency Tolar in October 1991, (ii) moderately restrictive money growth, (iii) conservative approach to creation of new banks (their number only doubled after independence from 16 to 35 at the peak, but later declined to 19 in 2004), (iv) two-tier banking system existed in Slovenia, being a part of the former Yugoslavia, already from the 1960s. Slovenian central bank is being known for inventive policy of monetization and sterilization of net inflow of forex in connection with managed floating exchange rate regime. In early stages, it was using open market policy in-

struments, while later on, i.e., since 1999, discount rate was applied as a main instrument.

– All costs of transition depression and of the dissolution of the former Yugoslavia have been accumulated in the banking sector (as »black hole«). To rehabilitate two largest banks (being under several and joint liability clause for all ex-Yugoslav external debt due) the Government replaced bad assets of these banks with government bonds (in the size of 12% of GDP), financed by the budget. With the constitutional law adopted in 1994, claims and liabilities to other ex-Yugoslav republics were placed in two largest old banks, while with all other assets and liabilities two new banks were established in 1994. These new banks obtained international ratings after Slovenia reached agreement with foreign creditors to service part of ex-Yugoslav debt.

– Fiscal policy was prudent from the beginning of independence in 1991. In the first half of 1990s the country had budget surplus. After tax burden was partly lifted from enterprise for reasons of higher competitiveness in the second part of 1990s budget started to create deficit of around 1-2% of GDP. Public debt is below 30% of GDP, external debt manageable and net external position close to equilibrium.

– Sui generis economic policy did not give priority to stability over growth (as in many other

transition economies dependent on IMF through conditionality), but tried to give both goals equal importance. Thus, average growth rate in the past 12 years was rather stable at an average annual level of around 4%. Inflation was for several years higher than in some other transition countries. After mid-2003, however, the trend of inflation is quickly decreasing to reach 3.5% at in 2004. Decreasing inflation is due to nominal convergence as country intends to enter the ERM2 regime until the end of 2004. Changed priority of economic policy led to declining GDP growth rate (below 3% in 2003), stagnating unemployment rate (at 6.8%), but Slovenia succeeded to retain external and internal equilibrium (current account slightly positive, budget deficit only 1.5% of GDP). Sustainability of growth had always priority over its overly and unsustainable stimulation as economic policy goal.

– Twin deficit was never a problem for Slovenia. Therefore foreign exchange was not urgently needed (managed floating) and therefore selling of domestic assets to foreigners was not a priority. Slovenia tries to retain some of blue chips in real and financial sector in domestic hands (the only country among developing countries with the chance for that), thus following example of all "old" EU-15 members. Such attitude towards inward oriented FDI was criticized by international finance institutions. Liberalization is gradual, and the goal of

Slovenia is, if country wants to become equal partner in the enlarged EU-25, to become net exporter of capital in the future. Outward oriented FDI (mostly towards East and South East of Europe) should be larger than inward oriented FDI from the West. Information capital was retained in domestic hands with such approach to FDI.

– In the real sector, privatization of enterprises was gradual (thus Slovenia was learning from mistakes front-runners made in the process) and in the form of compromise. Several possibilities were given and choice of privatization model remained with workers and government. As privatization could not be fast, efficient and just at the same time, the compromise among these three goals was found so that inequalities among citizens did not explode. Slovenia retains income (and wealth) distribution close to Scandinavian countries and is among the most equal among the transition economies.

– Solid GDP growth rate was obtained in the past 12 years by strong orientation to export (supported from managed floating) and by domestic orientation to infrastructure investment (building highways).

– Special feature of Slovenia was that it was able to retain a strong middle class (practically the only one among transition economies) as foundation for political stability. Elections are in regular terms of 4 years (only one exception in 2000). Proportional election system prevented overly polarization of political forces. Both potential candidates for poverty (and social problems) were well protected in Slovenia. Peasants used their strong political lobby (party) to obtain subsidies, pensioners their lobby to keep growth of pensions in relation to wage growth (or even faster).

All in all, closeness to the Western Europe, tradition of social and economic contacts with developed

world gave Slovenia advantage over other transition economies in transforming economy and society into standards required by EU, of which country became a member in May 2004.

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A Brief Overview of Reforms in Southeast Europe

By Vladimir Gligorov

1. The role of crisis

In the global research project on Understanding Growth, crisis has been identified as one factor that has been conducive to economic policy changes and thus to growth accelerations. Similarly, it has been argued in preliminary assessments of the global research project on Under-

standing Reform that crises are conducive to reforms – indeed, to regime changes in the case of post-socialist or post-authoritarian states.

In the country studies on Southeast Europe, crises do not play such a straightforward role. One crisis that does play a role

is hyperinflation. In a number of cases, stabilizations follow incidences of hyperinflation. Thus, stabilization in Bulgaria came after the near hyperinflation of 1997. Stabilizations in Macedonia and Croatia also came after episodes of high inflation. Most dramatically, the first stabilization in Serbia was

attempted after the record-breaking hyperinflation of 1993 and the beginning of 1994.

A crisis of another type was conducive to changes in Albania. There, the collapse of a pyramid scheme led to internal strife that verged on a civil war. That crisis led to a speed up in democratization and in institution building. Those, in turn, led to a speed-up in privatization and in other areas.

Of course, a crisis of institutional disintegration, as the one that befell former Yugoslavia at the beginning of the transition, can have far reaching consequences not only in terms of costs but also in terms of the ability for institutional development. Some institutional evolution if not necessarily inertia tends to be useful in transitions and large-scale reforms in general. In that sense, institutional shocks, when they occur or are even engineered, can have quite unpredictable and unintended consequences.

A typology of crises would be useful. That is still to be worked out. In this brief overview of the country studies of Southeast Europe, it could be argued that it is the type of the crisis and the type of the policy response that matter. There are crises, sometimes protracted crisis, which are very costly and bring in long-term problems that sap the development of a country. There are those which initiate corrections in some policy areas. There are still others which lead to inappropriate policy responses.

Finally, there are those which set a country on a long-term process of transformation and development. All of those can be found in the transition experience of Southeast Europe.

Thus, on the evidence from this region, it cannot be argued that crises are unequivocally beneficial for reforms. More importantly, the most successful transition in that region and perhaps in post-socialist countries in general, that of Slovenia, did not require a crisis at all. Thus, it cannot be maintained that the eruption of crisis is a necessary precondition for the adoption and implementation of reforms.

2. The speed of transition

In Southeast Europe some reforms can be characterized as of a shock-therapy type, and others as being more gradual. Indeed, Slovenia is the almost canonical case of gradualism. It is also by far the most successful transition economy in this group and certainly one of the most successful ones among all transition economies. It chose a combination of macroeconomic stabilization strategy and microeconomic adjustment with institutional reform that is quite distinct.

Its macroeconomic policy was based on a balanced budget and balanced current account rather than on speedy stabilization. As a consequence, its disinflation was slow and its liberalization of foreign financial transactions was gradual. It managed to have a

short transitional recession and than a sustained growth. Its microeconomic policy was based on the assumption that privatization should not be disruptive of the workings of the firms and that significant increase in unemployment should be avoided. Finally, it shied off significant institutional disruptions aiming to preserve the social cohesion of the country. Its transition was speeded up once the process of accession to the European Union intensified. By contrast, Slovenia managed its whole transition without a programme with the International Monetary fund (IMF).

All the other post-Yugoslavia states as well as the other countries in Southeast Europe chose different strategies of reform. If Slovenia's strategy is named as that of active gradualism, some others could be called defensive gradualism, misguided gradualism, adequate shock therapy, misguided shock-therapy and imposed shock-therapy. A country could try one or more of these strategies. Some examples may be illuminative.

Bulgaria followed the strategy of defensive gradualism until the crisis of 1996-1997. Then it adopted a partial shock therapy strategy with the introduction of the currency board. Afterwards it followed an increasingly active gradualism with the aim of joining the European Union.

Romania followed the strategy of misguided gradualism until the crisis

in the late 1990s. Since then, it has followed a strategy of increasingly active gradualism, again anchored in the expectation of European Union integration.

Albania experimented with the shock therapy in early 1990s, but then faced an institutional meltdown. Afterwards it has been relying on a combination of defensive gradualism, i.e., it is doing the unavoidable and more active gradualism, i.e., introducing reforms that should strengthen its institutional set-up.

Serbia and Montenegro are cases of an initially misguided gradualism, the idea being to change only those institutions that stand in the way of the emerging business and political elite and to preserve everything else. That strategy collapsed in 1993-1994 and a shock therapy type of reform was introduced in order to stabilize prices and initiate privatization. That attempt failed too. Montenegro then introduced euro unilaterally to an extent as a substitute for other reforms. After year 2000, a more far-reaching reform was attempted in Serbia, that has shock therapy elements in design but is proceeding as a defensive type of gradualism.

Croatia exhibits similar pattern of partial shock therapy and defensive gradualism. After 2000, gradualism has become more active and it may intensify in view of the speed up of the process of European Union accession.

Macedonia has followed the path of gradualism throughout. Initially, it was more defensive, while later on it showed signs of increased activism. However, the tenuous political stability and adverse economic developments have dampened the activism. It has generally been intensified in the times of crisis, of which there were quite a few.

In Bosnia and Herzegovina and in Kosovo a combination of an imposed shock therapy with a rather defensive gradualism has led to delayed transition and to longer-term institutional and economic problems.

Overall, it can be concluded that:

- wholesale shock-therapies have tended to lead to crisis and failures,
- partial shock-therapies have tended to be successful, especially in bringing about price stability,
- defensive gradualism was attempted almost everywhere, except in Slovenia, and has failed without exceptions,
- misguided gradualism, again practiced throughout the region especially in the initial period of transition has tended to lead to the emergence of weak institutions and to large informal sectors,
- imposed shock therapies have tended to be combined with defensive gradualism that has led to slow or stalled reforms, and
- partial shock therapy with active gradualism seems to have been the strategy that has brought about the best results in terms of the speed, the

quality and the sustainability of reforms.

3. The sequencing of transition

It has been argued that democracy precedes reforms in the more successful European transition countries. Democracy also supports the rule of law and the development of institutions. The latter is speeded up in the process of accession to the European Union. Thus, political and legal reforms are essential in such a comprehensive reform as is the transition.

While democracy comes first, rule of law gets established and strengthened throughout the course of the transition. It can be supported or delayed depending on the way the economic reforms are faring. Their success does depend on the sequencing of reforms. The initial idea of shock therapy was to do everything at once, but that is clearly utopian. The initial idea of defensive gradualism was to do only that which cannot be avoided, which usually means not to do much before crisis puts everything on the table. In between, there is the combination of the shock therapy and gradualism that seems to work the best. But then, sequencing is the key.

One strategy that combines these two approaches is to apply shock therapy to macroeconomic stabilization and active gradualism to the changes in ownership and in the economic structure. This raises the question of what

is meant by macroeconomic stabilization and how to do privatization and restructuring?

In Slovenia, macroeconomic stability was interpreted through macroeconomic balances. An economy is stable in the macroeconomic sense if its current account and its budget are balanced and if there is no high and sustained unemployment. That implied active exchange rate and interest rate policies and slow disinflation. This understanding of macroeconomic stability assumes liberalized internal and external markets, i.e., a shock therapy approach to liberalization of trade (not to financial transactions).

In other countries macroeconomic stability was defined mostly as price stability. Thus, most all stabilization programmes, irrespective of whether they were adopted and implemented earlier or later, were anchored in exchange rate stability. In some cases, fiscal balance was maintained to support the exchange rate and price stability, but external balances were not. Also, unemployment was let to rise to quite high levels.

The latter definition of macroeconomic stability

was believed to be appropriate on the assumption that the structural adjustments will also proceed rather swiftly. If privatization and restructuring took longer period of time, than price stability could be shaken. Again, in Slovenia, macroeconomic stability as defined there was in tune with gradual privatization and restructuring. In other cases, macroeconomic imbalances have set in and have even caused crisis because structural reforms have been delayed. The optimal speed of microeconomic transition may indeed be lower than it is required to sustain sharp deceleration of inflation. In any case, in Southeast Europe, structural reforms have tended to be slow and thus macroeconomic imbalances have developed and constrain some reform efforts.

4. The role of anchors

As is well-known, Southeast Europe has disintegrated internally and externally and has not relied as decisively as Central European countries in transition on the anchor provided by the European Union or rather by the prospect of accession to the Union. The lack of this anchor is quite important and explains a lot of prob-

lems in the transition in this region.

Substitute anchors of the International Financial Institutions and of direct international public governance have not proved to be very efficient. In fact, in the case in which the international community has taken over the responsibility of public governance and of the initiator and implementer of reforms, defensive gradualism has been the rule.

5. Overall conclusion

The main conclusion is that democratization is a necessary condition for successful transition in Southeast Europe, that partial shock therapy and active gradualism are the best strategy of reform, and that the anchor of the European Union cannot be substituted by another one.

Vladimir Gligorov is staff economist at the Vienna Institute for International Economic Studies.

Announcement: Launch of the new GDN project

Based on an initiative by The World Bank, the Vienna Institute for International Economic Studies started the project Global Development Network Southeast Europe (GDN-SEE) in January 2000 with financial support from The World Bank and the Austrian Ministry of Finance. Since 2002, the project is also supported by the Oesterreichische Nationalbank (Austrian Central Bank).

The purpose of the project is the creation of research networks throughout Southeast Europe in order

- to enhance the economic research capacity in South East Europe (SEE)
- to build new research capacities by mobilizing young researchers

- to promote knowledge transfer into the region
- to facilitate networking between researchers within the region (beyond country borders)
- to assist in securing knowledge transfer from researchers to policy makers.

In the period 2004 – 2006 the project has the following aims:

1. to build new research capacities for the analysis of important aspects of economic development in the region and the formulation of sound policy measures
2. to further develop research networks in the Balkans with the aim to conduct high level research

3. to encourage new research on selected topics such as: economic growth and competitiveness in the SEE region and the development of the regional labour markets with a special focus on human capital.

For more information on the GDN project and for the papers of the first and the second phase of the project please follow the link:

<http://www.wiwi.ac.at/balkan/gdnsee.html>

BELGRADE CENTRE FOR EUROPEAN INTEGRATION (BeCEI) is a non-governmental "think tank" which gathers leading Serbian and foreign experts in political, economic and security reforms that are necessary for the Euro-Atlantic integration of Serbia and Montenegro.

BeCEI's main role is twofold: to help the government's reform agenda with independent research and consultancy, and to help the public understand and participate in the country's full integration especially into the European Union. BeCEI performs these roles through its policy-oriented studies and other publications, through education and training for people from governmental and non-governmental organizations, and through public awareness campaigns. Following previous engagement of its members in many regional projects, BeCEI puts special emphasis on this aspect of its work, and cooperates with similar think tanks coming from, or dealing with, South East Europe.

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Analysing and forecasting economic developments in the transition economies of Central, East and Southeast Europe

Analysing and forecasting economic developments in the transition economies of Central, East and Southeast Europe, conducting studies on enlargement of the European Union and running the Balkan observatory together with the London School of Economics and the ELIA-MEP (Greece).

Undertaking research into reconstruction and stabilization in Southeast Europe, providing policy advice, supplying technical assistance and co-ordinating research networks, particularly within the framework of the World Bank initiative Global Development Network South-east Europe

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