



## **U.S. TREASURY DEPARTMENT OFFICE OF PUBLIC AFFAIRS**

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### **REMARKS BY TREASURY DEPUTY ASSISTANT SECRETARY NANCY LEE ON ECONOMIC COOPERATION AND INVESTMENT OPPORTUNITIES IN SOUTHEASTERN EUROPE AT CSIS**

**WASHINGTON, D.C.** –Thank you very much for the opportunity to speak to you today. It is a pleasure and an honor to participate in this very timely conference.

This is a good moment to take stock of the economic state of the Balkans. For 15 years, the countries of the former Yugoslavia have struggled with ethnic strife or the threat of ethnic strife, and with sectarian politics. The struggle has often pushed the region's economic interests into the background. The result has been economic performance well short of potential.

But now we can glimpse light at the end of the tunnel. If Kosovo's final status can be settled and the legacy of war crimes addressed, twelve months from now we could see a new Balkans emerge, a Balkans whose entrepreneurial spirit is finally unleashed, and a Balkans that is integrating as a region and with the rest of Europe.

I do not in any way want to downplay the risks or difficulty of resolving the remaining political challenges. Indeed, one of the highest priorities must be to ensure that the political structure that emerges in Kosovo promotes economic growth and reform, which are essential to long-term stability in the region. But if these challenges are met, the Western Balkans' future seems brighter than at any time in recent history.

Nor do I want to discount the very real progress that has already been made on economic reform and economic performance. My point is that the Balkan economies, while doing better, can do much better still.

One other point is clear. Trade is the key for this region. Small economies can succeed, but they must be open, competitive, and integrated with larger markets. This is not just theory. These features characterize all of the small economy success stories in Europe itself, from Ireland to the Baltics.

Let me spend a few moments reviewing economic progress and talking about remaining challenges.

#### **Macroeconomic Progress**

First, looking at the macroeconomic picture, we see respectable progress on both growth and inflation. Regional GDP growth is expected to reach 5% for the 2004-2007 period. Favorable external conditions have clearly helped. But improvements in fiscal and monetary policy have also helped the region move

past a constant preoccupation with managing precarious public finances. That level of growth puts this region between Latin America, where growth has averaged around 3%, and developing Asia, with 8% average growth.

Better macroeconomic policies have also put inflation in the Balkans on a downward path. An inflation rate of 7% is forecast for the region in 2006. This regional average masks differences across countries: inflation in Macedonia is running at only 3%, as compared to 12% in Serbia. But overall, inflation in the region remains somewhat higher than inflation in Latin American and developing Asia.

Are there macroeconomic risks on the horizon? I would highlight external imbalances. In 2006, the current account deficit in the Balkans is expected to average 10% of GDP, compared to surpluses in Latin America and developing Asia. Large capital inflows to the Balkans have fueled consumer credit growth and increased import consumption, whereas Asia and Latin America have done better on taking advantage of the current favorable global environment to boost exports.

There is nothing wrong with consumption-led growth in a region with years of pent-up import demand. In addition, while levels of credit growth are quite high, credit to GDP is growing from a very small base. Over the medium term, however, Balkan countries will need to shift their economies more toward export and investment-led growth.

### **The Business Environment**

Among emerging markets then, the Balkans region is in the middle of the pack in macroeconomic terms. But in one area this region is excelling. That is business climate reform. I am referring to measures like the ease of starting a business, enforcing a contract, paying taxes. These are measured in the annual World Bank *Doing Business* report. I am pleased to note that the latest report shows that the Balkan countries are among the most active reformers in the world. Their average ranking in 2006 was 84 (out of 175) – up from 94 in 2005. This puts the region in the company of Latin America with an average of 87 and developing East and Southeast Asia with an average of 82.

Financial sector development has led to a robust credit culture and better access to finance for business. Here, the Balkans rank higher than emerging markets in Latin America and emerging Asia. Big strides also have been made easing the burden of trade regulations, closing the gap with Latin America and developing Asia.

Romania – a “Top 10” reformer in 2004 and 2005 – has seen major improvements across the board in a short period of time. Its *Doing Business* ranking jumped 22 places in the past year. Better tax administration, followed by significant rate cuts in 2005, helped spur new business registrations by 22%. Corruption is also being addressed, with the percentage of businesses reporting bribes as “frequent” nearly cut in half between 2002 and 2005.

Bulgaria, in many ways, has been ahead of the game as an early reformer in the region. As result, the Bulgarian business environment ranks 54 – on par with the Czech Republic (52) and ahead of Hungary (66) and Poland (75). And now, Bulgaria has begun to tackle long standing corruption problems. According to the World Bank, the number of businesses reporting corruption as a significant problem fell from over 50% in 2002 to around 35% in 2005 – roughly the same level reported in Poland and Lithuania.

Last year, Serbia had one of the most dramatic improvements in its *Doing Business* rank - from 95<sup>th</sup> to 68<sup>th</sup>. Administrative changes have greatly reduced the time required to start a new business. A new private credit information bureau has been established. A new customs code and inspections system have greatly reduced import/export delays. The *Doing Business* report has cited this last reform as the biggest trade-related improvement of any country it surveyed this year.

After a slow start, Croatia has renewed the reform process. It has streamlined property registration procedures, simplified tax forms, and reformed trade regulations to reduce import delays.

Successful political transitions in Macedonia and Albania are also spurring renewed commitment to reform. In Macedonia, the new government aims to attract investment by fighting corruption and improving the business environment. The business start time has been reduced by 30 days and contract enforcement is 119 days faster than a year ago.

In Albania, the new government was elected on a strong anti-corruption platform. Acting quickly, it has replaced a large share of the personnel in the customs and tax offices and strengthened the judiciary.

With its introduction of the VAT, Bosnia is taking an enormous step forward for the business climate, especially if combined with further tax reform and simplification.

### **Benefits of Economic Integration**

As Balkan economies lower supply-side barriers, there must be concurrent progress on the demand side strategy. That means integrating with other markets, large and small.

Theory suggests that countries tend to trade more if the size of their economies is similar, if distances are short, if they share borders, and if common languages facilitate business transactions. Countries in close proximity should have more similar spending habits than those that are far apart. All of these conditions apply to the Balkans.

Yet intra-regional trade is still limited. In 1993, intra-regional exports in the Balkans accounted for only 6% of total exports. A decade later in 2003, intra-regional exports still accounted for only 6% of exports. Compare that with Southeast Asia where intra-regional exports account for nearly 25% of total exports.

Some 31 bilateral free trade agreements have been signed in the region. The European Commission has proposed replacing this web of bilateral agreements with a regional free trade agreement. Some countries that are further along the road to European integration have raised doubts about such a plan, seeing it as a proposal to recreate Yugoslavia. Intra-Balkan trade liberalization, however, is not a return to the past, but rather a vital part of European integration. The experience of countries entering the EU suggests that growing trade with the EU is accompanied by growing trade with their immediate neighbors.

When Spain and Portugal joined the European Economic Community, for example, not only did their trade with Europe increase, bilateral trade also grew rapidly as increasing similarity in industrial structure stimulated intra-industry trade. The same is true for the Central European countries that joined the EU in 2004.

### **The Competitiveness Challenge**

While we must acknowledge significant reform progress, we must also acknowledge that Balkan countries need to go much further to be able to thrive in a pan-European economic environment. Let me highlight two inter-related challenges: the continued burden of large inefficient public sectors and lagging productivity.

The share of the private sector is 65% of the economy in the Balkans versus 76% in the EU-8. Labor costs remain high relative to productivity. The average cost for a skilled manufacturing worker in

Croatia is higher than the cost for a worker in the Czech Republic or Hungary. Fixing this problem in a way that promotes higher living standards requires productivity-enhancing reforms.

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 overstuffed and inefficient public enterprises. Further privatization of large state enterprises would improve productivity, rationalize the wage structure, and eliminate the drains on public finances that divert financing away from private enterprises.

The region also needs to commit to transparency and competition in these privatizations to ensure that new owners restructure and raise productivity. Foreign investors can help to meet the region's large investment needs. But to attract further investment in a world in which competition for capital flows is fierce, Balkan countries will have to continue their positive shocks to business climates, particularly in the area of fighting corruption.

Stronger fiscal positions in many of the Balkan countries would also contribute to growth. In countries such as Croatia, Albania, and Bosnia, with fiscal deficits in the range of 2-4% of GDP, fiscal consolidation would release resources from the public to the private sector. Rigid expenditures structures in the Balkans limit the potential to lower taxes and increase pro-growth spending. As in other economies, pension reform would create room for increased public investment spending. In addition, following on gains from other tax rate cuts, reductions in labor taxation would help job creation and reduce the size of the informal sector.

There is no doubt that these are some of the most difficult reforms to accomplish in any country. But there is also no doubt that the goal of EU accession is an effective political driver for reform that leaders in the region must use as vigorously and quickly as possible.

### **Remaining Political Challenges to Economic Growth and Prosperity**

As I said at the start, one last formidable political hurdle remains before the region can truly move past the strife of the 1990s and focus on its economic future. The unresolved political status of Kosovo remains a serious threat to the region's stability and future prospects. For this reason, the United States supported the launch of UN-led negotiations on Kosovo's future. We believe that the future status of Kosovo must be acceptable to its people and must preserve Kosovo's multi-ethnic character.

Over the last nine months, the UN-led negotiations have covered a wide range of issues important to Kosovo's future, such as decentralization of local government and the protection of minority rights. But the Kosovo-status negotiations must produce a sustainable *economic* as well as political outcome. Previous post-conflict cases such as Bosnia and Macedonia provide important lessons on how political structures can foster, or alternatively, hinder growth. These lessons must be applied in Kosovo. With a young, growing population that expects rising living standards, strong economic growth and job creation will be vital to preserving long-term stability.

Macedonia's post-conflict settlement has many features that tend to promote growth and reform. The agreement guarantees minority rights but does not involve the duplication of government functions that add to fiscal costs. It provides voice and local control to minorities, yet does not add extra layers to government. Some decisions must be made by a majority of both ethnic groups, but neither side may indefinitely block fiscal decisions. As a result, the government does not crowd-out the private sector. Macedonia's government spending is 35% of GDP versus over 50% in some other parts of the region. The new government appears committed to moving ahead with reforms to improve the business environment and attract investment. And most importantly, it has a political system that can deliver those reforms.

For Kosovo, the lessons are clear. It needs a single, consolidated fiscal structure that ensures that minority communities receive their share of resources, but without creating additional layers of government. Its structure must force hard budget constraints on all levels, including state firms. Control of tax revenue streams must be properly paired with responsibilities at the central and local level. A new international presence, established to supervise implementation of the Kosovo settlement, should have a light touch to ensure political accountability. These are also crucial considerations for Bosnia as it considers constitutional reforms to move from its post-Dayton structure to one more compatible with EU integration.

## **Conclusion**

We are in the midst of a critical time in Balkans history. Much of the region is poised to deliver to its people much larger gains from democracy and from market-oriented reform. But this will require putting economics on the front rather than the back burner. We must not forget this region's formidable economic advantages in location and in human capital. Decisions regional leaders take in the very near future will determine whether this potential, long burdened by the weight of history, can finally be achieved.