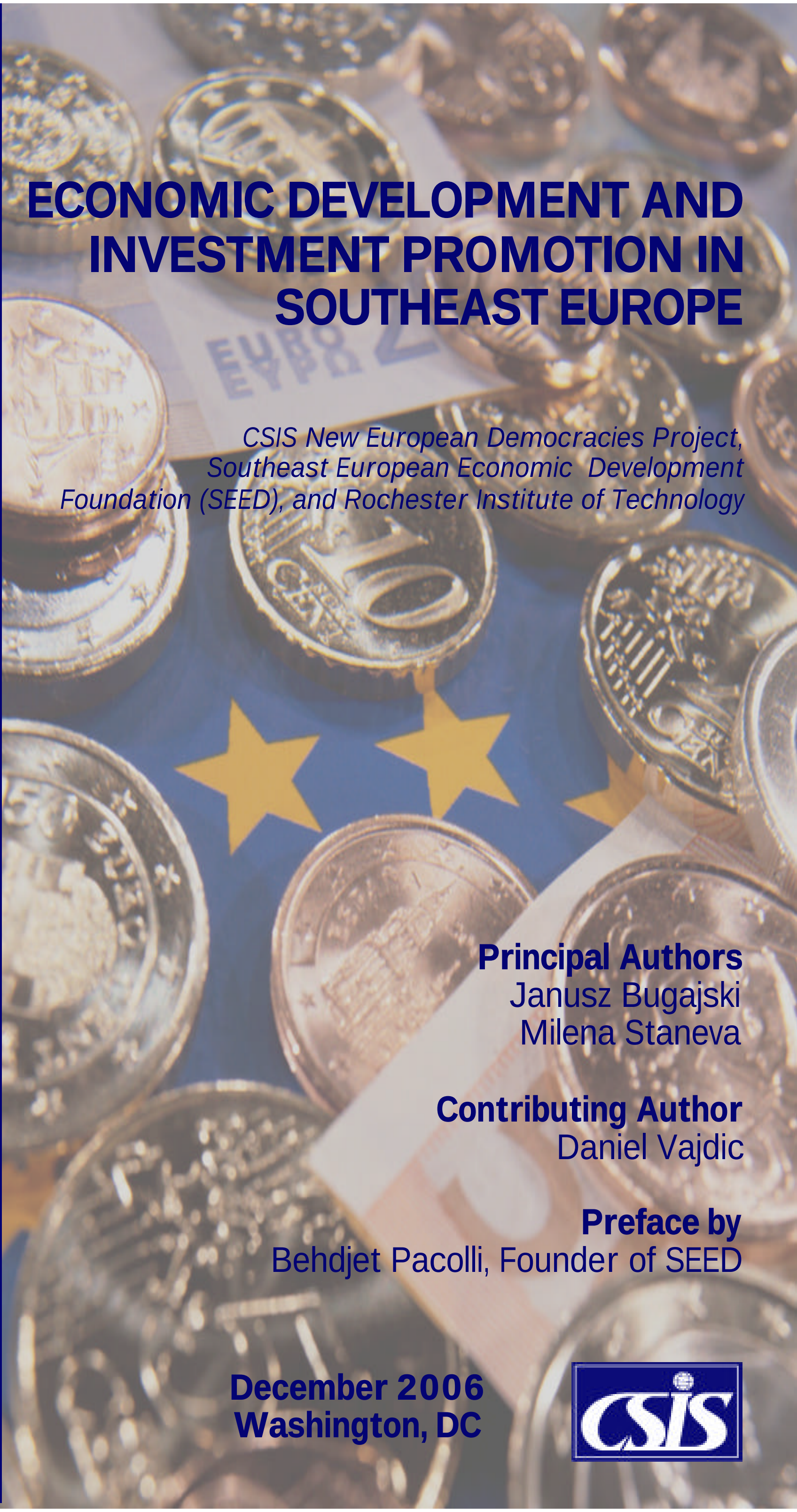
CSIS POLICY REPORT



ECONOMIC DEVELOPMENT AND INVESTMENT PROMOTION IN SOUTHEAST EUROPE

CSIS New European Democracies Project, Southeast European Economic Development Foundation (SEED), and Rochester Institute of Technology

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Preface by
Behdjet Pacolli, Founder of SEED

December 2006
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* * *

Preface

By Behdjet Pacolli, Founder of SEED

It is not necessary to debate the political situation in Southeast Europe or the tragedies that occurred after the break-up of Yugoslavia. While the rest of the states in Eastern Europe that emerged from communism quickly embarked on the path to democracy and development, the West Balkans faced destruction, wars, and large-scale population displacements.

But today, the only remaining political challenge in the region is the final status of Kosovo. The international community should be assured that only the full independence of Kosovo and the full recognition of this independence will guarantee stability, security, and mutual respect in this volatile region. A free Kosovo, recognized and accepted by others will also show respect to others and will successfully fight crime and corruption. Kosovo will be multi-ethnic, multi-religious, and multi-lingual, a democratic and civilized country, which will belong not simply to Albanians but to all Kosovo citizens.

We are forever grateful to the international community, in particular to the people and the government of the United States, for its involvement to ensure freedom and security for all people in the region. Now the responsibility for achieving these goals is understood and shared by the small nations of Southeast Europe.

Governments in the West Balkans realize that not through violence, but through cooperation, hard work, and respect for human beings of all ethnicities and religions, can they propel the region toward development and Euro-Atlantic integration.

With this vision in mind, I established the Southeast European Economic Development Foundation (SEED) to seek out possibilities for facilitating economic cooperation between the states and nations of this region, which would assist in creating new jobs, foster development, and raise the people's awareness of their rights and obligations. Collaboration in Southeast Europe will make the region more attractive to foreign investment, while the free movement of people, ideas, goods, and capital will consolidate trust and mutual respect among formerly divided nations.

There are strong opportunities for cooperation in fields like the energy sector, transportation, and trade. The implementation of joint projects can bring great benefits for efficient exploitation of the region's natural resources. I appeal to everyone work together and to respect each other, because that is the sole way out of crisis and poverty and toward lasting peace and prosperity.

* * *

Economic Development and Investment Promotion in Southeast Europe

Introduction

Mapping Southeast Europe's Future

The western part of the Balkan Peninsula stands at an important crossroads between the past and the future. The one remaining statehood issue between Kosovo and Serbia is rapidly approaching resolution by international actors. As a consequence, it is now clear that economic progress through domestic reform, regional collaboration, foreign business investment, and eventual European Union accession are the most important challenges and opportunities facing the entire region.

On October 5-6, 2006, the New European Democracies Project at the Center for Strategic and International Studies (CSIS), the Southeast Europe Economic Development Foundation (SEED), and the Rochester Institute of Technology (RIT) hosted an international conference aimed at refocusing attention on the West Balkan region in the next stage of its development. The conference underscored that it is imperative to promote self-sustained regional growth and that this effort will depend on the policies implemented by individual Balkan capitals. The conference focused on four major sets of issues that are fundamental to the region's progress: the political and legal framework, infrastructure development, trade barriers and opportunities, and the business environment and investment promotion.

A number of valuable proposals and recommendations were generated by the conference in several key areas with the objective to spur economic growth and investor confidence. Three of the larger recommendations will prove the most significant as they help frame the process and progress of economic development.

First, a region-wide free trade agreement needs to be finalized by the end of the year through an enlargement and modernization of the CEFTA (Central European Free Trade Area). Most governments are now committed to this beneficial accord. The highly successful Nordic Council that has contributed to economic development and regional political collaboration among the Scandinavian countries can serve as a valuable model for the wider Balkan area.

The European Commission and the EU as a whole are strongly pushing for a free trade agreement between all non-EU states in Southeast Europe to replace the multitude of confusing bilateral arrangements currently in place. Simplification and standardization will increase trade volumes, spur local economic productivity, and stimulate foreign investment. With this objective, the European Commission also seeks to increase assistance for small businesses in the region and encourage other initiatives that would spur the free movement of labor and capital.

Second, the regional energy market in Southeast Europe must be interconnected and expanded through the involvement of multinational energy companies. The Balkans can benefit from regional linkages and from the growing transit of oil and gas supplies from the Caspian basin to the European Union. In addition, the region will need to become fully integrated with the EU's Internal Energy Market in all energy sectors.

And third, all the West Balkan states need to create much more favorable conditions for foreign direct investment. By working with neighboring states, removing trade barriers and customs backlogs, and devising a regional investment framework, each country can become a hub for commerce and communications that will help attract foreign business. Many local leaders now understand that the Western Balkans are a significant emerging market of over 25 million people on the crossroads between Europe and Asia. Together with Bulgaria, Romania, and Turkey this market exceeds 120 million citizens. Each government in the region must pursue the structural and legal conditions that would significantly stimulate the developmental process, attract foreign capital, and create employment.

The approach of many EU leaders toward the West Balkans is rational and should not be viewed as some kind of substitute for Union entry. An economic boost around the region will help the advocates of regional incorporation in the Union and silence those voices that claim that the EU's "absorption capacity" has been exceeded. Pro-enlargers can argue that Balkan leaders are applying European standards in preparation for eventual EU integration.

The stage is now set for the next phase of Balkan development, where economic cooperation in areas such as trade, energy, communications, and infrastructure runs parallel with the process of "Europeanization." For each country in the region, "independence without borders" should be the operative slogan.

The most successful Balkan leaders will be measured according to their ability to move their countries into the European fold and to attract significant foreign investment. And citizens will vote for those politicians who can devise a strategy and implement a policy that will improve their living standards, enable them to travel and work anywhere in Europe, and give their children a brighter future.

* * *

Political and Legal Framework

The legacies of inter and intra-state conflict, ethnic tensions, and unresolved statehood questions remain the main obstacles to constructive cooperation among West Balkan states. While all the countries in the region share aspirations for improved living standards and European integration, any discussions of prospects for economic development and increased prosperity cannot be isolated from the underpinning political framework. Consolidating legitimate, stable, and effective democratic governments and institutions is critical to the long-term welfare of the region.

Recent Political Developments

The year 2006 has proven to be an important milestone in the region's political development and its democratic consolidation. A number of important elections took place throughout the West Balkans, including in Montenegro, which regained its independence from Serbia in a peaceful and democratic referendum. Despite the dwindling enthusiasm in many European capitals for further EU enlargement, the states in Southeast Europe are upholding their aspirations for Euroatlantic integration and the governments are hard at work in implementing reforms in line with EU standards.

Albania: For Tirana the most significant development in 2006 was the signing of a Stabilization and Association Agreement (SAA) with the European Union on June 12 after three years of negotiations. The event highlighted the far-reaching democratic changes that have occurred in post-communist Albania. The government has managed to implement a number of economic, social, and legal reforms in order to bring the country closer to the prospect of EU membership. Albania has received recognition for the steps it has taken toward fulfilling the Copenhagen Charter criteria. Despite ongoing disputes between political parties ahead of the 2007 presidential elections, the political situation remains stable. Nevertheless, many obstacles still remain. Particularly with regard to the rule of law, Tirana has a long way to go to comply with European standards. EU officials have identified the fight against organized crime and strengthening the judiciary as fundamental priorities in Albania's progress toward EU membership. A report issued by the European Commission in September 2006 also encouraged the Albanian government to speed up administrative and economic reforms, to promote freedom of media, to protect property rights, and to contain corruption.

Bosnia-Herzegovina: Just over ten years after the Dayton peace accord was signed in November 1995, Sarajevo received its most significant recognition for the progress it has achieved: the European Union commenced SAA negotiations with Bosnia on January 25, 2006. Potential EU membership for Bosnia-Herzegovina (BiH) has been the driving force behind reforms and a shared interest in EU integration is seen as a strong incentive to transform the relationship between Muslim, Croat, and Serb leaders. The European prospect is perhaps the strongest motivation to get all three sides to focus on the same goal. However, the Bosnian constitution as it stands and the country's institutions are not properly equipped to function in the way the EU accession process requires.

The international community has strongly advocated the need for constitutional changes and talks on the issue have been underway between the leaders of BiH's main political parties for over a year. The reforms are intended to strengthen and streamline the complex BiH administration and consolidate the central, state-level institutions. However, on April 26, 2006, in a 26-16 vote, parliament failed to achieve the required two-thirds major-ity to ratify the amendments.

Following the October 2006 elections in Bosnia-Herzegovina, there is fresh hope that the new political alignment in parliament will allow for the passage of needed constitutional amendments. The government will have to undertake renewed efforts to implement further political and economic reform as Bosnia moves from its post-Dayton structure to one more compatible with EU integration. In his remarks during the CSIS conference, Michael Mozur, deputy special coordinator of the Stability Pact for Southeast Europe asserted “the time has come for Bosnians to build their country, to strengthen national institutions, and to put aside more narrow political and ethnic interests.”

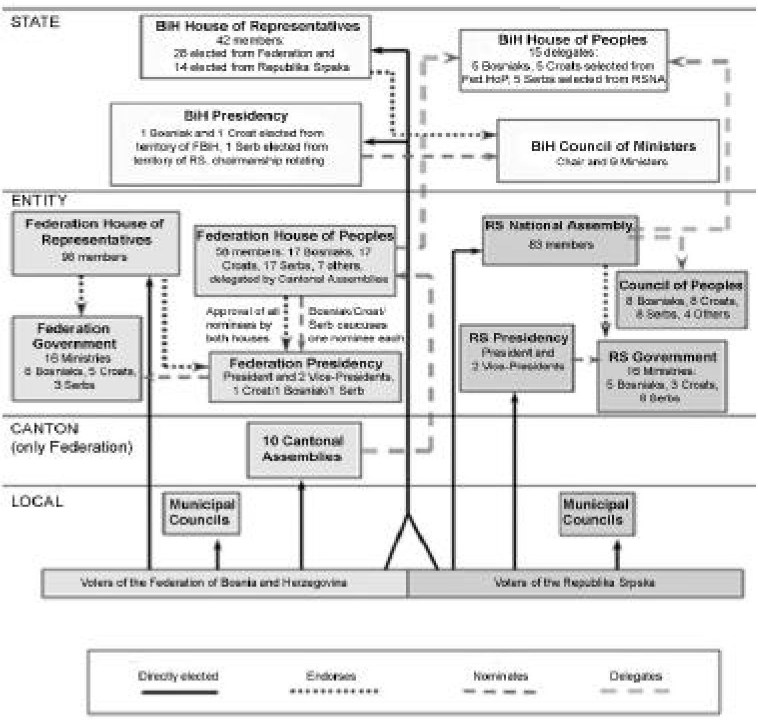


Fig. 1. Legislative and executive bodies of Bosnia-Herzegovina

Source: *http://www.colorado.edu/ibs/PEC/johno/pub/Dayton10yrsafter.pdf*

Croatia: After long delays, Croatia’s negotiations on EU membership were opened in late October 2005. Zagreb’s ties with Brussels have been significantly improved by the capture of war crimes indictee General Ante Gotovina. The green light given from the European Commission allowed Croatia to begin membership negotiations on 35 policy chapters for accession, but progress has been slow. Despite the setbacks, the country hopes to join the EU by 2009. But Croatia's EU bid could be harmed by insufficient progress toward arranging the return of refugees and better protecting minority rights.

In September 2006, the European Commission also criticized Zagreb for inadequately addressing the issues of organized crime and money laundering. EC officials are pushing the country to create effective legal preconditions for early detection of suspicious business ventures and real estate deals. Another challenge for the government in Croatia will be to address the public's concerns over EU membership. According to an opinion poll conducted by Pulse Institute in September 2006, 48.9 percent of Croatian citizens oppose joining the bloc. This represents a five percent drop in support since 2005.

Kosovo: At the beginning of 2006, formal negotiations on Kosovo's final status were launched with the intent to resolve the issue by the end of the year. The process has included talks on a wide range of issues, including minority rights, administrative decentralization, economic development, and protection of the religious and cultural heritage of all citizens. Several months into negotiations, it became clear that the final status of Kosovo simply cannot be resolved by any compromise between Belgrade and Prishtina, because of their diametrically opposed positions on the question of Kosovo's independence.

On September 20, 2006 the Contact Group, the multi-state body designated as an intermediary in the status negotiations, authorized U.N. mediator Martti Ahtisaari to propose a plan for final settlement that neither Belgrade nor Prishtina can block unilaterally. Once the Contact Group approves Ahtisaari's comprehensive report and his recommendations, then the UN Security Council is likely to issue a neutral resolution whereby Kosovo would be able to declare its independence without UN opposition. Even through status decision will be delayed until 2007, Ahtisaari is likely to recommend independence, arguing that because the two sides cannot reach a compromise, the only viable option is *de jure* separation and Kosovo's statehood but with specific international supervision over some key areas such as national defense. Meanwhile, the EU is preparing to take over from the existing UN mission in Kosovo where it will acquire considerable powers of guiding the administration in Prishtina.

Macedonia: Macedonia has been a notable success story in the West Balkans in terms of its progress in transcending ethnic divisions and achieving political consensus over the country's European future. The EU decision in December 2005 to grant EU candidacy status to Skopje is a significant recognition for Macedonia's progress in post-conflict development and its path to European integration. However, the country's ties with Brussels remain open-ended and various factors, including growing resentment among old EU members towards further enlargement, have slowed the advance toward opening accession talks with Skopje.

Implementation of the Ohrid Framework Agreement, five years after it ended the low-level insurgency by Albanian guerrillas in 2001, is nearly complete and essential reforms are underway. However, further steps need to be taken in specific areas such as strengthening the police and the judiciary. A number of bills and constitutional amendments have been drafted aimed at promoting judicial independence and curbing official corruption, but the international community needs to effectively monitor the government's implementation of such provisions.

Parliamentary elections in Macedonia in July 2006 resulted in a clear victory for the Macedonian center-right party VMRO-DPMNE. After extensive political negotiations, a new five-party coalition government was formed, which includes the Democratic Party of Albanians (DPA). The conduct of these elections was endorsed by the international community as neither nationalism nor ethnic issues figured in the election campaign. The main concern of voters was to elect leaders who would raise living standards and develop a functioning market economy.

Montenegro: On May 21, 2006 the citizens of Montenegro voted to restore their country's independence from Serbia in a referendum that was praised for its high democratic standards. The political sophistication and patience exhibited by the government in Podgorica showed that the goal of self-determination can be achieved peacefully. Montenegro formally declared its independence on June 3 and it was admitted as the 192^{nd} member of the United Nations on June 28, 2006. This launched the official procedure of establishing diplomatic ties with other states.

The pro-Western coalition that led Montenegro to independence achieved a sweeping victory in parliamentary elections in September 2006. The new government now has to achieve political consensus on a new constitution that will solidify Montenegro as a democratic multi-ethnic state. Officials in Podgorica will also have to speed up reforms to bring the country closer to NATO and the EU as its progress toward Euroatlantic integration is no longer held hostage to Serbia's failure to capture fugitive Serb war crimes suspects.

Montenegro now expects to re-launch negotiations on a Stabilization and Association Agreement with the EU in accordance with a decision made by the European Council in July 2006. Podgorica also received a green light for joining NATO's Partnership for Peace program at the NATO summit in Riga in November 2006.

Serbia: In October 2006 Belgrade marked the sixth anniversary of the public protests that toppled Slobodan Milosevic from power. But despite the political and economic progress Serbia has achieved since 2000, the legacy of the Milosevic regime is still noticeable in the country. Nationalist rhetoric remains rampant and provides one of the biggest obstacles to improving Serbia's relations with its neighbours and with Euroatlantic institutions.

As a result of Belgrade's failure to deliver war crimes indictee Ratko Mladic to the ICTY in The Hague, the EU suspended SAA talks with Serbia in May 2006. Despite hopes that the negotiations would be resumed in October, EU Enlargement Commissioner Olli Rehn issued a warning that the process will not be recommenced until full cooperation with the UN tribunal is ensured. The most recent progress report by the European Commission, released on November 8th, 2006 further emphasized that Belgrade's cooperation with the ICTY is the main obstacle to Serbia's progress toward EU integration.

The suspension of SAA talks also led to a political deadlock after the junior coalition partner G17 Plus withdrew from the governing coalition in protest at the derailed EU accession process. This left Prime Minister Vojislav Kostunica with a shaky minority government, which is further challenged by poor economic conditions.

In an attempt to mobilize the largely disillusioned Serbian population, the authorities in Belgrade pushed for the adoption of a new constitution. A national referendum on the new Serbian charter was held at the end of October 2006 and it passed by a narrow margin due to the low voter turnout, amidst charges of voting irregularities and an absence of public debate. The constitution is meant to pave the way for building institutions and moving forward with reforms, but it also asserts that Kosovo is an integral part of Serbia. International agencies congratulated the Serbian authorities on the passage of the constitution but voiced reservations over Belgrade's claims to Kosovo. Both the UN and U.S. envoys to the Kosovo status negotiations have stated that the new constitutional preamble with respect to Kosovo will have no impact on the final status settlement.

Following the referendum, Serbian President Boris Tadic called for both presidential and parliamentary elections to be held by the end of the year, which is largely interpreted as an attempt to delay final status resolution for Kosovo and prevent radical nationalist forces from increasing their support and gaining a place in government. After discussions between various Serbian parties, the parliamentary vote was scheduled for January 21, while presidential and municipal elections will be held later in 2007.

The EU and U.S. Roles in the Region

Democratic consolidation and economic development in the West Balkans depends on the region's political leaders, their vision, and their commitment to improving the quality of life of their countries' citizens. However, international players also have an important role to play in ensuring that reforms are implemented and that the region is drawn closer to European and Euroatlantic structures.

The EU: The prospect for EU membership has been the strongest incentive for local leaders to push forward with tough reforms and maintain political stability. The Stabilization and Association Process with the West Balkan states is the key mechanism that Brussels has put in place for bringing the region closer to European institutions. From a legal standpoint, there is little ambiguity in the process: there are clear criteria set for the aspiring states and the main objective for the Southeast European capitals is to bring their legislation closer to the *acquis communautaire* and to adhere to the EU's Copenhagen criteria. Although EU's tough conditionality has been criticized in the region, Brussels would be doing a disservice to both current and future EU members if it does not maintain consistency in its standards for accession.

The region still faces numerous hurdles on its path to EU integration. The European Commission annual report on November 8, 2006 stressed that strengthening the rule of law, curbing crime and corruption, protecting human and minority rights, and fostering regional cooperation should be the chief priorities for local leaders and they need to demonstrate the political will and the capacity to bring their countries in line with EU standards. But the challenges in Southeast Europe are exacerbated by the often cited "enlargement fatigue" in EU and the debate on future integration processes. The success or failure of the next wave of enlargement, with the accession of Bulgaria and Romania in January 2007, will also have an important impact on the future of the European project.

The current level of cooperation between the Western Balkans and the EU remains good and the EU continues to be the main donor for the region both as a bloc and on a bilateral basis from individual member states. EU members Greece, Austria, and Slovenia have displayed a particular commitment to European integration for the West Balkans.

Athens views full integration of the region into the EU as an important form geo-strategic and geo-economic bridging between Greece and the rest of the Union. Greece has expressed strong commitment to the creation of a free economic space in Southeast Europe that would include Turkey. Athens has invested EUR 14 billion in the region and over 3,000 Greek enterprises operate on the West Balkan market. Greece is also trying to facilitate a number of infrastructure and transportation projects, as well as major energy and pipeline initiatives throughout Southeast Europe.

Similarly, both Austria and Slovenia view stability in the Western Balkans as a key priority due the region's geographic proximity and cultural kinship. For example, the region is the second largest market for Slovenia after the EU. Slovenian FDI in Croatia, Bosnia-Herzegovina, Macedonia, Montenegro, and Serbia accounted for EUR 1.7 billion in 2005.

In terms of the Union as whole, EU assistance to the region this year alone has amounted to EUR 530 million. The aid has been extended through a number of existing Pre-Accession instruments, namely Phare, ISPA, SAPARD, and

CARDS. As of January 2007 the European Commission will replace the various assistance programs with a single framework entitled Instrument for Pre-Accession Assistance (IPA), which will be directed at both candidate countries and potential candidate countries. IPA funds will be allocated within the following categories:

- transition assistance and institution building;
- cross-border cooperation;
- regional development;
- human resources development;
- and rural development.

The table below shows the pre-accession assistance from the European Commission to individual states in the West Balkans in 2006:

Croatia	€ 140 million
Former Yugoslav Republic of Macedonia	€ 43.6 million
Albania	€ 45.5 million
Bosnia and Herzegovina	€ 51 million
Kosovo	€ 59.5 million
Montenegro	€ 23 million
Serbia	€ 167 million

Source: http://europa.eu

The introduction of the IPA framework was announced in the November 2006 annual report by the European Commission. The document also outlined the planned pre-accession assistance for the region for the period between 2007 and 2009.

Pre-acc. Assistance, in Million EUR	2007	2008	2009
Croatia	138.5	146.0	151.2
FYR of Macedonia	58.5	70.2	81.8
Albania	61.0	70.7	81.2
Bosnia and Herzegovina	62.1	74.8	89.1
Montenegro	31.4	32.6	33.3
Serbia	186.7	190.9	194.8
Kosovo	63.3	64.7	66.1

Source: *http://europa.eu*

Although the November 2006 EC report stated that further EU enlargement might be placed on hold in the short-term, it signaled that in the medium to long term the bloc will likely embrace the region, should the aspiring states satisfy all conditions for membership. The amount of IPA targeted for the West Balkans clearly shows that the EU will remain committed to the region and Brussels' aid will continuously increase in the next three years.

The United States: Despite its primary focus on the war against international terrorists and on security in the Middle East, Southeast Europe remains a region where Washington maintains strategic interests. The U.S. has allocated USD 4 billion in direct assistance since 1995 as part of its vision of united and peaceful Europe that embraces the Western Balkans. Washington has also provided hundreds of millions of dollars for civil society development, military reform, combating human trafficking, support for free media, fostering entrepreneurship, as well as technical assistance in the agricultural sector. The United States remains committed to completing the Balkan puzzle and has voiced support for eventual EU and NATO membership for all states in the region, provided that they meet the necessary requirements for accession. Washington has cooperated with the European

Union in devising a long-term strategy for the West Balkans, but it is also calling for the help of regional leaders in bringing stability and prosperity to the region. U.S. foreign direct investment cannot be increased substantially unless national governments take concrete steps to improve the business environment and the effectiveness of the rule of law.

General Recommendations

1. International Presence in the West Balkans: There is still a significant international presence in Bosnia-Herzegovina, Kosovo, and Macedonia, albeit reduced and in some cases restructured. The overriding focus of these international deployments has been on post-conflict stabilization and reconstruction and important successes have been achieved in maintaining order, ensuring human rights, and administering EU assistance. This continued presence will remain vital in the next stage of development, which must be centered on democratic consolidation and economic growth. The international community should maintain its commitment to the region, but it should simultaneously encourage the development of the capacity of national and local institutions. Germany and Britain have indicated plans to withdraw troops from Bosnia-Herzegovina due to other engagements, but a premature pullout could be risky in view of the UN High Representative's departure scheduled for June 2007. After Kosovo's status is resolved, the continued presence of the international community, including NATO, will be necessary to enforce compliance with the provisions of any future settlement. Instead of mapping gradual disengagement, the international community should focus on restructuring its presence in the West Balkans and act to complement and strengthen the capacity of indigenous political and economic structures.

2. Fostering Good Governance: The major international powers will continue to focus on promoting effective and legitimate institutions in all West Balkan states, but the quality of democratic governance and the efficacy of local administrations will depend on the ability of regional leaders to promote transparency, eradicate corruption, and build functioning multi-ethnic societies. In Kosovo and Bosnia-Herzegovina emphasis should also be placed on limiting the destabilizing role of outside powers in the domestic political process. Civil society will need to be further strengthened, as the role of the non-governmental sector in the policymaking process has been insufficient.

3. Europeanization: There is general consensus that the prospect and process of European integration has been a driving force behind stability and development throughout Southeast Europe. Improving the quality of democracy in the region and recovering the public's confidence in national institutions will continue to be motivated by the prospect of EU membership. Enhanced Europeanization will also foster economic growth and strengthen investor confidence. Therefore, Brussels should continue to pursue the ongoing SAA and accession negotiations, uphold pressure for compliance with European standards, and maintain positive rhetoric with regard to the future of EU enlargement. The European bloc is at a critical juncture, but it is important that while it debates its own future, it also keeps the door open to aspiring states that fulfil membership requirements. The states in the West Balkans are relatively small and if they achieve the necessary reforms, they should not pose a significant challenge to the EU's "absorption capacity."

4. Regional Cooperation: Economic development in the region has been stifled by the legacies of violent conflict and ethnic schisms. EU membership is expected to bring higher living standards for the West Balkan states, but economic stability cannot be achieved without improved regional cooperation. The upgrading of roads, railways, electrical systems, and telecommunications should be a priority for collaborative efforts among the West Balkan capitals, which will encourage domestic and foreign investment. Moves by Brussels to encourage regional cooperative arrangements in Southeast Europe have been met with scepticism in some West Balkan capitals due to fears that such arrangements are targeted as substitutes for EU accession. It is important for officials in the region to understand that regional integration and European integration are not mutually exclusive and could emulate other examples in Europe, like the Nordic regional cooperation framework.

Country-Specific Recommendations

1. Bosnia-Herzegovina: The new parliament and government in Bosnia-Herzegovina should focus on passing the constitutional amendments for structural changes to allow BiH to meet EU requirements and consolidate a functioning, effective, and efficient state structure.

2. Kosovo: An enduring problem in the region is the unresolved question of Kosovo's final status. International players are finally poised to move beyond the status quo, because political ambiguity is fostering crime, corruption, radicalism, and emigration. Kosovo's independence would provide the only viable option for achieving lasting stability and fostering economic development not only for the territory, but also for the wider region.

The U.S. and the EU should not allow Belgrade to exploit its recent constitutional referendum and the upcoming parliamentary and presidential elections as tactics to delay a decision on Kosovo's statehood. Serbian nationalism must be discouraged and its leadership convinced to exhibit political maturity for the benefit of Serbia's European future. On the other hand, leaders in Prishtina should also understand that independence is not an end goal. Independence and international recognition for Kosovo will only be the beginning of a long and arduous process of consolidating democratic institutions, curbing crime and corruption, and addressing poverty and unemployment. Any future government in Kosovo should also ensure that minority groups are included in the political process and that their rights are fully protected.

Although a decision to grant Kosovo independence should be unequivocal, the formal transition toward full sovereignty could be a multi-step process whereby Prishtina steadily assumes full control over key institutions and state functions. International agencies will have the vital role of supervising this process, ethnic Albanians will need to ensure the inclusion of the Serbian minority, and Belgrade must desist from blocking Serbian minority participation in Kosovo's institutions.

International observers have also speculated on the impact that Kosovo's independence could have on the unresolved separatist conflicts around the Black Sea region. It is essential that the U.S., NATO, and the EU clearly spell out the uniqueness of Kosovo's predicament while sending a strong signal to Moscow not the exploit Balkan developments to support separatist movements in Moldova and Georgia.

3. Macedonia: Macedonia is working hard to facilitate interethnic cooperation within an integrated state structure. In this regard, it could serve as a model in the region, especially for BiH, Kosovo, and Serbia. Macedonia's Ohrid Agreement guarantees minority rights and representation but does not involve the duplication of government functions that lead to inefficiencies, divisions, and higher fiscal costs. In a relatively stable political environment, the new government appears committed to moving forward with reforms to improve the business environment and attract foreign investment. The EU should show stronger support for Skopje's efforts by making EU financial assistance available for critical reforms in Macedonia's police force, the judicial system, the economic structure, and the country's administrative capacity. Brussels should also move toward setting a date for commencing membership talks with Skopje or risk discouraging the reformist momentum in the country.

4. Serbia: With respect to Serbia, the international community's emphasis must be on strengthening the role of political moderates. Pragmatic and legitimate political forces must be given credible options and incentives for moving away from nationalist aspirations and focusing on a reformist and integrationist agenda. Upon settlement of Kosovo's status, Serbia will finally be able to pursue more rigorous structural reforms and prove that it is a responsible and democratic member of the European family. In the interim, international representatives must maintain pressure on Belgrade to ensure cooperation with the war crimes tribunal in The Hague. The capture of fugitive general Ratko Mladic would provide a clear signal that Serbia is ready to fulfil its international obligations and to gain the benefits of international institutional integration.

Infrastructure Issues in Southeast Europe

The development of modern infrastructure is a vital necessity for linking the Southeast European region with the rest of Europe, both politically and economically. Integration of transport and energy networks among the West Balkan countries and with the rest of the continent is a key condition for fostering trade and growth and improving regional cohesion. The European Union's Stabilization and Association Process has so far provided impetus for infrastructure reform by encouraging the consolidation of legislative and regulatory mechanisms, the reorganization of some sectors, and adherence to environmental and safety standards. However, much more needs to be done not only under the guidance of the EU and the International Financial Institutions (IFIs), but also through regional frameworks and public-private partnerships.

Transport

Transport infrastructure in Southeast Europe is lagging far behind EU standards. The series of armed conflicts in the 1990s damaged and interrupted traffic throughout the region, while the creation of new states along with new borders was not accompanied with an adequate division of responsibilities and sufficient border crossings. More than 15 years of underinvestment and poor maintenance have also had their effects on the substandard condition of transport infrastructure in the West Balkans.

Roads: The region is endowed with an extensive network of roads, but the majority are secondary links, which do not comply with the requirements of European trucks with loads up to 11.5 tons. Throughout the West Balkans, the total length of highways barely reaches 700 miles, and there is a serious lack of periodic maintenance.

Southeast Europe is an important transit area for the EU and as a result, its transport infrastructure was included in the Pan-European network of transport corridors. These are strategic transport routes that the EU has identified as priorities for investment and development with the goal of incorporating them within the existent Trans-European networks among member states. A number of important Pan-European corridors pass through Southeast Europe, including Corridor 4, Corridor 5, and Corridor 10. Those links connect EU states with the new members and with aspiring candidates. Therefore, logically there is need for improved cooperation among the countries in the region for developing these priority corridors.

Transport Corridor 10, or E-75, is of particular importance for the West Balkans. It begins on Norway and runs through Finland, Poland, the Czech Republic, Slovakia, Hungary, Serbia, Macedonia, and Greece, with branches to Bulgaria, Croatia, and Slovenia. E-75 is part of the Trans-European network in its northern section and part of the Pan-European network in the section that crosses the territory of former Yugoslavia. The European Bank for Reconstruction, as well as various other IFIs, has been involved in upgrading Corridor 10 in recent years.

E-75

Railways: Developing the railway network in Southeast Europe can also affect economic growth by facilitating the movement of goods and people within the region and to the EU. The region currently has about 6000 miles of railroad lines, of which only about 37 percent have been electrified. The railways in the West Balkans also belong to the Pan-European transport network and thus investment in their development has become a priority for the EU and the IFIs.

The main rail routes belong to Corridor 10, which needs to be revitalized to be better equipped for long-distance traffic. There has been a decline in rail transport in the West Balkans since the collapse of the communist systems, with rail traffic currently below 50 percent of the 1990 level. Some of the decrease in passenger traffic is attributable to the rise in private automobile ownership, while the fall in freight traffic resulted to a large extent from the collapse of many of the region's heavy industries.

The inadequate development and maintenance of the railway network has contributed to the sharp drop in rail traffic. Growth in this sector will not be possible in the next decade without major improvements and expansion in the existing infrastructure. Due to the mountainous terrain throughout much of the region, the density of rail tracks is very uneven from country to country and requires national investment that would complement funding provided by the EU and development banks.

Finally, the disintegration of the former Yugoslavia necessitated the creation of a number of separate rail companies, which remain state-owned and state-operated. This has resulted in a number of mismanagement issues and limited technological improvements. The emergence of several new independent states in the region has also necessitated the streamlining of border crossing procedures.

Seaports and Airports: The countries of Southeast Europe with outlets on the Adriatic Sea should make better use of their access to seaports as a means to facilitate trade with the rest of Europe. Sea transport remains the cheapest means of transporting cargo, although container traffic in the region has not been fully developed.

Air traffic has also sharply decreased following the conflicts in the region. There are international airports in all countries in the West Balkans, but the increase in air routes in recent years has linked individual states with major European capitals, while intra-regional air traffic has remained low. In addition, air traffic control systems, airport infrastructure, and aircraft safety remain below European standards.

Energy

Energy is a critical sector for generating economic growth, but it is also important politically due to its impact on national, regional, and European security. The West Balkan region is becoming increasingly significant to the EU due to its location, which makes it a potential transit corridor for gas and oil from the Caspian, Central Asian, North African, and Middle Eastern regions. Several potential pipeline projects are already being planned across Southeast Europe by international investment consortia.

Although the West Balkan states are net importers of oil and natural gas, the region has significant coal and hydro resources with further potential to explore alternative sources and renewables such as wind power. There are also strong nuclear energy capacities in Romania and Bulgaria, and to a lesser extent Croatia and Slovenia.

With respect to power generation and related electricity infrastructure, the European Community and the IFIs estimated in their Generation Investment Study (GIS) in 2004 that the region will require more than USD 15 billion over the next 15 years for investments in the rehabilitation of existing plants and the construction of new ones. An additional USD 10 billion will be necessary for upgrading and expanding the transmission and distribution infrastructure. With limited resources and competing priorities, the governments in the region need to work together on energy issues in order to reduce costs and improve efficiency.

The West Balkan capitals have realized the significance of creating modern and efficient energy infrastructure and the need for regional cooperation in developing and expanding electric, gas, and oil networks. Balkan governments have taken significant steps toward ensuring that Southeast Europe is integrated with the EU Internal Energy Market and that the energy demands of each country are fully met. The region was synchronously interconnected in October 2004 and linked with the UCTE grid, the European electrical system. Cooperative efforts further culminated in October 2005 with the signing of the Athens Treaty, which established an Energy Community for Southeast Europe. Signatories included all states in the Western Balkans, including Kosovo, as well as Bulgaria and Romania.

The Athens Treaty went into force on July 1st, 2006 with the goal of establishing a larger competitive market that is more attractive for investors. The parties to the accord have set ambitious goals for themselves and have agreed to adopt EU energy, environmental, and competition directives. They also set the year 2015 as a target for full liberalization of the energy market in Southeast Europe. The treaty paves the way for a regulatory framework, competition and trade, as well as public and private investment, all based on the full implementation of the EU's *acquis communautaire* on energy. Finally, the Athens Process established a social responsibility working group, which is charged with deliberating ways to offset the impact of increasing energy prices on low income households.

These developments provide opportunities for foreign investors interested in the energy sector in Southeast Europe. Romania, Bulgaria, and Macedonia have privatized most of their energy distribution and are now focused on energy generation. Albania has recently adopted a policy to privatize its distribution and later its generation, while Kosovo, Serbia, and Bosnia-Herzegovina are seeking investors in the lignite and hydro sectors. Final status for Kosovo will give further impetus to the development of Kosovo's considerable lignite coal reserves and attract investment in new lignite thermal capacities. However, a number of regulatory, legal, and management reforms are necessary in order to make the region more attractive for foreign capital.

Natural gas use in the West Balkans is relatively restricted, but the gas sector is becoming increasingly important in the region in view of rising European demand. Southeast Europe will become an important dimension of the EU's Energy Security Strategy and plans for gas supply diversification. The EU projections for European gas demand in the coming years requires the construction of a number of new pipelines, securing long term contracts, and building more storage facilities. In this respect, Southeast Europe offers significant potential for low-cost gas storage.

Oil originating in southern Russia and Central Asia has so far been transported via tankers across the Black Sea. But heavy tanker traffic through the Bosphorus straits and the associated environmental risks have led to proposals for several new oil pipelines across the Balkans toward the West European market. As a result, the region will become a significant transit point for Caspian and Central Asian oil and gas exports to Europe.

Water Infrastructure

Another priority for the West Balkans is to develop a framework for a regional approach to addressing environmental threats, especially in cross-country issues such as water management. Southeast Europe still has much progress to make in harmonizing its environmental standards with EU regulations and complying with directives related to the quality of drinking water and the treatment of urban wastewater. The process is very complex and enforcement of environmental legislation remains weak in most states in the West Balkans. This highlights the need for substantial investments and institution capacity for the proper implementation of regulations.

The water utility sector in Southeast Europe is relatively good in large urban centers. However, in rural areas these utilities do not meet the necessary standards. Bacteriological agents in potable water are generally within the prescribed limits, but the presence of nitrates and metals in the water represents a serious public health hazard.

The technical capacity for water utility management in the region is strong, but improvements in water infrastructure cannot occur in the absence of legal and regulatory standards and without investment. In most West Balkan states, water utility management is the responsibility of local governments as it constitutes a public service. However, there is often a general lack of political will and ecological awareness among municipal officials and faced with competing priorities, they do not have sufficient motivation to fund water projects. Enforcement of legislation for water quality and the discharge of waste water will need to be centrally enforced with added pressure by the EU. The water sector could also greatly benefit from private investment.

Regional Infrastructure Initiatives

The Stabilization and Association Process between the West Balkan states and the EU has been a key driving force behind various reforms, including the infrastructure sector. A number of regional and multilateral initiatives have also been launched to improve transport and energy links throughout Southeast Europe and to set up independent regulatory bodies.

The need for regional cooperation and the prioritization of investments in Balkan infrastructure projects was emphasized in the European Commission strategy paper “Transport and Energy Infrastructure in South East Europe” released in 2001. Following the report, the Infrastructure Steering Group (ISG) was set up in late 2001 with the objective of facilitating the development of regional infrastructure. The ISG brings together experts from the European Commission, the World Bank, the European Bank for Reconstruction and Development (EBRD), the European Investment Bank (EIB), the Council of Europe Development Bank, and the Office of the Special Coordinator of the Stability Pact. Such a coordinated forum between IFIs does not exist for any other region in the world.

The work of the ISG paved the way for the signing in June 2004 of a Memorandum of Understanding (MoU) on the Development of a South East Europe Core Regional Transport Network. Through the MoU, the countries and entities in the region, along with the European Commission, pledged cooperation on projects of regional significance and in identifying priorities for investment. The South East Europe Transport Observatory (SEETO), headquartered in Belgrade, has since been set up to oversee the implementation of the MoU. SEETO is financed by the EC and politically guided by the states in the region in collaboration with Brussels.

During 2006, the ISG has been overseeing the execution of 48 projects for a total value of EUR 4.97 billion. More than half of these projects are in the transport sector, followed by energy, water infrastructure, and improving border crossings. The tables below show the breakdown by country and by sector, according to the most recent progress report by the ISG issued in May 2006.

With regards to water and environmental infrastructure in particular, the existing initiative seeking to strengthen the administrative capacities of West Balkan states in enforcing environmental regulations is the Regional Environmental Reconstruction Program for Southeast Europe (REReP). It brings together the countries in Central, Eastern and Southeast Europe, the IFIs, the European Commission, the Stability Pact, and donor states to enable effective coordination of international assistance and environmental initiatives in order to complement the EU's Stabilization and Association process.

Note: The figures for Serbia and Montenegro were combined in the tables on the next page, since the data was collected prior to the restoration of

Montenegro's independence following the national referendum in May 2006. Source: ISG progress report, May 2006

Ongoing Regional Infrastructure Projects as of May 2006			
Projects implemented in:	No. of projects	Cost (millions of EUR)	(%)
Albania	8	€ 479.33	9.64
Bosnia-Herzegovina	5	€ 521.09	10.48
Croatia	3	€ 283.15	5.7
Kosovo	0	€ 0.00	0
Macedonia	3	€ 95.50	1.92
Serbia and Montenegro	8	€ 935.68	18.82
Total For West Balkan States	27	€ 2,314.75	46.56
Regional projects	6	€ 225.98	4.55
Bulgaria, Romania, Turkey and Moldova	15	€ 2,430.19	48.89
TOTAL number of projects overseen by ISG	48	€ 4,970.92	100

Ongoing Regional Infrastructure Projects as of May 2006			
Sector:	No. of projects	Cost (millions of EUR)	(%)
Transport	27	€ 2,761.25	55.55
Roads	18	€ 1,662.31	33.44
Railways	5	€ 637.00	12.81
Ports and Waterways	1	€ 126.15	2.54
Airports	3	€ 335.80	6.76
Energy	11	€ 1,769.93	35.61
Electricity	10	€ 1,749.79	35.20
Gas, Oil, and District Heating	1	€ 20.14	0.41
Water and Environment	4	€ 296.40	5.96
Waste Water	3	€ 196.00	3.94
Environment	1	€ 100.40	2.02
Cross Border/ Trade Facilitation	6	€ 143.33	2.88
TOTAL number of projects overseen by ISG	48	€ 4,970.92	100

Recommendations

1. Strong regulatory framework. In Southeast Europe investment in infrastructure is a precondition for economic development and hence for prosperity and peace. It is therefore of utmost importance that adequate conditions for efficient use and development of infrastructure are established. These conditions must include a strong regulatory framework with transparent accounting and monitoring of non-compliance.

2. Improved coordination and compliance with EU standards. The emergence of several new states in the region ensures that infrastructure will be administered by different authorities, which do not automatically apply the same administrative procedures and technical standards. Lack of cohesiveness and coordination can lead to a loss of effectiveness and performance. To this effect, it is important that the countries in the region have all expressed determination to transpose EU legislation. Through regional cooperation and implementation of EU standards, all states in the region can integrate their networks. This applies to the water, transportation, and energy sectors.

3. Regional Coordination. A special temporary coordinator could be nominated for the region, comparable to the six coordinators appointed by the European Commission for TEN-T priority corridors, for streamlining and harmonizing the implementation of EU legislation for the transport sector, and for accelerating investments in rehabilitating and upgrading transport infrastructure.

4. Financing infrastructure projects. The transport sector needs to be restructured with substantial investments, not only for purposes of rehabilitation, but also for enabling it to perform more efficiently in a modern setting. The region is intersected by a number of Pan-European corridors and it must be able to perform the proper transit function. The vast investments needed for the rehabilitation of national networks and upgrading of transit corridors, while ensuring financial stability, pose an enormous challenge for the relevant governments. In view of the limited funding capacity of the governments in the region, the principle of the user paying should be explored. As a consequence, the financing of investments in infrastructure will not exclusively depend on the state budget or on loans, but also on private sources of funding to accelerate the upgrading of networks.

5. A transport treaty for Southeast Europe. The energy treaty between the countries of the West Balkan region and the EU is a good example for integrating the region's infrastructure with that of the Union. Such a treaty could also be prepared and negotiated for land transport and there are a number of initiatives already being undertaken to this effect. Such a document should on the one hand ensure that EU legislation is transposed by the signatories in a uniform manner and on the other hand create conditions for investing in rehabilitating or upgrading critical infrastructure. The treaty between the EU and Switzerland on land-transport may also serve as an example.

6. Memorandum of Understanding on rail transport. The World Bank has undertaken an initiative on a MoU for the region on rail transport, which could be seen as first step for the above-mentioned treaty. Governments from outside the region, but committed to the development of Southeast Europe, and in particular the U.S. government, should support this World Bank initiative.

7. Efficiency of border crossings. Inadequate border crossing operations for road and rail transport are one of the biggest obstacles to an efficient transport system and they hinder international trade and limit development. Governments in the region need to enhance cooperation with authorities and operators for streamlining border-crossing operations.

8. Electricity Infrastructure. Investment in electricity distribution and collection grids is necessary to facilitate the further opening of the energy market.

9. Water Infrastructure. For the water distribution networks, substantial investments will be necessary to achieve compliance with EU standards. This is important for environmental reasons, while the benefits for public health are also of great significance.

Trade Barriers and Opportunities

Assessing Economic Progress in Southeast Europe

After over a decade of military, economic, and political crises, Southeast Europe has begun to record economic growth. The progress can be attributed to the strengthening of market economies, a restoration of regional trade links, increasing foreign direct investment (FDI), and the consolidation of democratic institutions. The achievement of relative macroeconomic stability has allowed the West Balkan states to maintain an annual growth rate of nearly 5 percent in real terms since 2000.

Albania: Albania successfully completed its IMF (International Monetary Fund) program in November 2005 and began a new three-year program in February 2006. Cooperation with international financial institutions and the continued implementation of policies aimed at fiscal consolidation have contributed to the preservation of macroeconomic stability. However, delays in court decisions, such as the difficulty of obtaining court rulings or enforcing court contracts, has had harmful implications for Albania's economic development. Uncertainty regarding land ownership rights and collateral recovery continue to hamper bank lending and investment opportunities.

Despite strong GDP growth and low levels of inflation, Albania has suffered from frequent power supply shortages resulting in a 0.5 percent loss of growth in 2005. Estimates of real GDP growth were consequently reduced to 5.5 percent for 2005. The percentage of the population living in poverty has decreased from 25 percent in 2002 to roughly 18 percent in 2005, however jobless rates remain high. Official unemployment rate declined to 14 percent in the first quarter of 2006, down from 14.4 percent in 2004. Average inflation stood at a modest 2.5 percent in August 2006, but public debt accounted for a staggering 55.3 percent of GDP in 2005.

Albania has privatized many of its formerly state-owned enterprises and by 2005 the private sector accounted for 80 percent of GDP and total workforce employment. In 2004, the privatization of the Savings Banking brought in large revenues for the state budget, which led to a boost for Albania's FDI statistics. But foreign direct investment declined from 4.6 percent of GDP in 2004 to 3.1 percent in 2005 due to lingering administrative, legal, and regulatory problems. However, the average time needed for business registration has been reduced from 30 to 8 days in 2006, symbolizing a general reduction in the number of administrative impediments obstructing market entry. Although fiscal indicators continue to improve, the largest threat to Albania's macroeconomic stability remains the deterioration of its trade and current account deficits, which have widened to 24.1 percent and 7.8 percent of GDP, respectively.

Bosnia-Herzegovina: In Bosnia-Herzegovina, the authorities have improved their capacity to coordinate economic and fiscal policy. They have also assumed greater responsibility from the IMF and the Office of the High Representative (OHR) for the budget process. Although Bosnia-Herzegovina's performance with regard to its implementation of agreed policy prescriptions has been satisfactory, it has failed to fully comply with a number of requirements set out by the World Bank. Growth estimates for Bosnia-Herzegovina ranged between 5 percent and 6 percent of GDP in 2005, down from 6 percent in 2004. Rising raw material prices, coupled with large-scale privatization in the Republika Srpska (RS), one of Bosnia's two entities, have initiated production increases in a number of sectors.

Despite relatively strong export growth, Bosnia-Herzegovina's trade and current account deficits have expanded to 53.3 percent and 22.5 percent of GDP, respectively. Foreign direct investment declined from 7 percent of GDP in 2004 to roughly 5.2 percent in 2005 and still further to 3.9 percent of GDP as of June 2006. Job creation has remained stagnant and unemployment high. Although official data revealed an unemployment rate of 44.6 percent in 2005, the estimated rate, which attempts to include employment in the informal sector, stands at roughly 20 percent of the working-age population.

The inflation rate reached 7.6 percent in January, representing a drastic increase from 0.4 percent a year earlier. Private sector activity represented 55 percent of GDP in 2005. Evident disparities persist in the speed of the privatization processes in the RS and the Bosnian Federation. Forty percent of the initial nominal capital intended for privatization in the RS remains to be privatized, compared to 60 percent in the Federation. The cost of business registration remains high and has actually increased from an average of 49 days in 2004 to 54 days in 2005. Although Bosnia-Herzegovina possesses a reasonably high number of courts, political interference and a large backlog of unresolved cases continue to impede the country's economic development. The functioning of market forces and the efficient allocation of resources are threatened by the strong influence of the public sector in the economy, large and complex bureaucracies, a weak legal climate, and the fragmentation of a common market between entities.

Croatia: Relatively low inflation and exchange rate stability have contributed to the preservation of macroeconomic stability in Croatia. Nevertheless, fiscal and external deficits continue to threaten this stability. As a result of substantial increases in domestic demand Croatia's real GDP growth was 4.3 percent in 2005, up from 3.8 percent in 2004. The officially registered unemployment rate has continued to decrease and stands at 15.7 percent as of July 2006, which represents a decline of 1.2 percent compared to the same month a year earlier. In 2005 the share of the private sector in total employment increased to roughly 68 percent from 66.2 percent in 2004.

The average consumer price inflation has grown considerably from 2.1 percent in 2004 to 3.6 percent in July 2006. State intervention and state ownership continue to obstruct the efficient allocation of resources in significant sectors of the economy. The Croatian government has facilitated company registration procedures by establishing a network of "one-stop-shops." However, the formation and management of businesses in Croatia remains a complicated process plagued by bureaucratic procedures in administrations and courts. Recently adopted amendments to the Bankruptcy Law seek to simplify and accelerate bankruptcy procedures. But the effective implementation of such legislation will require sustained improvements in the efficacy of the judicial system. The banking and service sectors attracted the vast majority of FDI in 2005, exposing the relatively slow pace of the privatization and restructuring processes. Small and medium-sized enterprises represent 99 percent of total firms in Croatia and 65.5 percent of total employment, generating 55 percent of GDP and 25 percent of exports.

Kosovo: In November 2005, the United Nations Mission in Kosovo (UNMIK) and the Provisional Institutions of Self-Government (PISG) in Kosovo signed a Letter of Intent and a Memorandum on Economic and Financial Principles aimed at ensuring a sustainable fiscal path. Although a consensus has been reached with regard to economic policy, the authorities of Kosovo have been largely unsuccessful in complying with and implementing previous commitments. The rapid transition from donor-financed investments to budget-financed investments has threatened both fiscal and external sustainability. As a result, full macroeconomic stability has not yet been reached in Kosovo.

The IMF estimates that the Kosovo economy contracted by 0.2 percent in 2005. Nevertheless, substantial growth trends have been recorded in the private sector driven by significant increases in business registration, tax revenues, and trade. Kosovo has a per-capita GDP of EUR 1,100. According to the World Bank, 37 percent of the population lives in poverty with 15 percent living in extreme poverty. Kosovo's trade and current account deficits are 43 percent and 15 percent of GDP, respectively. Low levels of FDI, which reached 3 percent of GDP in 2005, have forced Kosovo to rely on foreign assistance in order to cover its current account deficit.

Official unemployment is estimated at 42-44 percent, but the real rate is likely to be lower due to the informal economy. In the first seven months of 2006, Kosovo has recorded deflation of 1.3 percent, which can be attributed to the downsizing of the international community's presence in the province. The privatization process in Kosovo progressed well in 2005 and has remained on course in 2006. The Kosovo Trust Agency intends to have privatized 90 percent of total assets and 50 percent of the total number of state or "socially-owned" companies by the end of 2006. Business registration and market entry processes are favorable, requiring an average of 23 days and 5 procedures. Although the legal framework of Kosovo has remained market-oriented, little progress has been made in the enforcement of court rulings and the establishment of property rights. The overall economic situation in Kosovo remains difficult.

Macedonia: Macedonia has been relatively successful in achieving and maintaining a satisfactory level of macroeconomic stability in recent years. Significant progress has been made in reducing impediments to market entry and exit, reinforcing the legal and institutional framework, and enhancing the transparency and accountability of public procedures. Macedonia's real GDP growth slowed to 2.6 percent in the first half of 2006. Higher exports contributed to the reduction of the current account deficit to 1.4 percent of GDP, compared to 7.7 percent in 2004. Foreign direct investment is projected at 6 percent of GDP in 2006. The privatization process in Macedonia has remained on course, but the state maintains ownership of 30 companies, which represent an estimated 16 percent of GDP. Furthermore, privatization revenues remain the largest sources of FDI, with Greenfield investments making negligible contributions to overall FDI.

At the end of August 2006, Macedonia's foreign reserves stood at USD 1.68 billion, which represents over four months of imports of goods and services. The official unemployment rate has declined to 36.1 percent in the second quarter of 2006. Increases in excise taxes and higher energy costs have resulted in a consumer price inflation rate of 3.3 percent for the first nine months of 2006, compared to 0.4 percent during the same period last year. However, inflation has largely remained under control. Improved tax collection and lower expenditures have resulted in a decrease in the budget deficit.

Macedonia's public debt declined from 40.1 percent of GDP at the end of 2005 to 35 percent of GDP by mid-2006. Much like Croatia, Macedonia has established a one-stop-shop system aimed at reducing the average time needed to register companies. This has resulted in the reduction of barriers to market entry and exit. Although the necessary legal system is generally in place, increased government efforts to simplify and accelerate legal procedures will contribute to Macedonia's economic development. The establishment of a fully functioning market economy is still inhibited by bureaucratic inefficiencies, legal problems, and substantial labor market imbalance.

Montenegro: Montenegro has been largely successful in maintaining macroeconomic stability. Strong growth in tourism, financial services, and construction has resulted in real GDP expansion of 6.5 percent in the first half of 2006. Robust domestic demand and a limited export capacity have widened Montenegro's current account and trade deficits to 12.2 percent and 34.2 percent of GDP, respectively. The current account deficit has deteriorated further in the first half of 2006 and now represents 13.1 percent of GDP.

The privatization of Telekom Montenegro, Podgorica Aluminum Plant, and Podgoricka Banka resulted in a record FDI in 2005, which amounted to 22.8 percent of GDP. Foreign direct investment in the first half of 2006 has amounted to USD 223 million. While record high levels of FDI in 2005 were mostly achieved through privatization, FDI inflows in 2006 are mostly attributable to Greenfield investments. The fiscal position of the government has tightened and a budget deficit of 0.6 percent was recorded in the first half of 2006, down from 2.9 percent in 2005. Despite decreases in general government debt, Montenegro's total public debt remains relatively high at 39.9 percent of GDP.

Price liberalization and deregulation is almost complete, although the government retains administrative price controls for a small number of products and services. Montenegro has continued to implement plans to restructure state owned companies through privatization or liquidation. By the end of 2005, 272 out of a total of 386 formerly state and socially owned enterprises had been sold to private investors. The registration of businesses in Montenegro can be achieved in four working days and requires three documents. Although overall business registration procedures are efficient by regional standards, significant price discrepancies exist in the granting of licenses for the same purpose. The efficacy of the judiciary in managing commercial disputes has improved significantly. However, Montenegro's labor market remains highly inflexible. High dismissal costs, such as six months average pay, and strict employment contracts dissuade both domestic and foreign companies from hiring workers.

Serbia: In 2005, Serbia's real GDP grew by 6.3 percent compared to 9.3 percent in 2004. The first half of 2006 has witnessed continued growth at 6.7 percent year-on-year. Serbia received record levels of FDI in 2005, which reached USD 1.54 billion, and rising to 5.7 percent of GDP in 2005 from 4.3 percent in 2004 due to an increase in privatization revenues. In the first seven months of 2006 FDI amounted to USD 993 million and is expected to reach USD 4 billion by the end of the year following the USD 1.95 billion sale of

Serbia's second largest mobile service provider Mobi 063.

As of November 2006 Serbia's foreign currency reserves stand at USD 11.2 billion, up from USD 6.3 million in 2005. After several years of decline, the external debt of the Serbian economy has increased, reaching 66 percent of GDP. As a result of strong growth in exports, Serbia's trade and current account deficits decreased in 2005 from 12.6 percent to 9.8 percent of GDP and 29.8 percent to 23.1 percent of GDP, respectively. Sectors that had been largely privatized or restructured in recent years experienced the highest growth rates.

In 2005 and early 2006, five state-controlled banks were auctioned, increasing foreign ownership in the banking sector to roughly 77 percent of total assets. However, despite substantial progress in the privatization of state owned enterprises (SOE) in recent years, a competitive private sector has not yet been fully instituted in Serbia. Much like in Croatia, while macroeconomic stability has been largely maintained, market mechanisms have been restricted in ensuring an efficient allocation of resources by an overly active public sector. As a result, the Serbian government has made preparations for the restructuring and privatization of several large state-owned enterprises, including the NIS oil and gas company.

Despite many remaining challenges, the countries of Southeast Europe have made significant economic progress in recent years. Macroeconomic stability has been achieved and consolidated through privatization and the continued implementation of reforms. Inflows of FDI have increased significantly, while inflation has been reduced to modest levels. Most countries have facilitated business registration and market entry procedures. Nevertheless, general public debt and trade and current account deficits have expanded in many of the region's respective countries. Shortcomings in the rule of law, uncertainty over property rights, poor infrastructure, and widespread corruption continue to impede economic activity, including prospects for increased regional cooperation in trade.

EU-Western Balkan Trade Relations

The aim of the EU is to ensure peace, stability, freedom, and economic prosperity in the countries of the Western Balkans. To achieve its objectives, the EU has offered these countries the possibility of full integration following the fulfillment of the requirements set out by the *acquis communautaire*. The implementation of this strategy includes massive financial assistance, such as the CARDS program, making the EU the largest single donor to the region as a whole. In addition, the EU remains the region's largest trading partner, ranking first in both imports and exports.

The Stabilization and Association Process (SAP) was launched in 1999 and currently represents the foundation of EU policy in the Western Balkans. The three main instruments in this policy framework are the Stabilization and Association Agreement (SAA), the trade preferences, and technical and financial assistance. The EU utilizes these tools in its efforts to stabilize and gradually bring the Western Balkan countries in line with its own economic and legal structures. The SAA encompasses a large number of issues, placing particular emphasis on legal approximation in trade and trade-related matters. It also provides for the establishment of a free trade area with the EU.

The EU has adopted a four-tiered approach to bilateral trade relations with respect to the West Balkan countries. The four pillars of this strategy consist of the following: autonomous trade measures, the creation of bilateral free trade areas as part of the SAA, support for regional trade integration, and support for World Trade Organization (WTO) membership.

Autonomous trade preferences were granted in 2000 to all of the countries of the region, allowing free access to the EU market for more than 95 percent of products originating from Southeast Europe. The only exceptions are wine, baby beef, sugar, and certain fisheries products. These preferences have resulted in a substantial increase in Western Balkans' exports to the EU. In 2005, the autonomous trade measures were extended to 2010.

Another pillar emphasizes the importance of a comprehensive regional trade agreement, which is currently being negotiated in the form of an expanded Central European Free Trade Agreement (CEFTA). Although the EU will not be a signatory to the future agreement, the European Commission (EC) will continue to offer its political and technical support in hope of facilitating negotiations between the parties.

The fourth pillar identifies the common requirements necessitated by EU and WTO membership. By implementing the reforms of the WTO accession process, the countries of the Western Balkans will simultaneously be fulfilling conditions for EU membership.

Regional Trade Cooperation and CEFTA

A revival of economic links, coupled with the implementation of an extensive network of free trade agreements (FTA), has contributed to a substantial increase in trade volume between countries in Southeast Europe. In addition to knowledge of existing markets within the former Yugoslavia, the lower competitiveness of regional economies has contributed to the expansion of trade in the West Balkans. The regional market often serves as an alternative for products that prove unsuccessful on the EU market. Nevertheless, imports from neighboring states are relatively insignificant for most countries, except for Macedonia and Bosnia-Herzegovina.

Trade still represents a relatively small segment of GDP for the West Balkan countries. Albania, Bosnia-Herzegovina, and Serbia had export shares under 20 percent of GDP during the period 2001-2004. Croatia and Macedonia, two EU candidate countries and SAA signatories, reported shares of 30 percent of GDP. According to recent studies by the European Bank for Reconstruction and Development (EBRD), the trade gap of potential and actual trade for countries in Southeast Europe is 60 percent. Serbia and Croatia possess the greatest potential for trade growth.

The countries of the Western Balkans, including Kosovo, have negotiated 13 bilateral FTAs in compliance with WTO rules. As of December 2004, all of these agreements have taken effect. However, the large and growing number of bilateral free trade agreements presents challenges to both government agencies and business communities wishing to expand trade and increase investments in the region.

On June 27, 2001 the process of regional trade liberalization was initiated with the signing of the Memorandum of Understanding on Trade Liberalization and Facilitation in Brussels, under the auspices of the Stability Pact for Southeast Europe (SPSEE) and its Trade Working Group. The SPSEE Trade Working Group has established a procedure to facilitate the elimination of non-tariff barriers and has enhanced the regulatory environment for trade in services in Southeast Europe. Consequently, political and economic relations between West Balkan countries have improved significantly. Leaders in Southeast Europe have largely embraced the process relating to the formation of a regional trading bloc. This includes Croatia, which had until recently opposed regional trade integration due to its anxieties regarding the potential recreation of an economic former Yugoslavia and fears that regional integration was intended to supplant Croatia’s EU membership bid.

At their meeting in Sofia, Bulgaria, on June 10, 2005 the ministers of economy of Southeast Europe instructed the SPSEE Trade Working Group to determine the viability of forming a comprehensive regional FTA to replace the many bilateral agreements currently operating. Such an agreement must permit a harmonized trade regime throughout the region and consider modern trade policy issues such as trade in services, government procurement, state aid, and intellectual property rights. The Trade Working Group has advised the ministers and their respective governments to pursue a single FTA through the enlargement and expansion of CEFTA. Currently, the only Balkan states CEFTA encompasses are Bulgaria, Romania, and Croatia. At a summit in Bucharest, Romania, on April 6, 2006, the countries of Southeast Europe agreed to commence negotiations on the entire region's accession to CEFTA with the objective of reaching full implementation by 2007. The agreement will create a regional free trade area by building on and extending the trade concessions provided for in existing bilateral free trade agreements. Cooperation and gradual liberalization of trade in services will be encouraged. The agreement will include a clear and effective mechanism for dispute settlement and will provide a framework for improved compliance by all parties both to the agreement and to WTO rules.

A comprehensive regional free trade agreement will bring clear benefits to the countries of Southeast Europe. Each of the signatories will profit from the reorganization of tariff rates and investment regulations within the region. Trade liberalization and facilitation are vital prerequisites for economic development. The formation of a single regional market will result in larger inflows of FDI and will increase attractiveness for foreign investors in the region's continuing privatization processes. Many multinational corporations have increased their interest in Southeast Europe as a result of the pending regional free trade area. Exposure to foreign competition will compel domestic industries to increase their efficiency and competitiveness. In addition, increased FDI typically results in a reduction in the costs of key inputs and the development of incentives to expand research and development initiatives. By removing import barriers, trade liberalization will decrease the cost of goods for consumers and increase the variety and quality of those available.

The implementation of CEFTA should increase trade between signatories given the familiarity of the region's companies with this market. In sectors where the countries of the region have a comparative advantage, trade champions will emerge, rationalizing their export development strategies.

Larger inflows of FDI and increased regional trade will spur growth, employment, and social stability. By facilitating the administration and coordination of trade and trade-related regimes, CEFTA will allow regional governments to make better use of their limited resources. The EU has been promoting a regional trade agreement as a precursor to eventual membership for the countries of the Western Balkans and is itself founded on the principles of regional integration. Adoption of CEFTA will contribute to the further development of relations between the EU and the Western Balkans. The agreement will also improve adherence by all parties to provisions in the bilateral FTAs and the rules and procedures of the WTO.

On November 9, 2006 Albania, Croatia, Bulgaria, Macedonia, Moldova, Montenegro, Romania, and Kosovo agreed on the provisions of an amended and expanded CEFTA. The eight parties announced their intent to sign the document on December 19, 2006 in Bucharest. Bosnia-Herzegovina and Serbia have failed to confirm their participation in CEFTA, seeking greater protection of their primary domestic goods and better terms for their key industries. Bosnia-Herzegovina is demanding improved terms of trade for its agricultural products, while Serbia is aiming to shield its tobacco industry. Philip Morris International and British American Tobacco, which both own tobacco factories in Serbia, have welcomed the decision of the Serbian government to postpone its signing of CEFTA.

Non-Tariff Barriers in Southeast Europe

Non-tariff barriers (NTB) continue to stifle regional trade in the West Balkans. This can partly be attributed to the fact that the countries of the region are at different stages of the EU accession process and are therefore at different stages of fulfilling the requirements of the *acquis communautaire*. Nevertheless, the region's leaders have issued a number of Ministerial Statements requesting that the SPSEE Trade Working Group implement the provisions of the 2001

Memorandum of Understanding, specifically the Procedure to Eliminate Quantitative Restrictions and Measures with Equivalent Effect on Trade. In 2004 the European Union began providing technical assistance through the EC CARDS and SECO programs aimed at assisting the region's countries in identifying and eliminating NTBs.

Certification and customs procedures represent the most detrimental NTBs in Southeast Europe. Despite evident long-term benefits, the EU accession process itself is a contributing factor to the creation and preservation of regional trade barriers in the short term. Rules of origin restrictions obstruct regional firms from importing intermediate goods from other regions in order to further process and export these goods to the EU market. Such complicated regulations hinder trade by raising transaction costs, increasing bureaucracy, and decreasing transparency in customs administrations.

The EU Schengen regulations form another NTB adversely affecting regional trade. Current visa policies and practices restrict the movement of people in the region. As of January 1, 2007 the citizens of Albania, Bosnia-Herzegovina, Macedonia, Montenegro, and Serbia will require visas to enter Bulgaria and Romania, increasing the number of neighboring states already needing entry visas for these countries.

After years of war damage and neglect, the region's infrastructure has improved significantly and has facilitated the expansion of trade. The 2004 Memorandum of Understanding to form a core regional transport network, as well as various other initiatives to improve border crossings, and increasing the effectiveness of customs administrations are also instruments to foster the flow of goods, services, and people in the region. Nevertheless, despite such initiatives, the region's underdeveloped infrastructure continues to inhibit a more rapid expansion of regional trade.

A lack of harmonized legislation between the region's countries amplifies existing NTBs. Differences in national tax rates, inefficient mechanisms of import licensing, and large import quotas discourage greater growth in the export of services. The adoption and implementation of *acquis requirements* through the EU accession process will cause regional legislation to converge in the long term.

Politics remains a significant barrier to increased regional trade between the countries of the West Balkans. Croatia, for example, is more willing to import from the Federation of Bosnia-Herzegovina than Republika Srpska, while many Kosovo Albanians are currently speaking of a boycott of Serbian goods. Domestic politics also obstructs the successful implementation of free trade agreements. In June 2006, the government of Bosnia-Herzegovina unilaterally suspended segments of its FTAs with Croatia and Serbia due to internal pressure from the agricultural and food processing interest groups. Its failure to utilize the agreed mechanisms for dispute resolution underscores the importance of devising more effective procedures under the terms of an expanded CEFTA.

Recommendations

1. Attract larger amounts of FDI. There is a strong correlation between FDI and export growth and competitiveness. Despite significant increases in FDI in recent years, foreign investments in the countries of the Western Balkans remain relatively low and are insufficient to finance large trade and current account deficits. The region must do more to attract foreign investors, particularly those capable of making Greenfield investments, which are becoming increasingly important as the region's privatization processes wind down.

2. Ensure the rapid adoption and implementation of CEFTA. In order to increase the effectiveness of CEFTA the parties must initiate a public relations campaign aimed at informing potential investors about the numerous opportunities provided by the formation of a common regional free trade area.

3. Eliminate visa requirements. The EU should abolish its current visa policies in Southeast Europe and place all candidate and potential candidate countries on the White Schengen List. At a minimal, visa requirements should be eliminated between the region's countries, especially for businessmen and potential investors.

4. Expand regional air traffic. Facilitating travel for potential investors will expand trade between countries in Southeast Europe. The signing and implementation of the Open Skies Agreement should be encouraged.

5. Harmonize transport and transit requirements based on Swiss-EU model. If the level of regional transport and transaction costs were lowered to half of the EU-15 average, there would be significant gains in trade in the West Balkans. An increase in road quality and road networks will expand trade between the region's countries and overall trade between the EU and the region as a whole. Despite positive recent initiatives, greater investments must be made in infrastructure.

6. Devise a strategy for the cohabitation of EU accession and regional trade integration. On January 1, 2007 Bulgaria and Romania will be obligated to withdraw from CEFTA following their accession into the EU. Compelling countries to abandon initiatives aimed at regional integration creates barriers and hinders cooperation in Southeast Europe. Such commitments must be permitted to remain intact even after EU accession.

Business Climate and Investment Promotion

Despite substantial external support in the form of financial aid and technical assistance, the Western Balkans continue to face serious economic problems and regional disparities. Most recent policy instruments were built around the concepts of post-conflict stabilization and reconstruction, but the region is slowly starting to decrease its dependence on donors and increasing its ownership of the reform agenda, which includes a more comprehensive long-term strategy for attracting foreign direct investment. The danger of military conflict has been largely overcome, so the policymaking and corporate worlds need to have a fresh look at the region as an area of opportunities, rather than one rife with violence and crime. With a very favorable geographic location and a highly educated workforce, Southeast Europe has a lot to offer to potential investors.

Business and Investment Climate: Achievements and Shortcomings

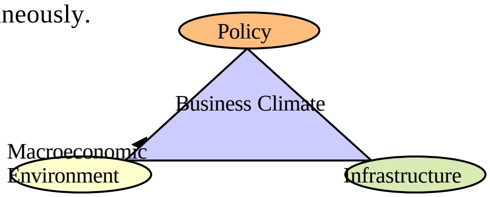
The Western Balkans are an emerging market, which has enjoyed macroeconomic stability and relatively strong progress in its reform efforts. Although conditions are still underdeveloped compared to both old and new EU members, in general the business climate is improving. The governments in the region have been recognized in the annual World Bank *Doing Business* report as some of the most active reformers in the world. Recent initiatives to ease business start-up, improve the enforcement of laws and contracts, and strengthen the tax system have moved the Western Balkans on average to a higher ranking, just below that of East and Southeast Asia. Serbia in particular has experienced one of the most dramatic improvements in its *Doing Business* rank - from 95th to 68th.

In the past few years, Southeast Europe has displayed rapid economic growth, a trend that is expected to continue in the short-term, despite increasing energy prices.

Note: The figures for GDP growth in 2006 in the table on the next page are projections. Source: ICEG European Center, EIU, Central Bank of Montenegro / Agenda of Economic Reforms of Montenegro 2002-2007, www.mier.sr.gov.yu / Serbia Memorandum on the Budget and on Economic and Fiscal Policy for 2006

Real GDP Growth Rate (%)			
Country	**2004**	**2005**	**2006***
Albania	5.9	5.9	5.8
Bosnia and Herzegovina	5.1	5.5	6.0
Bulgaria	5.7	5.5	6.0
Croatia	3.8	4.3	4.6
FYR Macedonia	4.1	3.5	3.5
Montenegro	3.7	4.1	4.5
Romania	8.3	4.1	5.5
Serbia	9.3	5.1	5.0
Regional Average	**5.7**	**4.8**	**5.2**

With their opportune geographic location, access to the EU market, well-qualified and inexpensive workforce, and considerable endowment of some natural resources, the states in the West Balkans have strong potential to attract foreign investors. International experience shows that market size is the top determinant of attractiveness for foreign direct investment (FDI). Individually, countries in Southeast Europe are too small to provide for economies of scale, but combined they represent a market of over 20 million people, or 50 million when Bulgaria and Romania are included. Many other factors can significantly improve the region's ability to draw FDI. Liberal trade and foreign exchange systems, reforms in infrastructure, improved governance, and lower corruption can encourage investment even in small and fragmented markets. West Balkan leaders should understand that the policy framework, macroeconomic environment and infrastructure are interdependent and progress should be made on all fronts simultaneously.



FDI has been steadily on the rise in Southeast Europe, from EUR 4.5 billion in 2002 to EUR 10.6 billion in 2005. Credit ratings have also been increasing as a signal of increased investor confidence and macroeconomic stability. But FDI inflows continue to depend heavily on privatization, as opposed to greenfield investments. Furthermore, over 70 percent of the funds secured went to the larger economies of Bulgaria, Croatia, and Romania. Serbia has recently attracted relatively high amounts of foreign investment, but this may be largely due to the fact that that its privatisation process commenced later than in other countries in the region.

FDI Net Inflows (EUR million)

Country	2002	2003	2004	2005
Albania	151	158	269	209
Bosnia and Herzegovina	282	338	489	240
Bulgaria	980	1851	2727	1789
Croatia	1195	1788	989	1328
FYR Macedonia	83	84	126	80
Moldova	140	69	124	181
Montenegro	76*	44*	53*	384*
Romania	1212	1946	5183	5197
Serbia	504	1204	777	1196
Total SEE-9	**4623**	**7482**	**10737**	**10604**
Total CEC-5	**22665**	**8710**	**19718**	**22446**

Source: Vienna Institute for International Economic Studies (WIIW), 2006. *Central Bank of Montenegro, 2006.

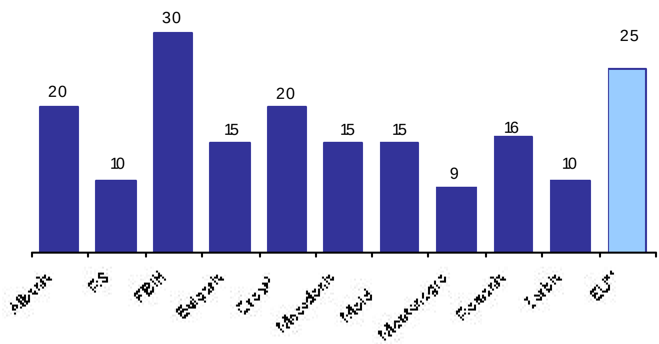
The Western Balkan states have demonstrated a reform impetus in specific areas such trade liberalization, tax policy, and investment promotion. Financial sector restructuring has led to better access to credit for companies, while administrative changes have greatly reduced the time required to start a business. But with regard to regulatory governance, anti-corruption, human capital, and competition the region’s performance is less impressive. Specific countries lag behind in establishing the basic legal and institutional framework for some key dimensions, particularly:

• Anti-corruption: Albania, Bosnia-Herzegovina, Montenegro, Serbia;
• Regulatory reform: Albania, Bosnia-Herzegovina, FYR Macedonia;
• Human capital: Albania, Bosnia-Herzegovina, Moldova, Serbia.
• Competition: Moldova, Montenegro, Serbia.

Source: OECD Investment Compact for Southeast Europe

Tax reform in the region is by and large incomplete. Countries have introduced low corporate tax rates that range from 9 to 20 percent, but tax administration remains weak. VAT reimbursements are time-consuming and rarely monitored, while tax inspections and audits require the implementation of objective criteria and improved efficiency. Tax collection is not uniformly enforced and this provides opportunities for corrupt practices. In most countries, appeals procedures are also very lengthy and burdensome. Without effective tax administrations, the benefits of a low corporate tax rate are diminished for investors.

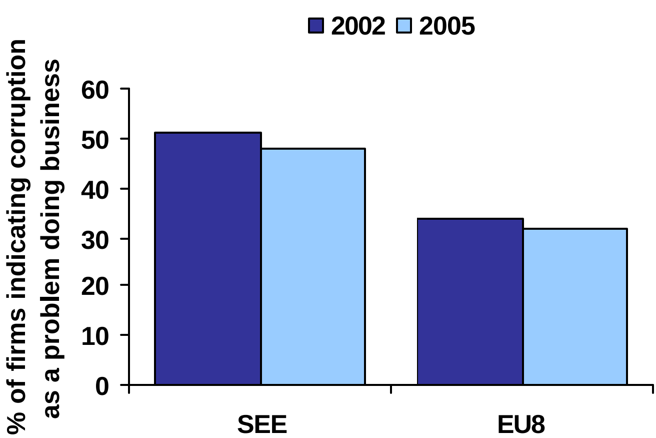
Corporate tax rates in 2006



*Sources: *FIAS (Foreign Investment Advisory Service)(2003),* *Macedonia: Administrative Procedures for doing Business in Macedonia, International Finance Corporation and The World Bank. KPMG's Corporate Tax Rate Survey 2006.*

Public governance in the region needs to be improved, notably in terms of anti-corruption reform. Widespread corruption is not only an obstacle to EU membership, but it also hurts investor confidence and increases transaction costs for business. While laws and institutions are in place to fight corruption, enforcement remains insufficient. Investigation and prosecution of corrupt officials are not extensive. Public procurement practices lack transparency and proper procedures, which further provides fertile soil for corrupt practices by civil servants.

EBRD-World Bank BEEPS Corruption as a Problem Doing Business (%)



The development of the banking and financial sector in Southeast Europe was also a lengthy process and it posed a serious obstacle to FDI inflows in the early 1990s. Progress in reforming the banking sector has been considerably faster than in developing securities markets and non-banking financial institutions. Most major banks in the region have been privatized, while a number of new foreign and domestic banks have also been established. This led to enhanced competition and improvement of banking services, but the region as a whole is still lagging behind the new EU member states in this respect and the cost of banking remains high. Furthermore, the slow development of securities market and non-banking financial institutions hinders the inflow of portfolio investment.

Economic and legal reforms and GDP growth have not significantly reduced unemployment in the Western Balkans, which remains over 20 percent on average. In Bosnia-Herzegovina and Macedonia, official jobless rates are 42 and 36 percent respectively. This places the states of the region in strong competition with each other to attract foreign investment and improve prospects for job creation. A balanced policy and a solid institutional framework, at the country and regional levels, is needed in order to develop a competitive edge, overcome the limitations of small and fragmented markets, and convince investors that the region can be a reliable and competitive location for investment.

Without further reforms, the Western Balkans risk being marginalized by competition from new EU member states and from low-cost, labor-intensive producers in Asia and North Africa. Regional cooperation on trade and streamlining policy implementation will prove essential in order to attract investors. With this in mind, in June 2006, regional economic ministers adopted a Regional Investment Framework that will oversee better coordination across a range of investment-related policies that should improve the attractiveness of the region as a whole to foreign and domestic investors.

To achieve this vision of a focused and coherent cooperative agenda, countries of the region will increasingly have to assume ownership of the process from the international community. Representatives of the Stability Pact (SP), the European Commission, and donor governments have encouraged the region to endorse the establishment of a Regional Cooperation Council (RCC) linked to the existing South East Europe Cooperation Process (SEECP), which also includes Greece and Turkey, as a successor to the Stability Pact. The SP Investment Compact, led by the OECD, will remain involved in improving the investment framework and monitoring regional actions. Together with the governments from the region and with representatives from the SP Business Advisory Council, it will facilitate the establishment of a Southeast European Investment Committee, which will serve as the investment arm of the proposed RCC.

Recommendations

1. Investment Policy: West Balkan states need to collaborate to eliminate administrative barriers to investment such as licensing procedures and permits. They will have to actively enforce intellectual property rights, for which they will need to allocate adequate financial and human resources. Protection of land real estate property is not yet fully secured in Southeast Europe and outdated land registers and titles remain a problem.

2. Investment Promotion: The insufficient emphasis on a proactive investment promotion approach translates into a weaker image for the region and more limited contacts with potential new investors. The Western Balkans need to adopt both country-specific and regional investment promotion strategies. The development level of investment promotion agencies varies across the region for proper image building and investment facilitation. The region has to focus on creating more incentive-based programs.

3. Tax Policy: Despite the introductions of low corporate taxes, the Western Balkan states are plagued by weak tax administrations, whose capacity has to be improved through more systematic training of tax officials, especially auditors. Lengthy and burdensome appeals procedures need to be streamlined and the introduction of online tax filing systems will be necessary to improve efficiency.

4. Anti-Corruption Policy: The implementation of anti-corruption policies should be strengthened and more transparency must be introduced in public procurement deals. Additional legislative reforms will have to be adopted in order to bring the Western Balkans in line with EU standards. Public-private partnerships could be established with the goal of fostering good governance for both the public administration and for private companies.

5. Competition Policy: The legal framework for competition policy in Southeast Europe is largely in place in line with EU standards, but most Western Balkans countries still need to complete their secondary legislation. Competition authorities in all states should be given sanctioning powers. Public awareness of competition policy should also be improved.

6. Trade Policy: The expansion of the CEFTA to include Southeast Europe will significantly facilitate free trade in the region. However, each state will have to continue working on reducing non-tariff barriers to trade. Those include streamlining technical standards and sanitary standards, restructuring burdensome customs procedures, and strengthening the structures for conformity assessment and import/export procedures.

7. Regulatory Reform: States in the West Balkans have established regulatory institutions, but they are understaffed and lack the power to challenge draft legislation. Many countries in the region also still require rapid and extensive adoption of EU regulations in order to comply with the *aquis communautaires.*

8. Human Capital: The region prides itself on having a highly educated and skilled labor, but the workforce in Southeast Europe nonetheless needs education and training to meet the needs of foreign investors, especially with regards to language and management skills and technical know-how. Each capital needs to conduct regular assessments of skill gaps and incorporate the results in education and training strategies. Emphasis should also be placed on work ethics guidance and workshops.

9. Productivity: As a legacy of central command economies, labor costs in the region remain high relative to productivity even in comparison to the new EU members. To increase productivity, more progress will have to be made in reducing the size of the public sector. Too many resources are still trapped in overstaffed and inefficient public enterprises. Further privatization of large state enterprises would also improve productivity, rationalize the wage structure, and eliminate the drain on public finances.

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