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REPORT FROM THE COMMISSION

The Stabilisation and Association process for South East Europe

Third Annual Report

PART I

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PART II

Commission Staff Working Papers on Albania, Bosnia and Herzegovina, the former Yugoslav Republic of Macedonia and Serbia and Montenegro.

PART III

The Commission's proposal for European Partnerships with Albania, Bosnia and Herzegovina, the former Yugoslav Republic of Macedonia and Serbia and Montenegro.

PREFACE

The Annual Report on the Stabilisation and Association process for South East Europe (SAp) provides an assessment of the progress of Albania, Bosnia and Herzegovina, the former Yugoslav Republic of Macedonia and Serbia and Montenegro, including Kosovo as defined by UN Security Council Resolution 1244, within this process over the past year. It is therefore the key indicator of their readiness to move closer to the European Union.

The first part of the Annual Report summarises progress made during the year by the individual countries, and monitors the development of co-operation within the region. Annexed to the report is an evaluation of the European Union's trade measures vis-à-vis the region.

The second part of the Annual Report comprises a set of Commission Staff Working Papers on each country. These assess the political and economic situation, implementation of reforms and related measures, including recommendations made in previous reports. No paper was prepared on Croatia this year since the Commission will publish its Opinion on Croatia's application for EU membership. The report on Bosnia and Herzegovina concentrates on an update of progress on the 16 priorities for action identified in the Commission's Feasibility Study for opening SAA negotiations, published in November 2003.

The third part of the report contains the Commission's proposal for the first European Partnerships. These identify short and medium term priorities which each country needs to address. The European Partnership for Croatia will be presented with the Commission's Opinion on the membership application.

The Annual Report and the European Partnerships combine to guide the countries through their transition and help them move closer to the European Union.

Information used in compiling these reports was provided by the authorities in the countries, the Commission delegations in each capital, international organisations and representatives in the region. The report reflects developments until 20 February 2004. Therefore the report could not fully assess recent events in Kosovo.

1. THE OVERALL CONTEXT

1.1. An enlarging Union

On 1 May 2004, the European Union extends its membership from 15 to 25 states. Negotiations are well advanced with **Bulgaria** and **Romania**, which aim to join the EU in 2007. The Commission will present before the end of 2004 a report on **Turkey's** fulfilment of the Copenhagen political criteria, along with a recommendation on the possible opening of accession negotiations.

For the acceding countries, the accession process has served as a **catalyst for change**, accelerating the implementation of complex and difficult political, institutional and economic reforms. The conclusion of the process is a significant achievement that was based on sustained commitment over many years to the goal of membership.

The European Union will ensure that the enlargement process does not raise new barriers, and that the Union remains inclusive and outward-looking. The Commission has put forward a new framework for relations with its new eastern and southern neighbours which currently do not have the perspective of membership of the EU, the European Neighbourhood Policy¹. The European Neighbourhood Policy does not apply to the Western Balkan countries since they have a membership perspective.

1.2. The Western Balkans' European vocation

As potential candidates, the countries of the Western Balkans have the prospect of **future membership** of the European Union, an objective endorsed by the European Council in Feira in June 2000 and reconfirmed by the European Council in Thessaloniki in June 2003. This is a promise which the EU will honour when each country fulfils the necessary criteria.

The same basic **entry requirements** apply to the countries of the Western Balkans as to other countries that aspire to join the Union, namely the political, economic and institutional criteria established by the Copenhagen European Council in 1993 and set out in Articles 6 and 49 of the EU Treaty. The countries must also meet the criteria specific to the Stabilisation and Association process (SAP) as set out in the Conclusions of the General Affairs Council in April 1997 and in accordance with the Commission Communication of May 1999 on the establishment of the SAP². These criteria include full co-operation with the International Criminal Tribunal for the former Yugoslavia (ICTY)³, respect for human and minority rights, the creation of real opportunities for refugees and internally displaced persons to return and a visible commitment to regional co-operation. Important principles established during the present enlargement process also apply to the countries of the Western Balkans: each country proceeds towards membership on its own merits and at its own speed.

Fulfilment of the SAP and accession criteria entails far-reaching reforms, principally the development of adequate institutional capacity. Following through on commitments and having the basic capacity to negotiate, conclude and implement a Stabilisation and Association Agreement is demanding, but is necessary if the countries wish to achieve a more advanced relationship with the Union.

The Commission will continue to support the countries in their efforts to make progress towards these goals. The **Thessaloniki** European Council and the Summit between the EU and the Western Balkan countries in June 2003 demonstrated this. The "Thessaloniki Agenda" proposed that a number of **instruments**, which proved successful in the pre-accession process, be introduced in the Stabilisation and Association process. The most far-reaching of these new instruments are the **European Partnerships**. The Commission now presents the first set of draft European Partnerships for the Council's consideration.

1.3. The European Partnerships

Based on the assessments in the Annual Reports, the European Partnerships identify **short and medium-term priorities** which the countries need to address. Implementation of these

¹ Communication from the Commission to the Council and the European Parliament: Wider Europe – Neighbourhood: A new Framework for Relations with our Eastern and Southern Neighbours, COM (2003)104 final.

² COM (99) 235

³ Cooperation with the ICTY is a legal obligation under UN Security Resolution 827 of 25 May 1999. It is also an obligation under the General Framework Agreement for Peace (the "Dayton/Paris Peace Agreement").

priorities will require commitment, political will and the allocation of adequate resources. As progress is achieved, the European Partnerships will increasingly be geared towards the adoption of the *acquis*. The successful fulfilment of the Partnership priorities will equip the countries with the institutional and legislative framework and administrative capacity required to govern a modern democratic society with a functioning market economy. It will also speed up their progress towards EU membership.

The countries of the western Balkans are strongly encouraged to adopt plans for implementing the priorities identified in the European Partnerships, including a timetable for doing so. The Partnerships and subsequent plans can also guide the countries in their budgetary decisions. Progress will be monitored by the Commission and assessed in the Annual Reports.

The Partnership priorities will also be the basis for programming **assistance**, which is provided under the CARDS programme. Preparations for future integration into the EU will require considerable resources. Due to the conflicts of the last decade, the development of functioning market economies in this region is more demanding and will take longer than did the transition in Central Europe. The process is far from complete in the Western Balkans. The economic and social situation is still precarious in large parts of the region. The cost of economic, legal and administrative modernisation is considerable and will partly be borne by the countries themselves, but also requires external assistance. The EU and the international community will need to continue to provide a high level of support to the region.

The Stabilisation and Association process will address challenges in the region as priorities generally continue to shift from those of a post-conflict situation – essentially crisis management, reconstruction and rehabilitation – to issues closer to those faced by the candidate countries as they prepared for EU membership – institutional, judicial, economic and legislative reform. Consequently, the EU needs to ensure that its **presence in the region** reflects its evolving relationship with the individual countries. The Commission Delegations play an increasing role in supporting the reform process and managing assistance flows in the context of the new European Partnerships. Proper co-ordination among EU representatives in the region remains a high priority.

1.4. Regional priorities

There are a number of common issues that set the context for reform efforts in the region.

Regional co-operation is a practical means for promoting reconciliation and under-pinning reform. Further efforts are needed to re-establish good neighbourly relations. **Reconciliation** among the peoples of the region also requires that those indicted for war crimes stand trial. Co-operation by the countries concerned with the International Criminal Tribunal for the former Yugoslavia (**ICTY**) remains generally insufficient. Despite certain improvements, the work of the court is still systematically obstructed, as highlighted by the Chief Prosecutor of the ICTY⁴.

The continuing prevalence of **organised crime and corruption** in the region delays political reform, holds back economic development and puts into question the rule of law. Progress on these issues and improvements on border management could undoubtedly facilitate the movement of persons and have an impact on the willingness of the Union to review the situation. Initial discussions on these issues have begun, within the framework of the SAP.

⁴ Report of the Chief Prosecutor of the ICTY to the UN on 9 October and presentation to the General Affairs and External Relations Council on 13 October 2003.

Several countries are still held back by disagreements concerning the **distribution of power** among peoples, parties, national and sub-national levels of government and by complex or ambiguous constitutional arrangements. Proper functioning of democracy, promotion of a healthy political climate, freedom of media, respect of human and minority rights and the efforts to establish a political culture more close to EU standards should be given a higher priority.

Firm commitment to political and economic reform will allow the countries of the Western Balkans to move away from the past, to reconcile differences and to rebuild trust so that they can focus on improving their citizens' living standards and bringing them closer towards EU membership. A redoubling of efforts within the SAp, coupled with the introduction of European Partnerships, enhanced institution building and participation in certain EU structures can, with continuing support from the EU, help to meet our common objectives.

2. THE STABILISATION AND ASSOCIATION PROCESS AND ITS INSTRUMENTS

The Stabilisation and Association process supports the countries' development and preparations for future EU membership by combining three main instruments: the Stabilisation and Association Agreements, autonomous trade measures and substantial financial assistance.

2.1. Relations with the individual countries

Since January 2003, there have been nine rounds of negotiations on concluding a Stabilisation and Association Agreement (SAA) with **Albania**. While all major issues of substance have been discussed, Albania needs to accelerate reforms and achieve far more concrete results, particularly as regards implementation of legislation, if it is to conclude and implement an SAA within a reasonable time.

A Feasibility Study on opening SAA negotiations with **Bosnia and Herzegovina** was adopted by the Commission on 18 November 2003.⁵ The Commission concluded that although much progress has been made, structural weaknesses persist and implementation of a SAA would be a major challenge. The Commission identified 16 priorities which should be addressed during 2004 and will decide on a recommendation to begin negotiations when Bosnia and Herzegovina can show that significant progress has been made in meeting these priorities.

Croatia signed an SAA with the EU on 29 October 2001, which will enter into force when it has been ratified and concluded by the Member States and the European Communities. Croatia presented its application for accession to the European Union on 20 February 2003. In April 2003, the Council requested the Commission to submit its Opinion on the application and a series of questions was transmitted to the Croatian authorities in July, to which the Croatian government responded in October. This has been followed by an exchange of questions and information between the Commission and the Croatian Government prior to the finalisation of the Commission's Opinion. The Commission will submit its Opinion on the membership application in spring 2004. Consequently, no further assessment is made in this document on Croatia's progress in the Stabilisation and Association process.

The SAA with the **former Yugoslav Republic of Macedonia** was signed on 9 April 2001. It has been ratified by all member states and will enter into force shortly. The former Yugoslav

⁵ COM(2003)692 final

Republic of Macedonia submitted an application for membership, on the basis of Article 49 of the Treaty on the European Union, on 22 March 2004. The application will be considered according to the rules laid down in the Treaty.

The Commission started work on a Feasibility Study on opening SAA negotiations with **Serbia and Montenegro** during the autumn of 2003, after the country had adopted a new Constitutional Charter and presented an Action Plan for the creation of a single trade policy and a single market. Following Parliamentary elections in Serbia, the new Government will require time to address remaining issues, including in particular political conditionality, constitutional issues and the Action Plan. For this reason, the Feasibility Study was postponed. Building on the earlier Consultative Task Force, an Enhanced Permanent Dialogue serves as the forum for advice on sectoral reforms and will increasingly focus on technical and policy dialogue with the EU. **Kosovo**⁶ benefits from all the elements of the Stabilisation and Association process, with the exception of the possibility of contractual relations with the EU. To ensure compatibility of reforms in Kosovo with the *acquis*, and with the participation of UNMIK and the Provisional Institutions of Self Government (PISG) in Kosovo, the Commission has established the Stabilisation and Association process Tracking Mechanism (STM), which plays a key role in providing policy advice and measuring progress. The eruption of violence in March 2004 was a major setback for Kosovo. The events confirm the need to firmly anchor Kosovo in the Stabilisation and Association process. The European Partnership will provide guidance on the way forward but may need to be adapted following a thorough assessment of the causes and implications of the events. The PISG should publicly condemn the violence, ensure that there is no recurrence, and should set aside funds in Kosovo's consolidated budget to cover reconstruction costs resulting from these events. Those responsible must be brought to justice.

Political dialogue has increased between the European Union and the countries of the region. Within the framework of the EU-Western Balkan Forum, the first meetings were held with the Ministers responsible for Justice and Home Affairs' issues in November 2003 and with the Foreign Ministers in December 2003. Political Dialogue has been extended to all countries of the region.

As close partners of the European Union, the countries of the Western Balkans are regularly invited to **align** themselves with EU *demarches*, Declarations and Common Positions on Common Foreign and Security Policy issues. The Commission monitors the follow-up to these shared political positions and reports its findings in the Annual Reports. In this context, the Commission regrets that Albania, Bosnia and Herzegovina and the former Yugoslav Republic of Macedonia have signed bilateral immunity agreements with the United States, which run contrary to the "EU guiding principles concerning arrangements between a state party to the Rome Statute of the ICC and the United States regarding the conditions of surrender of persons to the court"⁷. The EU remains firmly committed to the effective functioning of the **International Criminal Court (ICC)** and is determined to preserve the full integrity of the Rome Statute, as underlined in the Council Conclusions and Guiding Principles adopted in September 2002 and in a Common Position of 16 June 2003.

⁶ Kosovo is administered under UN Security Council Resolution 1244

⁷ The guidelines were adopted by the Council on 30 September 2002.

2.2. The European Union's trade measures

The introduction of the EU's exceptional trade measures for the Western Balkans in September 2000 provided the region with uniform and wide-ranging free access to the Union's market for almost all goods.

Western Balkan exports to the EU have increased substantially since the late 1990s. This is due to a combination of factors such as post-conflict reconstruction, the transition to a market economy and the introduction of the trade measures by the EU, the region's biggest trade partner. The impact of the trade measures on the countries varies, depending on the structure of their exports and on previous trade arrangements. At this stage, Albania and Serbia and Montenegro appear to have benefited the most from the trade measures which brought about lower tariffs for about half of their exports, the other half already benefiting from duty-free access to the EU market. The tariff reduction was significant for most exported products. In the context of parallel EU trade liberalisation towards other third countries, the trade measures have assisted the Western Balkan countries in maintaining their preferential position on the EU market.

To fully benefit from the EU's trade measures, the countries need to increase competitiveness, diversify production, raise awareness among economic operators of the potential of the trade measures, facilitate a dialogue with business counterparts on the EU market and upgrade trade related institutions. They need to further harmonise their standards with those of the EU, including in the veterinary and the sanitary and phytosanitary field.

An examination of the region's long-term prospects of exports to the EU shows a significant untapped potential. Exports from the countries of the region to the EU could be considerably higher than currently. To exploit the underlying potential, the countries must attract sufficient levels of foreign direct investment to broaden their export base and to increase their production capacity and productivity and to ensure compliance with EC standards. Governments need to pursue structural reforms, modernise administrations, including in particular the judiciary, and to ensure the rule of law to realise this objective.

A more extensive evaluation of the impact of EU's trade measures is annexed to this report.

2.3. Community assistance

European Union assistance for the region is provided mainly through the **CARDS**⁸ programme. The EU has allocated around €5 billion to this programme for the period 2000-2006. The main focus of Community assistance has gradually shifted from infrastructure rehabilitation and democratic stabilisation (including aid to refugees) to institution building and justice and home affairs. The programme includes capacity building in the public administration, judiciary, police, border services, support to and reform of the media and assistance in drafting legislation. The **priorities** reflect the emphasis in the SAp on the need to strengthen the countries' capacity to implement reforms. The impact of assistance is not limited to the sector directly concerned. Programmes to create competent institutions and judicial systems have a positive impact on economic development and reform.

⁸ Community Assistance for Reconstruction, Development and Stabilisation, Council Regulation No 2666/2000, OJ L209/1.

To address reconstruction needs and to stabilise the region, disbursements of the CARDS budget were proportionally greater in the first years of the period. An additional €71 million were allocated to the Western Balkans in the 2004 budget, an increase of some 13%⁹. The Commission has adopted a revised financial programme for 2005 and 2006, which foresees an annual increase of some €70 million for the Western Balkans.¹⁰ The increase will allow CARDS to continue to address needs until the end of this budgetary period.

In addition to the CARDS programme, the EC has committed since 1992 around €1 billion in **macro-financial assistance**¹¹, of which €873 million had been disbursed by the end of 2003. At present, there are two operations; in Bosnia and Herzegovina (€60 million) and in Serbia and Montenegro (€200 million).¹² A proposal for further macro-financial assistance for Albania (€25 million) has been adopted by the Commission¹³. The EC is also providing substantial financial support to **international bodies and interim administrations** in the region, such as the OHR and UNMIK and, from 2004, the Office of the Special Co-ordinator of the Stability Pact for South-Eastern Europe.

To be eligible for Community assistance, the countries must respect the principles of democracy, the rule of law, respect for human and minority rights and fundamental freedoms. Community assistance is also subject to the conditions defined by the Council in 1997.¹⁴ The Commission examines compliance with these conditions and will, as appropriate, submit proposals concerning eligibility for assistance in general or for particular projects.

The Commission will submit to the Council before 30 June 2004 two reports that will provide an independent and reliable assessment of the implementation of Community assistance in the region, and help map out the future of Community assistance programmes. The first is an **evaluation** of implementation of assistance under the **CARDS regulation**¹⁵. The evaluation will be based on five criteria: relevance, impact, efficiency, effectiveness and sustainability of the assistance programme. It should also assess and, where appropriate, make recommendations as regards complementarity with Member States' assistance, local ownership and participation, as well as coherence with other EU policies and with the priorities of partner governments. The Commission will also submit an evaluation of implementation of assistance under the **regulation on the European Agency for Reconstruction**.¹⁶ This report will assess the agency's implementation of EC assistance and make a proposal on the future status of the agency.

The Commission's communication "Wider Europe – Neighbourhood: A New Framework for Relations with our Eastern and Southern Neighbours"¹⁷ indicated that the Commission will

⁹ Excluding macro-financial assistance and the Western Balkans' contribution to the European Training Foundation.

¹⁰ Work on establishing Multi-Annual Indicative Programs for 2005 and 2006 is on-going.

¹¹ EC macro-financial assistance is untargeted financial support in the form of grants and/or loans to help address identified balance of payments needs and to support reforms in the context of adjustment programmes by the International Monetary Fund (IMF).

¹² A detailed account of the implementation of EC macro-financial assistance to third countries is provided by the Annual Report of the European Commission to the European Council and European Parliament. The 2002 Report is available on the Europa website at: http://europa.eu.int/comm/economy_finance/publications/external_relations/macrosfinancial_en.htm

¹³ COM(2003)834 final

¹⁴ Council Regulation (EC) No 2666/2000 of 5 December 2000, OJ L306/1

¹⁵ Ibid

¹⁶ Council Regulation (EC) No 2667/2000 of 5 December 2000, OJ L 306/7

¹⁷ COM(2003)104 final

consider the possibility of creating a new instrument to support cross-border co-operation at the EU's external borders. A subsequent communication, 'Paving the way for a **New Neighbourhood Instrument**'¹⁸ (NNI), issued in July 2003, assessed the possibilities in this area and identified four objectives for the instrument: (1) promoting sustainable economic development; (2) working together to address common challenges in fields such as environment, public health, prevention of and fight against organised crime; (3) ensuring efficient and secure borders; (4) promoting local, "people to people" type actions. Pending the introduction of the NNI, Neighbourhood Programmes currently under preparation for the period 2004-2006 will provide a framework for enhanced co-ordination among the existing funding instruments, in particular Interreg, Tacis, CARDS and the Phare Cross-Border Co-operation (CBC) programme. CARDS will provide a financial contribution of €45 million for these programmes as part of its Regional strategy over these three years.

Future needs in the Western Balkans will remain substantial, not all of which can be met by the present level of assistance under the CARDS programme. The countries share many common problems. These include an inadequate infrastructure in areas such as health care, education and social security. Economic development is held back by energy shortages and inadequate transport infrastructure. Funds are limited and the Commission needs to focus on a limited number of priority areas where assistance can have the greatest possible impact. Additional funds will be needed in the medium term to help the countries address remaining challenges and prepare for future EU membership. These needs have been included in the recent Commission Communication "Building our common Future: Policy challenges and Budgetary means of the Enlarged Union 2007-2013"¹⁹.

2.4. New forms of support

In line with the Commission's Communication "The Western Balkans and European Integration"²⁰ and "The Thessaloniki Agenda for the Western Balkans"²¹, the Commission has introduced, alongside the European Partnerships, a number of new instruments which will help strengthen the countries' ability to implement their reform programmes.

One instrument originally developed as part of the EU's efforts to help candidate countries strengthen their administrative capacity is **twinning**. This involves the secondment of officials from the Member States to their counterpart authorities in the region; it has so far been introduced in Albania, Bosnia and Herzegovina and Croatia and preparations are under way for its introduction in the former Yugoslav Republic of Macedonia and in Serbia and Montenegro.

Another example of the successful transfer of experience from the enlargement process to the western Balkans is the extension in December 2003 to the Western Balkans of the services provided by **TAIEX**²².

¹⁸ COM(2003)393 final

¹⁹ COM(2004)101 final

²⁰ COM (2003) 285 final

²¹ "The Thessaloniki Agenda for the Western Balkans" was adopted by the General Affairs and External Relations Council on 16 June 2003 and endorsed by the Thessaloniki European Council on 19-20 June 2003.

²² Technical Assistance and Information Exchange Office

The Commission has begun a Feasibility Study on the establishment of a **Regional School for Higher Education and Public Administration** and is awaiting the conclusions of the study before making concrete proposals.

Countries in the region will be able to take part in the work of selected **Community programmes and agencies**, according to their particular needs, interests and capacities. The European Commission issued a Communication²³ on 3 December 2003, setting out ways and means and a time schedule. This will enable the Western Balkan countries to improve their understanding of the policies and working methods of the EU.

The Commission has proposed that the Western Balkan countries should be eligible to participate in **tenders** under various pre-accession programmes (Phare, ISPA, SAPARD and programmes for Cyprus, Malta and Turkey). This will enable companies in the region to compete for contracts, to familiarise themselves with tendering procedures, to gain business opportunities and to establish links with economic operators in the countries concerned.

Implementation of the Thessaloniki Agenda is well under way. The Thessaloniki commitments are joint undertakings, however, and require practical steps on the part of the Western Balkan countries themselves as well as of the EU.

3. PROGRESS BY THE COUNTRIES IN THE STABILISATION AND ASSOCIATION PROCESS

3.1. Political developments

The countries of the Western Balkans have continued to make progress. The security situation has been stabilising across the region. The eruption of ethnically motivated violence in Kosovo in March 2004 was a serious setback in this context, however. Further detailed assessments of the causes and implications of these events are still needed.

Across the region, reforms are underway in the public administration and in various sectors, including defence. Regional co-operation is increasing. Progress is uneven, however. In several countries, many of the recommendations in the 2003 Annual Report remain unfulfilled. There is little progress in the fight against organised crime and corruption. Administrative and judicial reforms are slow and implementation and enforcement of legislation weak.

Albania continues to play a constructive role in the region and its economy has remained stable. Organised crime and corruption remain widespread, however, and threaten stability and reform. Albania needs to step up its efforts in this area. It also needs to strengthen the judiciary and public administration and to ensure free and fair elections at all levels. Implementation capacity is an issue of particular concern. Albania should also devote more attention to addressing the claims of its minorities.

The Feasibility Study for **Bosnia and Herzegovina** (BiH) confirmed that considerable progress has been made in stabilisation but also that the country still suffers from significant structural weaknesses. The constitutional order, as defined by the Dayton/Paris Peace Agreements, is complicated, costly and does not facilitate reforms. However, reforms in the areas of defence and taxation show that incremental and politically acceptable change is

²³ COM (2003) 748 of 3.12.2003 "Preparing for the participation of the Western Balkan countries in Community programmes and agencies".

possible. One of the main challenges for BiH today is to address remaining structural weaknesses and become a self-sustaining state able to maintain closer relations with the European Union. This may require a strengthening of the powers and capacity of central government and an appropriate division of responsibilities between State and Entities. The High Representative has played an important role in pushing through reforms. The Government of BiH now needs to take more direct responsibility for the reform process.

The security situation in **former Yugoslav Republic of Macedonia** is stabilising and the political climate has improved. National unity and political maturity marked the period following the tragic death of President Trajkovski. President Trajkovski played an important role in establishing and implementing the Ohrid Framework Agreement and he was strongly committed to bringing his country into the European Union. The Commission is confident that the government of the former Yugoslav Republic of Macedonia will carry forward his work. During the reporting period, implementation of the Ohrid Framework Agreement has progressed although some of the most sensitive pieces of legislation remain to be adopted and/or implemented. The entry into force of the Stabilisation and Association Agreement on 1 April 2004 should further accelerate the much needed reforms to ensure stable, functioning institutions, the rule of law and economic development.

The adoption of the Constitutional Charter and of an Internal Market and Trade Action Plan in **Serbia and Montenegro** were important achievements, but they have not been fully implemented and the Action Plan remains incomplete. In *Serbia* the state of emergency following the assassination of Prime Minister Zoran Djindjic led for a time to greater engagement in the fight against the networks of organised crime and political extremists. However, the respect for human rights and the rule of law was affected during this period. Parliamentary elections in Serbia in December 2003 led to the formation of a coalition government led by Prime Minister Kostunica. In **Kosovo**, the completion of the transfer of non-reserved powers from UNMIK to the Provisional Institutions of Self-Government paved the way for the opening of a new phase in relations between the international and local authorities. This will be based on a closer partnership to jointly realise the targets set out in the document "Standards for Kosovo" put forward by the Special Representative of the Secretary General in December 2003 and subsequently endorsed by the UN Security Council. Progress in fulfilling these standards has become even more important after the March 2004 events. The events have also demonstrated that progress will require a stronger commitment of Kosovo's leadership to a stable, secure, democratic and multi-ethnic Kosovo and to the European integration agenda. Ethnically motivated threats, violence and destruction of property are not compatible with European values and standards. The EU aims to maintain Kosovo firmly anchored in the Stabilisation and Association process and to ensure that progress in fulfilling the UN standards remain compatible with, and reflect the relevant EU policies and the EU's values.

Ensuring fully functioning **democratic systems of government** remains one of the main challenges in the region. During the course of the year, elections were held in several countries. They were generally considered free and fair and were conducted in accordance with international standards. The Albanian local elections were carried out on the basis of a new electoral code but were nevertheless problematic, notably with regard to voter registration, voter lists and delays and interference in the tabulation of results. The repeat of the Serbian presidential elections in November 2003, following a series of unsuccessful attempts in 2002, failed as the turnout was below the required threshold.

The functioning of government institutions in several countries is still hampered, and sometimes paralysed, by internal political conflicts. A lack of support for, or disagreements

over constitutional arrangements combined with a legacy of distrust between political opponents is often at the core of the problem, slowing down the legislative process and economic recovery. Throughout the region, trust has to be rebuilt among leading reformers and between the politicians and their electorates. Progress has been made in reform of the military in Bosnia and Herzegovina and in Serbia and Montenegro.

The performance of the **parliaments** has improved in several countries. Substantial issues are being discussed, working methods have improved, and more laws are adopted. The quality of output of some parliaments is still affected by the lack of an adequately qualified administration and of technical resources. In Serbia and Montenegro, the functioning of the republican legislatures has been marked by instability and a lack of consensus on the need to adopt key laws. The state parliament has been engaged in very limited legislative activity which led to delays in the implementation of the Constitutional Charter.

A **civil society** that can articulate popular needs, preferences and concerns is an important element of any democratic society. Civil society is still very underdeveloped in some of the Western Balkan countries, although the situation is gradually improving. NGOs and other independent bodies need to improve their advocacy skills and their financial viability, relying as they do largely on external donor funding.

Efforts should be stepped up to reform the **education systems**, and to support the non-governmental youth organisations, whose active participation in society can ensure an open and pluralistic democracy. The issue of education in minority languages deserves continued attention.

There has been limited progress in **public administration** reform. Generally, administrative capacity remains poor throughout the region at state and lower levels of governments. The ability of the civil service to coordinate policy and to carry out strategic planning are held back in several countries by a lack of human and financial resources and of a clear division of responsibilities. Political interference is widespread. The countries need to establish a legal framework and procedures that ensure the professionalism and independence of the civil service. This is of paramount importance since the public administration needs to prepare and implement the reform process.

Another common challenge for the countries is reform and strengthening of **judicial systems**. The deficiencies in the judicial systems identified in last year's report remain largely unaddressed. There are considerable backlogs of pending cases in the courts. In the region as a whole, training of judicial staff depends to a large extent on contributions from external donors. Training institutes have not yet evolved into permanent bodies with comprehensive training programmes. Further progress should be made in building the capacity to prosecute war crimes.

The performance of the judicial system in *Albania* remains weak, which adversely affects the prosecution of serious crimes. Salaries for judges and prosecutors are low, the infrastructure is poor and corruption within the justice system is widespread.

A comprehensive judicial reform strategy was adopted in *Bosnia and Herzegovina* in February 2002; appointment procedures will be reviewed and the number of courts and judges reduced. The creation of a BiH State Court and State Prosecutor was an important step forward. However, judicial reform remains a major challenge for BiH at state, entity and local level. Particular efforts are needed to build judicial capacity at state level and to ensure appropriate representation of all peoples in the judiciary.

There have not been any major changes of the functioning of the judiciary in the *former Yugoslav Republic of Macedonia*. Hearings in civil cases are often postponed, the delivery of notifications of summons and orders to appear before courts is inefficient and there are significant delays in enforcement of cases.

In *Serbia and Montenegro* the judiciary continues to struggle with serious backlogs, political interference and limited resources. The state of emergency in Serbia led to undue political interference in the judiciary and to the adoption of legislation via emergency procedures with negative effects which persisted after the state of emergency was lifted in 2003.

Work has continued to fight **corruption**. Most countries have adopted anti-corruption strategies and set up bodies to monitor their implementation. However, their work often suffers from unclear or unrealistic objectives and insufficient resources. The strategies are not implemented vigorously enough. The results of anti-corruption measures have so far been limited and corruption is still widespread throughout the region. Efforts must intensify to get to grips with these problems. A positive development was that Serbia and Montenegro joined the GRECO co-operation structure (Groups of States against Corruption) in October 2003. All Western Balkan countries are now participating in this inter-governmental anti-corruption co-operation.

The respect for **human and minority rights** is guaranteed in constitutions or in law in all countries. Improvements need to be made in terms of practical application. Institutions guaranteeing the respect for human rights need to be supported, adequate funding must be provided and their decisions must be respected and implemented. In some countries, co-ordination between different levels of government on these issues needs to be further stepped up. Violence by members of the police force persists and the conditions in prisons remain problematic in several countries. Accusations of human rights abuses must be properly investigated and dealt with. **Gender equality** is insufficiently ensured and domestic violence remains a problem in several countries.

Significant numbers of **refugees and internally displaced persons** are still returning to their homes. Many have also chosen not to return but to resettle. Their rights, including property rights in their country of origin, must be respected. The return of refugees to *Bosnia and Herzegovina* has been impressive with more than one million returns since the end of the war, although the pace is now slowing down²⁴. At the end of 2003 over 90% of all property claims in BiH arising from the war in the 1990s had been resolved. The main challenge today is the creation of sustainable economic and social conditions for the returnees. In *Kosovo* inadequate security continues to be a major obstacle to returns. The difficult economic situation and other social reasons are additional factors discouraging displaced people from returning. At the end of 2003, the number of displaced persons in Serbia and Montenegro with origin in Kosovo was 225,000, a slight decrease compared to 2002. New reflections will also be required on an appropriate strategy to ensure that those displaced by the recent acts of violence in Kosovo can return and to avoid any further displacement.

²⁴ 44,868 returns were registered in BiH in 2003 compared to 102,000 returns during 2002 (UNHCR Sarajevo, Recorded minority returns 2003 in BiH). 100,000 refugees from BiH remain displaced in Serbia and Montenegro and about 4,000 in Croatia. The number of internally displaced persons in BiH is 327,000 (UNHCR, Estimate of refugees and displaced persons still seeking solutions in South-Eastern Europe, updated to reflect the situation on 1st January).

Free, independent, professional **media** are a key element in functioning democracies. The Western Balkan countries have made progress in adopting and, to a lesser extent, implementing media legislation in line with European standards. Further progress is needed to transform state broadcasters into genuine public service broadcasters and to ensure free access to information, freedom and independence of the media, full independence of Regulatory Bodies and the transparent and fair allocation and regulation of emission frequencies. Political interference in the media, sometimes through financial and fiscal pressure, still persists in most of the countries, and protection against undue defamation is not satisfactory. More efforts are required to ensure the media's financial viability over the long term, particularly as far as the transparency of financial sources and the rules of media ownership and concentration are concerned. A level playing field for public and private broadcasters is needed to ensure the co-existence of viable public and private sectors. Efforts should also be directed at consolidating professional structures, raising professional and ethical standards – thereby promoting self-regulation – and ensuring the appropriate involvement of relevant professional and other bodies in the functioning of the media.

In the broadcasting sector, the countries should advance towards adoption of EU standards concerning, inter alia, advertising and sponsorship rules, protection of minors, the promotion of European works and the right of reply. The Commission and other relevant European organisations are reinforcing their co-operation with the public authorities and professional sectors in the countries, in order to increase awareness of best practices in the media and to identify ways to accelerate the pace of the necessary reforms.

3.2. Economic development²⁵

Economic growth in the region reached above 4% in 2003 for the fourth consecutive year continuing to show resilience to the sluggish growth of the world economy in general and to the downturn in the European Union in particular. Most of the countries show slightly higher growth rates as compared to previous year. The level of gross domestic product (GDP) **per capita** reaches a regional average of €400, ranging from about €700 in Kosovo²⁶ to €5400 in Croatia. If Croatia is excluded, per capita GDP of the remaining countries average €1700. Income levels in the Western Balkans generally lag well behind those in acceding countries of Central- and Eastern Europe (CEECs), where the average per capita GDP amounts to some €6000.

Inflation has been brought down to a regional average of 3.5%, mainly due to policies based on external anchors and prudent macroeconomic frameworks and continued improvement in Serbia and Montenegro. **Public finances** improved during 2003. The general government deficit (before grants) across the Western Balkans decreased to 4% of GDP, ranging from about 1.5% of GDP in the former Yugoslav Republic of Macedonia to 5.5% of GDP in Albania.

The countries have all made some progress on **structural reforms**, but overall the pace of reform remains modest and significant structural reforms remain to be introduced. In addition, some achievements are fragile and need to be consolidated. Privatisation of small and medium sized enterprises is well advanced in most of the countries and substantial further progress

²⁵ The reliability of statistics from the region remains generally poor and data should be interpreted cautiously.

²⁶ Per capita income in Kosovo has been significantly revised downwards by the IMF compared to last year's figure.

took place in Serbia and Montenegro. On the other hand, privatisation of large state or socially owned enterprises advanced slowly with noticeable progress in only a few countries. Overall, in Serbia and Montenegro the momentum of reform appears to have slowed down in some areas compared to the last two years, and in Bosnia and Herzegovina reforms are to a large extent pushed by the Office of the High Representative.

Economic restructuring may be associated with job losses, but if this process is undertaken with sufficient vigour, new economic activity is expected to lead to net job creation and a reduction of unemployment. Recorded unemployment is high in all countries, particularly in the former Yugoslav Republic of Macedonia, Kosovo and in Bosnia and Herzegovina. **Sustained high rates of unemployment** may cause social and political tensions undermining further economic and political reform, not least since it mainly affects young people and minorities.

Some 20-25% of the citizens of several of the countries are estimated to live below the **poverty line**²⁷ and the infant mortality rate is five times higher than the EU average in Albania and three times higher in Bosnia and Herzegovina, the former Yugoslav Republic of Macedonia and in Serbia and Montenegro.²⁸ Living standards are particularly low in rural areas and for minorities, low skilled workers and the unemployed.

The economies of the Western Balkans have large **informal sectors** as occurs in most economies in transition. Estimates of the size of the informal economy are often high and may reach as much as 50% of GDP in some cases following significant growth in size and scope during the years of conflict. Substantial informal sector activity hampers the emergence of an effective public sector since it reduces the tax base and impedes effective targeting of social policies due to a lack of reliable information.

International financial **assistance** in the form of grants and loans remains an important source of budgetary financing. In 2003, grants are expected to account for more than 2% of GDP in the former Yugoslav Republic of Macedonia and 4% of GDP in Bosnia and Herzegovina. In Kosovo, the figure could exceed as much as 40% of GDP. While providing a vital source of income for the countries, **remittances from migrants abroad**, which for 2002 are estimated to amount to more than 10% of GDP in most of the countries (i.e. far greater than the volume of foreign direct investment), are spent primarily on imports and are often associated with significant trade deficits.

The continuous **loss of human resources** in the form of migration has started to decline from the high levels of previous years. In 2003, three countries appear among the top-40 nationalities seeking asylum in industrialised countries, against four in 2002, as there has been a reduction in the number of asylum applications from nationals of these countries.²⁹ While the reasons for this change remain difficult to verify, it may reflect an increasing sense of stability and economic opportunity in the region.

²⁷ Poverty lines vary in time and place, and each country uses lines which are appropriate to its level of development, societal norms and values as what is necessary to satisfy basic needs varies across time and societies.

²⁸ United Nation's Statistical Division (2003). The infant mortality rate reaches approximately 25 deaths per 1.000 children born alive within one year of birth in Albania, while the figures for BiH, the former Yugoslav Republic of Macedonia and Serbia and Montenegro is around 15. In Croatia, the figure is 8.

²⁹ UNHCR: Asylum levels and trends in industrialized countries, January to October 2003.

Trade liberalisation is an integral part of the EU accession process and of the Stabilisation and Association process. Trade in the Western Balkans increased in 2002 with import growth (9%) outpacing export growth, which almost came to a halt during the year. The EU remains the region's main trading partner accounting for close to 60% of their total trade (ranging from about 45% for BiH to 80% for Albania) out of which Italy and Germany cover more than half. The Western Balkans remains a modest trading partner for the EU, making up less than 1% of its total trade in 2002. The EU's ten new member states will apply the EU's Common Commercial Policy, including the EU's trade measures towards the Western Balkans, from 1 May 2004, thus offering enhanced opportunities for duty free exports to the EU.

The overall **trade deficit** remains large at more than 25% of GDP across the region in 2003, spanning from about 17% of GDP in the former Yugoslav Republic of Macedonia to almost 40% in Bosnia and Herzegovina and 95% in Kosovo. While the **current account deficits** are expected to decline to a regional average of some 8% of GDP in 2003, the region's level of external debt is estimated to reach about 55% of GDP. The external imbalances deserve careful and continuous monitoring.

Levels of **foreign direct investment** (FDI) increased significantly in 2003 (up 40% on 2002) and reached about 5.4% of GDP or about €130 per capita, mainly due to a near doubling of flows into Serbia and Montenegro resulting from the privatisation process. On a cumulative basis over the past years, the flow of FDI to the Western Balkan countries is significantly lower in per capita terms compared to the FDI flows to the acceding countries, but rather similar in terms of percent of GDP. The geographical distribution of the FDI flows is uneven with Croatia having received more than half of the total. FDI represents an essential source of foreign currency earnings and plays an important role in financing current account deficits, a role which is particularly important in transition countries where the ability to raise domestic savings is often limited and where large current account deficits finance an increase in consumption and investment.

Continued work is needed on the establishment of a functioning market economy and a business environment that will attract FDI. A stable, predictable and supportive legal and regulatory framework is key to **sustained high rates of growth** in the long term. Additional efforts are needed in a wide range of areas including respect for the rule of law, the establishment and implementation of a transparent legal framework (including reform of the cadastre and the settling of ownership issues), the reform of public administrations and the continuous fight against corruption. The countries also need to continue financial sector reforms and improve financial intermediation, including in particular (in most of the countries) measures to improve long-term financing for small and medium sized enterprises. Continued liberalisation and development of the **telecommunications sector** is important for the development of the economy. Governments should encourage the adoption of information and communication technologies and work towards promoting a knowledge based economy based on the new EU regulatory framework for electronic communications.

The Commission has established **economic dialogues** with Albania, Croatia and the former Yugoslav Republic of Macedonia. The first dialogues with Bosnia and Herzegovina and Serbia and Montenegro are expected to be held in the course of 2004. The economic dialogues allow for an exchange of information and views on progress with economic and structural reforms in the countries. The dialogues also familiarise the Western Balkan countries with economic developments and policy coordination within the EU.

Small and medium sized enterprises play an important part in economic development and job creation. At the Thessaloniki Summit, the countries of the Western Balkans endorsed the **European Charter for Small Enterprises** and thereby committed themselves to implement its ten principles. Kosovo is covered by the scheme through the work of the United Nations Mission in Kosovo (UNMIK). The Commission's report on the implementation of the Charter in the Western Balkans of January 2004 displays a mixed picture of progress across the countries and the ten areas covered. Each of the countries has voluntarily set a number of targets to improve the business climate for the next twelve months. The Charter will become an annual mechanism for tracking progress in this field.

A Ministerial round table, "The Balkans: From Reconstruction to Economic Integration", was held in Venice in October 2003 to promote private sector development and the creation of modern networks and infrastructures in the fields of energy and transportation.

In June 2003, the Thessaloniki European Council reaffirmed the central role of trade in the Stabilisation and Association process and endorsed the Council's invitation to the Commission to prepare the extension of the **pan-European diagonal cumulation of origin** to the countries of the region in a manner consistent with all relevant community policies and dependent on their administrative capacity. At this stage, the Commission focuses its efforts on Croatia and the former Yugoslav Republic of Macedonia, the only two countries so far to have signed or concluded a Stabilisation and Association Agreement with the EU.

Following findings that the system of management and control of the preferential origin of sugar in Serbia and Montenegro did not allow the authorities fully to verify the originating status of sugar exports, the Commission suspended the preferential arrangements **for sugar** imported from Serbia and Montenegro for an initial period of three months in May 2003 to protect the financial interests of the European Community. This measure was extended for six months in August 2003 and for another six months in February 2004. Serbia and Montenegro has recently made encouraging progress in addressing many of the structural shortcomings identified by the Commission. However, decisive anti-fraud action on specific cases is still needed. Some of the detected structural deficiencies still exist and might affect all goods exported to the EU. Therefore, a **Notice to Importers** covering all products from Serbia and Montenegro (a formal Commission warning alerting traders that the certification of origin can not be fully trusted) was published in the Official Journal in January 2004. The Commission continues to monitor developments carefully.

4. THE REGIONAL DIMENSION

Many of the challenges facing the Western Balkan countries are not only common to all but also have a cross-border dimension. Refugee return, infrastructure and economic development and the fight against organised crime are examples of areas where the countries need to cooperate closely to achieve results. Regional co-operation goes hand in hand with further development of the individual countries. It also constitutes an essential element of the Stabilisation and Association process and is a requirement under the SAAs. Much progress has been made in this area, as documented in the increasing number of bilateral co-operation agreements between the Western Balkan countries. Regional co-operation is becoming the natural way to tackle shared problems and to make further progress in important sectors.

At the Thessaloniki Summit, the countries of the region committed themselves to enhanced regional co-operation and the promotion of a series of specific objectives and initiatives. The Commission also encourages the countries to increase co-operation both with EU member

states and with the candidate countries. The countries of the Western Balkans could benefit from drawing on the experience of the candidate countries and new member states from their transition and pre-accession preparations.

4.1. Political and institutional co-operation

Political dialogue between the countries is intensifying. Several countries have made agreements concerning refugee return, border crossings, visa regimes and the fight against terrorism, organised crime and trafficking.

The public apologies expressed by the President of Serbia and Montenegro for crimes committed in Bosnia and Herzegovina and the initiative of the Presidents of Croatia and Serbia and Montenegro to apologise for past wrongs is an encouraging sign of improved relations between the countries, and a willingness to promote reconciliation.

Border delimitation and demarcation between several of the countries still need to be resolved.

4.2. Regional Trade

Negotiations on a network of bilateral free trade agreements (FTAs) were concluded between the countries of the region (and with Bulgaria and Romania) in early 2003, based on the terms of a MoU signed by the countries in 2001 under the auspices of the Stability Pact. However, during the course of the year Serbia and Montenegro requested revisions of four of its FTAs. Following a meeting of Trade Ministers in Rome in November 2003, the four FTAs were finalised at the end of 2003. The Commission regrets that Bosnia and Herzegovina has unilaterally delayed the implementation of certain aspects of its FTAs with Croatia and Serbia and Montenegro. This casts doubt on the country's ability to abide by and implement international agreements.

In May 2003, the United Nations Mission in Kosovo (UNMIK) unilaterally committed itself to the terms of the MoU following the conclusion that its mandate under UNSCR 1244 extends to the signing of FTAs on behalf of Kosovo. So far, UNMIK has concluded an FTA with Albania and is engaged in further talks with other interested partners of the region. It is important that Kosovo is not left out of this regional trade liberalisation process.

To reap the full benefits of trade liberalisation in the region the FTAs need to be ratified swiftly and fully and efficiently implemented. The process of trade liberalisation in the region ought to continue to further facilitate trade and to attract foreign direct investment. The countries are encouraged to explore possibilities to harmonize their FTAs with a view to establish a regional free trade area in the medium term.

4.3. Co-operation in Justice and Home Affairs

The debate on Justice and Home Affairs (JHA) in the Western Balkans has intensified over the past year. The "Thessaloniki Agenda" emphasised the growing importance of JHA issues in the relations between the EU and the Western Balkans. The first meeting of the EU–Western Balkans Forum took place at the level of JHA Ministers on 28 November 2003.

The countries need to intensify their efforts to fight organised crime in the region. At the JHA Ministerial meeting on 28 November 2003, each country presented implementation strategies for specific action oriented measures to fight organised crime. Two regional priority measures were included in the country strategies. One of these concerns co-operation among Financial

Intelligence Units in combating money laundering, and the other development of co-operation between prosecutors in the region. The measures identify priority actions and set out a strategy for their implementation with timetables, benchmarks and the identification of resource requirements. The responsibility for implementation lies with the countries, and the Commission will monitor progress within the SAp.

Europol has a mandate to negotiate co-operation agreements with all countries in the Western Balkans. Exploratory talks have taken place and some of the countries have already provided information that will help launch negotiations. These agreements will be a useful contribution to the fight against organised crime.

As regards the fight against drug trafficking, an Action Plan on Drugs covering the EU and the countries in the Western Balkans, and Romania, Bulgaria and Turkey was adopted by the Council in June 2003 and is being implemented.

The Thessaloniki Summit welcomed the results of the Ohrid Regional Conference on Border Security and Management on 22 May 2003, where the Western Balkans countries presented a list of short-term objectives to be implemented in order to cope effectively with illegal immigration, border security and border management. Each country has presented written reports indicating concrete steps they will take to implement these commitments. The review mechanism set up at Ohrid will allow the international community to monitor and to support the countries' implementation efforts.

A first meeting in November 2003 between Member States' liaison officers posted in the area was a starting point for future co-operation in the region on subjects such as organised crime and immigration. This initiative needs to be developed further to strengthen co-operation between Member States and the region so that they can tackle cross border challenges in the area of Justice and Home Affairs. The countries in the region are also encouraged to cooperate with the liaison officers stationed in their countries.

Given the irregular refugee and migration flows ensuing from discrepancies in entry policies, the EU-Western Balkans Forum encouraged the countries to work closely together within the framework of relevant programmes on asylum and migration.

A readmission agreement between the European Community and Albania was initialled on 18th December 2003.

The perspective of the liberalisation of the visa regime is a long-term issue and should be put in a broader context: any progress in this area is linked to the countries' ability to implement major reforms in areas such as strengthening the rule of law, combating organised crime, corruption and illegal migration, improving their border management and document security, and generally improving their administrative and implementation capacity. Many of these issues can be discussed as part of an overall JHA dialogue in the context of the SAp.

4.4. Co-operation in other sectors

Progress in regional co-operation is most evident in the web of agreements and sectoral strategies that are beginning to bind the countries in a framework of agreed and mutually supportive commitments. These agreements and strategies define the network that will help ensure sustainable growth in the region, and are designed to ensure the smooth integration with the networks of the EU.

Infrastructure: Continuing progress was recorded in the development of regional infrastructure strategies, under the supervision of the Infrastructure Steering group for South-East Europe (ISG). It was matched by concrete progress in implementation of the regional infrastructure project list which is monitored by ISG (53 projects totalling €4 billion, of which 3 were completed and 40 had started at the end of 2003).

Transport: Drawing up an integrated regional transport strategy that is consistent with the Trans-European Networks and takes into account the Pan-European Corridors³⁰ is a high priority. Significant progress was recorded in a Report³¹ published by the chair of the Infrastructure Steering Group in December 2003. The integrated regional transport strategy was developed by the Commission, together with the IFIs, the Stability Pact and the Western Balkans countries. Technical back-up was provided by the EC-funded and ISG-steered Regional Balkan Infrastructure Study (REBIS-Transport). It was agreed that efficient planning of public investment in the transport sector hinges on the development of four main building blocks: the establishment of a Core Regional Transport Network as a jointly agreed reference for planning investment of regional relevance; a process to prioritise investments of regional importance and which are financially affordable and suitable for international financing; a commitment to policy reforms, notably to improve sector management and address cross border issues; and the establishment of an institutional framework to coordinate efficiently among the countries of the region.

2003 was thus marked by the completion of a two-year phase of reflection and consensus building amongst the countries of the region. The result is an agreement to work together to enhance regional transport within a regional framework, to hold reciprocal consultations on transport policy and to introduce the institutional reforms needed to make investments sustainable. In spring 2004, the countries of the Western Balkans will seal their commitment by signing, with the Commission, a “Memorandum of Understanding on the development of the South East Europe Core Regional Transport Network.”

Energy: Economic and social development is impossible without a steady and sufficient supply of energy. This is still an enormous problem in parts of the region and it can only be resolved through regional co-operation. The “Regional Energy Market” (REM) process, which was initiated in November 2002 with the signing of the “Memorandum of Understanding on the Regional Electricity Market in South-East Europe (SEE) and its integration into the EU Internal Electricity Market”, is an important initiative in this context. Day-to-day co-operation has developed between the countries of the region, with full support of the financial institutions and bilateral donors. Coordination, review of progress, the promotion of a common strategy among donors and private sector involvement were enhanced during the two “SEE Energy weeks”. In March 2003, the President of the REM process, Turkey, published the results of a first peer review exercise.

The process has been extended to the gas sector and to develop a basis for regulation of the market³². A revised Memorandum of Understanding on the Regional Energy Market was discussed and concluded by the Commission and the countries of South East Europe in Athens in December 2003. The MoU lays down the rules and objectives for the creation of an integrated regional energy market in South East Europe by 2005, which eventually will be

³⁰ In particular Corridors V, VII, VIII and X.

³¹ “Implementing regional transport priorities in the Western Balkans”

³² See also the Communication [COM(2003)262] of 13 May 2003 on “The Development of Energy Policy for the Enlarged European Union, its Neighbours and Partner Countries”

integrated into the European Community's Internal Energy Market. Furthermore, the intention to negotiate an Energy Treaty, embodying trading and market regulation rules, was confirmed; the aim is initial an agreement during the course of 2004. The regional energy market in South East Europe will be achieved by progressively approximating state policies and by promoting harmonised rules throughout the region. The integrated regional approach pursued in the energy sector offers the right environment to attract international, public and private, investors.

Environment: Environment is by its nature a regional issue and many challenges need to be addressed. The Regional Environmental Reconstruction Programme for South Eastern Europe (REReP) helps to improve the environmental policy framework in South Eastern Europe and received support from the 5th "Environment for Europe" Kiev Ministerial Conference. The programme includes institution building, measures for raising environmental awareness in civil society and cross border co-operation. The Commission will continue to assist the countries in fulfilling the SAp requirements in the environmental sector³³. In 2004, the initiative will intensify its assistance to the countries in developing their environmental policies to be in line with the *acquis*. A meeting of the Ministers for Environment in Skopje in October 2003 demonstrated increased regional ownership of the policies. Regional networks of high officials and experts continued to develop and the SAp countries are now also participating in the activities of the European Environment Agency. A priority environmental investment programme has drawn up priorities for the region, identified regional investment programmes, compiled a list of priority investment infrastructure projects and was accompanied by an assessment of the institutional and policy framework. The "Thessaloniki Agenda" and the conclusions of the May 2003 informal meeting of environment ministers of the EU and South-East Europe recommended the drawing up of Integrated Water Resources Management Plans for trans-boundary water bodies in the region. The DABLAS (Danube-Black Sea) Task Force completed the identification of priority water projects and presented the projects to the Project Preparation Committee in April 2003.

Science and technology: Reconnecting the Western Balkan countries into the European research community is a strategic challenge. An EU-Western Balkans Ministerial meeting on co-operation in Science and Technology was convened on in Thessaloniki in June 2003. A *Shared Vision* for the regional Science and Technology co-operation policy and a corresponding three-year *Action Plan* were endorsed that will help the Western Balkans integrate into the European Research Area. The main goals are improved skills and research infrastructure, institution building, and the promotion of joint RTD activities which are of mutual benefit and have a regional impact. A *Work Programme* to implement the Action Plan was defined in Florence in November 2003. The South Eastern European Research and Education Networking (SEEREN) project has completed the extension of the pan-European high-speed research network GÉANT to the Western Balkan countries.

Statistics: Continuing progress can be noted regarding the adoption and implementation of EU standards and methods for statistics. Reinforced regional co-operation was observed regarding implementation of two important data collection projects on External Trade Statistics and Purchasing Power Parities. A new meeting forum for the Director Generals of the Statistical Offices was created for discussions on Strategic Management. Data collection began for the first leaflet on the Western Balkans and issued specially for the EU-Western

³³ Communication [COM(2003)062] of 6 February 2003 on "Pan-European Environmental Co-operation after the 2003 Kiev Conference"

Balkan Summit. Additionally, a list of indicators have been established and collected for the purposes of the statistical annex to the annual SAP report.

4.5. Ensuring complementarity of regional initiatives

The Stability Pact for South Eastern Europe is playing an important role in promoting regional co-operation and in supporting the region on its path towards further European integration. The EU has invited the Stability Pact to continue complementing the regional co-operation element of the Stabilisation and Association process. The Stability Pact has reorganised its activities and structures to increase focus on its core mandate of fostering regional co-operation. Based on the review of Stability Pact activities in 2003, the Regional Table in Tirana agreed to continue to concentrate its work on six core objectives - Local Democracy and Cross Border Co-operation, Media, Trade and Investment, Energy and other Regional Infrastructure, Fighting Organised Crime and Managing and Stabilising Population Movements - and endorsed the proposed set of targets for 2004. The Commission attaches great importance to a continued focus on the core objectives.

The South-East European Co-operation Process (SEECP) has further consolidated its role as a voice of the region. Both the Serbia and Montenegro and subsequent Bosnia and Herzegovina Chairs in Office secured a high level of political coordination among SEECP members on key issues, in particular as regards Justice and Home affairs the "Sarajevo Declaration" was adopted. The SEECP made significant contributions to various EU/Western Balkan events, such as the Thessaloniki summit in June, the Trade ministerial and the Justice and Home Affairs Ministerial meeting in November. The SEECP plays a crucial role in securing effective regional ownership of the reform process and in bringing about regional co-operation. The Stability Pact has been invited to pursue and intensify its co-operation with the SEECP. This momentum should be preserved after the Sarajevo Summit in April 2004, when Romania will take over as Chair-in-Office.

The Special Coordinator of the Stability Pact has assumed a central role in enhancing coordination with other regional co-operation initiatives, such as the Adriatic-Ionian Initiative or the Central European Initiative. Regular exchanges of information have already taken place while operational coordination will receive further attention in the future.

The continued close co-operation between the Stability Pact and the SEECP and the recent establishment of regional offices of several Stability Pact initiatives indicates an increased desire by the countries of the region to take control of the reform process.

The Commission appreciates the constructive and systematic co-operation taking place with international partners such as the Council of Europe, the OSCE and the World Bank. In the case of Bosnia and Herzegovina and Kosovo, close co-operation with the High Representative and UNMIK is indispensable to promote the reform process. This kind of co-operation at policy level and coordination in deploying assistance will help the countries of the region accomplish the aim shared by the whole international community of seeing them develop into stable, self-sustainable states that eventually will be able to meet the Copenhagen criteria and join the European Union.

5. PUBLIC OPINION AND PERCEPTION OF THE EUROPEAN UNION

The perception of the Union is overwhelmingly positive and public support for a closer relationship with the European Union remains high in all of the countries. The public sees EU

membership as a medium or long-term prospect. The main perceived benefits of EU rapprochement and future membership are economic development, improvement of living standards and freedom of movement of persons. The media, and in particular television plays an instrumental role in shaping public perception of the EU, and show an increased interest in EU related issues. The EU is increasingly perceived as a political player in the region. Media interest in the countries focuses mainly on the political aspects of the relationship with the EU, including EU military/police missions in the region and issues related to the Stabilisation and Association process, such as trade relations, financial assistance and the implementation of the Thessaloniki Agenda. Regional aspects of the SAP receive little media coverage. Internal EU developments, such as the Convention and the IGC, the EU position on Iraq and the enlargement process attracted significant public attention, indicating an interest for EU developments not related to the Western Balkans. The quality of coverage of EU-related issues has improved, but a persistent lack of professionalism and politicisation of the media still result in a number of misinterpretations and misperceptions of the role of the EU in the region.

Knowledge about the Stabilisation and Association process has increased but there is still a considerable lack of public awareness of the European integration process. Citizens in the Western Balkans do not have a clear picture of what is required to bring their countries closer to the EU and public opinion often oscillates between high expectations and pessimistic perceptions of their European future. A more effective communication of the long-term benefits of the SAP and European integration to the public by the governments of the region could be a decisive factor in mobilising support for the necessary political and economic reforms. Greater efforts are needed to explain the opportunities and challenges of the SAP to all sections of society, so that the concrete benefits from the process and the necessary efforts are better understood. Moreover, efforts should be enhanced to provide the societies of the countries with precise information on the values, principles, objectives, activities and the overall functioning of the European Union.

The major role in communicating the European integration process to citizens in the Western Balkan countries should be played by the national governments, regional and local authorities, media and civil society organisations in the region. In some of the countries, authorities have launched or are planning public communication strategies about their European integration process. The Commission supports these efforts and deploys significant resources in the region to improve public knowledge and understanding of the SAP and of the European Union. Communication activities are implemented at regional and local levels, in close co-ordination with actions undertaken by the Council to promote visibility of the EU's political support and other assistance to the Western Balkans.

6. CONCLUSIONS

In the light of the above, the Commission's conclusions are the following:

- (1) At the EU-Western Balkan Summit in Thessaloniki in June 2003, the EU renewed its commitment to the European perspective of these countries. The Commission is following through on the commitments it made at the Summit and has introduced an array of new instruments to support the reform process and to bring the countries closer to the European Union. These instruments will only deliver their potential benefits if implementation is stepped up also on the part of the countries of the region.

- (2) With this report, the Commission is presenting its first proposals for European Partnerships. By identifying priority measures for the short and medium term, the Partnerships will help the countries with their reforms and preparations for future membership. Addressing the priorities in the Partnerships should be a catalyst to support the European integration process. The countries are strongly encouraged to develop plans for the implementation of the European Partnership priorities, with a time table, and to, if possible, indicate their allocation of human and financial resources. This will speed up their European integration process.
- (3) The countries' efforts to ensure stability, to reform and to bring their citizens closer to the European Union will require substantial resources. The Commission therefore considers that the European Union needs to sustain a significant level of financial assistance over the longer term.
- (4) The Commission welcomes progress made by the countries of the Western Balkans in the Stabilisation and Association process (SAp). Reforms are underway in several sectors. The Commission has begun negotiations for a Stabilisation and Association Agreement (SAA) with Albania. Bosnia and Herzegovina is working on implementing the priority areas identified in the Commission's Feasibility Report of November 2003. The SAA with the former Yugoslav Republic of Macedonia is about to come into force. Serbia and Montenegro has made progress towards a closer relationship with the EU through the adoption of a Constitutional Charter and an internal market and trade action plan.
- (5) The Commission is particularly encouraged by the increase in regional co-operation, notably in the areas of infrastructure, trade, transport and energy.
- (6) The Annual Report also shows that many challenges remain for the countries to complete their transition to fully functioning democracies and market economies and to be able to sustain a closer relationship with the EU. The countries need to ensure the proper functioning of democratic institutions and to uphold the rule of law. Their administrative capacity and ability to implement and enforce legislation and reforms need to be strengthened.
- (7) Further efforts are needed to achieve reconciliation in the region. This will ensure stability and re-establish trust and co-operation between peoples and countries in the Western Balkans.
- (8) Several countries are still not fully co-operating with the ICTY, a legal obligation which must be respected and a condition for a closer relationship with the EU.
- (9) All countries need to fight more vigorously organised crime and corruption which continue to hamper reform and economic development. The strategies presented at the Justice and Home Affairs Ministerial meeting in November 2003 should be implemented. EU measures to facilitate the movement of persons are linked to progress in the area of justice and home affairs. Discussions on these issues will be held in the fora of the Stabilisation and Association process.
- (10) The economies of the countries continued to grow at a higher rate than the world economy in 2003 and inflation has remained low. However, unemployment is high, the informal sector large and a large part of the population lives below the poverty line. The countries need to improve the business climate and the competitiveness of

their industries, attract foreign direct investments and increase the pace of reforms. This will require in particular modernisation of administrations and upgrading trade related institutions. It is important that they widen their export base and increase their production capacity so that they can realise their export potential and take full advantage of the substantial trade preferences provided by the EU and to realise their export potential. The network of bilateral free trade agreements in the region should be ratified and fully and efficiently implemented.

- (11) Recent events in Kosovo were a serious setback and confirm that the Kosovo question remains critical for the stability of the region. A thorough assessment of these events will be required and should provide a basis for further measures to prevent a recurrence of violence and instability. The EU needs to ensure that Kosovo is firmly anchored in the Sap. The instruments developed in the context of the SAp will be used to help the Kosovo institutions make substantive progress in implementing the UN-endorsed Standards for Kosovo. In this context, the SAp Tracking Mechanism will be strengthened to enhance Kosovo's European reform agenda and the effectiveness of EU's assistance, while at the same time reinforcing the UN-led standards exercise.
- (12) The European Union will also need to continue to ensure co-operation and co-ordination among the different international actors in the region if it is to make the best use of the resources available and to have the largest impact possible in an increasingly wide range of sectors. The EU needs to ensure that its presence in the region reflects its evolving relationship with the individual countries.

LIST OF ABBREVIATIONS

| | |
|-------|--|
| BiH | Bosnia and Herzegovina |
| CARDS | Community Assistance for Reconstruction, Development and Stabilisation |
| EU | European Union |
| FTA | Free Trade Agreement |
| IFI | International Financial Institution |
| ICC | International Criminal Court |
| ICTY | International Criminal Tribunal for the Former Yugoslavia |
| ISG | Infrastructure Steering Group |
| JHA | Justice and Home Affairs |
| MoU | Memorandum of Understanding |
| NGO | Non-governmental organisation |
| OHR | Office of the High Representative |
| OSCE | Organisation for Security and Co-operation in Europe |
| REBIS | Regional Balkan Infrastructure Study |
| REReP | Regional Environmental Reconstruction Programme for South Eastern Europe |
| RTD | Research, Technology and Development |
| SAA | Stabilisation and Association Agreement |
| SAP | Stabilisation and Association process |
| SEE | South East Europe |
| SEECF | South East Europe Co-operation Process |
| STM | Stabilisation and Association process Tracking Mechanism (Kosovo) |
| TAIEX | Technical Assistance and Information Exchange Office |
| UNMIK | United Nations Interim Administration Mission in Kosovo |

THE EFFECTS OF THE EUROPEAN UNION'S TRADE MEASURES

Introduction

In September 2000, the EU granted exceptional trade measures to the countries and territories which participate in the EU's Stabilisation and Association process (SAP).³⁴ These measures provide the Western Balkan countries with duty- and quota-free access to the Union's market for practically all goods, except for some fishery products, beef and wine for which there are duty-free or preferential quotas. In 2001, these provisions were, by and large, put into a contractual agreement with Croatia and the former Yugoslav Republic of Macedonia by the signing of the respective countries' Stabilisation and Association Agreement (SAA). Pending the ratification of the SAAs, the Union's trade relations with these two countries are governed by Interim Agreements.

The trade measures established a uniform system of trade preferences for the countries of the Western Balkans and were the culmination of several years of gradual trade liberalisation. All countries except Serbia and Montenegro qualified for some form of preferential treatment previously.³⁵ The greatest change compared to earlier system(s) is the complete liberalisation of imports of industrial products and the almost complete liberalisation of agricultural- and fishery products.

The Annual Report of last year provided an overview of trends in EU imports from the Western Balkans as a first basis for an evaluation of the effectiveness of the trade measures. This year's report further examines the number of products making up the exports from the region and the extent to which the trade measures have provided these products with improved market access compared to previously. It also considers the Western Balkans' relative margin of preference on the EU market with respect to third countries following the introduction of the trade measures. An analysis of the countries' export potential indicate the extent to which the countries make use of the trade measures and the scope for boosting exports from the region (and thereby economic growth) which was the main intention behind the introduction of the trade measures in 2000.

There are some limitations to the analysis that need to be borne in mind. The countries have been provided with gradually increased trade preferences in a complex way since the mid 1990s. This makes it difficult to identify when and where the trade measures have come into effect. The effects on exports from the region caused by the trade measures compared to changes caused by post-conflict reconstruction and the gradual transition from central planning to a market economy are further likely to be small. Moreover, following the

³⁴ Council Regulation (EC) No. 2007/2000 of 18 September 2000, amended by Council Regulation (EC) No. 2563/2000 and 2487/2001.

³⁵ Albania benefited from the EU Generalised System of Preferences (GSP), while Bosnia and Herzegovina, Croatia and the former Yugoslav Republic of Macedonia had limited access to the GSP (only for agricultural and fisheries products) and had been entitled to trade preferences under the first generation of trade measures introduced in 1997 (Council Regulation (EC) No 70/1997, amended by Regulations 2636/97 (for 1998) and 2863/98 (for 1999), and Council Regulation (EC) 6/2000 (January-October 2000)), which also briefly applied to the then Federal Republic of Yugoslavia (today Serbia and Montenegro) before the preferences were revoked. As of 1998, trade with the former Yugoslav Republic of Macedonia was governed by the co-operation agreement with the European Union.

introduction of the trade measures in 2000 full annual trade statistics are available only for 2001 and 2002 which leaves only a short period of time available for studying the effects of the trade measures.

Effects of the EU's trade measures³⁶

Between 1999 and 2002, Western Balkan exports to the EU have increased by some 40% but remain low at about €5 billion (see Table 1). **The EU is by far the most important export market** for the five countries, receiving about 60% of their exports. The largest importers are Italy, Germany, Austria, France and Greece, which absorb close to 90% of the region's exports to the EU. Croatia is the largest exporter accounting for close to half of all exports from the five countries. Although, the region's share of the EU market remains low at about 0.5%, it has nevertheless increased between 1999 and 2002.

The low level of exports from the region indicates a rather **narrow export base**. The number of products making up the countries' exports to the EU is low and has been further reduced between 1999 and 2002 (see Table 2).³⁷ This indicates a greater growth in fewer already exported products, which may be explained by factors such as better market access under the trade measures, expanding supply capacity and a more competitive production. Most of the countries export goods in the categories of clothing and footwear, wood products and furniture and certain mechanical and electrical items. At product level a vast majority of the items is exported by only one or two countries.

Table 1: Volume and market share of Western Balkan exports to the EU in 1999 and 2002

| Country | Exports (€million) | | Change (%) | Share of EU imports (%) | |
|--|--------------------|-------------|------------|-------------------------|--------------|
| | 1999 | 2002 | 2002/1999 | 1999 | 2002 |
| Albania | 228 | 330 | 44 | 0.030 | 0.035 |
| Bosnia-Herzegovina | 358 | 624 | 75 | 0.047 | 0.066 |
| Croatia | 1892 | 2357 | 25 | 0.251 | 0.250 |
| former Yugoslav Republic of Macedonia | 591 | 552 | -7 | 0.078 | 0.058 |
| Serbia and Montenegro | 563 | 1.287 | 129 | 0.075 | 0.136 |
| Western Balkans | 3663 | 5150 | 42 | 0.481 | 0.545 |

Source: Eurostat.

Given the short period of time since the introduction of the EU's trade measures, they could be expected to promote an increase in exports of products that are already supplied by the region and which have experienced a change in tariff payable. Table 2 shows that tariffs on relatively few exported products were lower in 2002 compared to 1999, affecting about 17%

³⁶ The analysis was carried out on two-thirds of each Western Balkan country's exports to the EU in 1999 (one year before the introduction of the trade measures) and in 2002 (the latest full year for which trade statistics are available) which was considered to form a sufficiently large sample.

³⁷ The number of products is analysed at the 8-digit level of the CN.

of the region's exports.³⁸ About half of the exports of Albania and Serbia and Montenegro were subject to abolished tariffs following the introduction of the trade measures. The tariff cut was significant (>5%) for 22% and 30% of their respective exports (not shown in the table).³⁹

Table 2: Number of, and tariffs facing, Western Balkan exports to the EU in 1999 and 2002

| Country | No. of products exported | | Number of products for which 2002 tariff is: (% of exports in parentheses). | | |
|--|--------------------------|-------------|--|-----------------|--------------------|
| | 1999 | 2002 | Zero MFN | Same as in 1999 | Lower than in 1999 |
| Albania | 34 | 23 | 7 (8%) | 2 (6%) | 14 (54%) |
| Bosnia-Herzegovina | 44 | 40 | 12 (18%) | 26 (48%) | 1 (1%) |
| Croatia | 128 | 126 | 32 (22%) | 83 (37%) | 3 (2%) |
| former Yugoslav Republic of Macedonia | 42 | 37 | 5 (10%) | 27 (48%) | 2 (4%) |
| Serbia and Montenegro | 80 | 70 | 15 (11%) | 0 | 45 (48%) |
| Western Balkans | n.a. | n.a. | (16.6%) | (28.3%) | (16.9%) |

Note: The rows may not add up to the number of products (at the 8-digit level of the CN) exported in 2002 as products with changed CN codes have been excluded.

A tariff reduction could be expected to generate a larger increase in exports if it simultaneously improves the margin of preference relative to other major suppliers of the same goods. Table 3 summarises the number of products and their share in exports for which the 2002 and 1999 tariff payable under the trade measures was lower than the tariff paid by the main source of EU imports. Overall, in 2002 the Western Balkan suppliers had a margin of preference on very few products, covering less than 10% of their exports, and the number of products enjoying margins of preferences vis-à-vis other suppliers have decreased since 1999. Rather than offering a competitive advantage for exported products from all the Western Balkan countries, it appears as if the trade measures have acted to mitigate EU parallel trade liberalisation towards other main suppliers.

³⁸ It should be noted that this is an underestimate as the analysis is based on a sample of the countries' exports.

³⁹ Under the assumption that in those cases where a range of tariffs apply it is the highest that was applicable in 1999.

Table 3: Western Balkan margin of preference in 2002 and 1999 over main EU supplier

| | Number of products for which margin of preference is: | | | | | |
|--|---|-------------|-----------------|-------------|-------------|-------------|
| | ≥ 10% | | 5% - 10% | | ≤ 5% | |
| Country | 1999 | 2002 | 1999 | 2002 | 1999 | 2002 |
| Albania | 0 | 4 (5%) | 0 | 1 (6%) | 16 (22%) | 3 (12%) |
| Bosnia-Herzegovina | 8 (4%) | 0 | 7 (20%) | 0 | 4 (3%) | 0 |
| Croatia | 18 (8%) | 0 | 14 (5%) | 2 (0.5%) | 17 (7%) | 0 |
| former Yugoslav Republic of Macedonia | 9 (15%) | 2 (4%) | 2 (1%) | 0 | 4 (6%) | 0 |
| Serbia and Montenegro | 0 | 3 (2%) | 0 | 4 (10%) | 0 | 10 (8%) |
| Western Balkans | (7%) | (1%) | (5%) | (3%) | (6%) | (3%) |

Note: Share of exports in parentheses.

In light of the above, the rate of increase in overall exports from Albania and Serbia and Montenegro (the two countries mainly affected) amounted to 44% and 129%, respectively, between 1999 and 2002 (see Table 1). The corresponding rate of increase in exports for products which experienced lower tariffs in 2002 compared to 1999 is 58% for Albania and 213% for Serbia and Montenegro (not shown in the table).⁴⁰ Too few products of the other three countries obtained improved market access to allow a meaningful comparison.⁴¹

Long-term export potential

A central issue to the Western Balkans is post-war reconstruction (except for Albania) and transition towards market economy. These processes have proceeded with different speed in the different countries. Only in Albania has gross domestic product (GDP) reached a level higher than before the start of transition and the period of conflicts. The region's ratio of exports to GDP is about 15%. This indicates that exports from the Western Balkans have difficulties in competing on the world market. For comparison, Romania, whose level of GDP is similar to that of the Western Balkans, displays a corresponding figure of 30%.

Partly as a consequence, the effects of the trade measures have thus far mainly applied to conventional products that experienced a reduction in tariffs following the introduction of the trade measures in 2000 and which have survived the problems and disruptions of recent years. As the trade measures cover a much wider range of products it is plausible that as 'normality' increasingly returns to the region and as investment in productive capacity becomes operational, new exports will emerge for which the trade measures will provide substantial advantages.

⁴⁰ If the item "17019910 - white sugar, containing in dry state ≥ 99.5 % sucrose (excl. flavoured or coloured)" in the case of Serbia and Montenegro is excluded, the rate of increase amounts to about 160%.

⁴¹ Increasing the sample to about three-quarters of the countries' exports to the EU did not change the result. Albania and Serbia and Montenegro remain the two countries mainly affected.

The likely long-term potential of Western Balkan exports to the EU can be projected using a so called 'gravity model' which predicts that trade between two countries is determined by their economic size, per capita income and the geographical distance between them. Using previous estimations assessing the trade potential between the EU and the candidate countries⁴² and applying them to the Western Balkans, the model indicates that the Western Balkan countries ought to be able to export to the EU at a level two to three times higher than at present. This does not take into account the estimated sizeable grey economy which suggests an even greater export potential. This substantial **untapped export potential** is to be compared with the candidate countries whose trade with the EU had more or less reached its potential level in the late 1990s.⁴³

A questionnaire distributed to economic stakeholders, government officials and academics in the region reveal that the awareness of the trade measures appears to be low throughout the region. Respondents who were aware of the trade measures, or whose attention was drawn to them, tend to believe that its benefits will be felt in the medium to long-term. Respondents further sought more information about the development of markets in the EU, mainly from government sources who provide no or little such information, but also from individual EU governments and from the European Commission. Supply-side issues (poor and outdated product technology, weak quality control, lack of export finance, and inadequate packaging and marketing) were overwhelmingly quoted as the main impediments to the development of exports. Improvements in these areas were seen as the most important factors to facilitate an increase in Western Balkan exports.

Conclusion

The trade measures have served to create an enabling environment for an increase in exports. They do not in themselves support the development of the broad and competitive export base needed to take full advantage of the substantial preferences at hand. The countries' export potential can only be achieved through continued reforms in a wide range of policy areas thereby providing the basis for an increase in investments in general and of foreign direct investment (FDI) in particular. FDI implies transfers of technology and know-how with associated beneficial effects on productivity which in the long term should lead to an increase in production and export capacity and to the creation of employment opportunities. Investors and significant levels of FDI will in the long-term be attracted to politically stable and reform oriented locations where the rule of law is applied, courts are perceived as fair, where corruption is successfully fought and the grey economy is being reduced. To facilitate further exports in the short-term, the countries need to make economic operators aware of the potential of the trade measures, assist them in establishing business contacts in the EU, develop export promotion activities and continue to work to meet EU standards and regulations.

⁴² European Journal of Political Economy Vol. 16 (2000), pp 807-827: Trade integration and the EU economic membership criteria.

⁴³ Ibid.

EXECUTIVE SUMMARIES OF THE COUNTRY REPORTS

ALBANIA

Reform in Albania over the past twelve months has been limited. Despite some progress in specific areas, many of the recommendations included in the 2003 Stabilisation and Association process (SAP) report have not been properly implemented.

The political climate has not allowed for sound reform implementation. The fragile political stability achieved in 2002 has been replaced by tensions between the main political parties and within the ruling Socialist Party (SP) itself. The fight for SP leadership has adversely affected Government stability. With Government attention increasingly focused on these internal difficulties, and with an increasingly obstructive opposition, the reform programme has continued to suffer delays. As a consequence, many shortcomings identified in the 2001 High Level Steering Group Report, the 2002 and the 2003 SAP reports, and in subsequent political dialogue with Albanian authorities have not been addressed. The local elections of 12 October were carried out on the basis of a new electoral code. However, serious deficiencies were observed during the elections, and required international standards were not met. The ability of the public administration to implement Albanian commitments in respect of the Stabilisation and Association Agreement (SAA) remains an issue of concern.

In the economic field, real GDP growth in 2003 has been estimated at 6.0%, up from 4.7% in 2002. At the end of 2003, inflation reached 3.3%, in line with the Government's target. Privatisation of the largest bank of the country, the Savings Bank, has been a notable achievement. Preliminary steps have been taken towards addressing the land ownership issue. However, the medium-term sustainability of economic growth as well as the country's ability to alleviate poverty are being jeopardised by political uncertainty and limited reform focus. The Albanian economy remains informal to a considerable extent. The business environment is inadequate and offers little to encourage investment. Corruption, organised crime, deficient law implementation and administrative inefficiency continue to place barriers to business and to hinder legal security. Despite its achievement in establishing Free Trade Agreements (FTAs) with countries of the region, Albania has been unable to fully implement all its WTO accession obligations.

The Government has continued to state that Albania's progress in the SAP is a top priority. However, its actions have not always supported this statement. Despite progress made during SAA negotiations in discussing the text of the future agreement, many of the reforms necessary to guarantee its proper implementation have not been carried out. Of particular concern are those issues central to the rule of law. These include the fight against organised crime and corruption, and the functioning of the judicial system. Albania deserves credit for a number of initiatives, including its generally constructive role in the region, the reduction of smuggling and trafficking in human beings over the Adriatic and Ionian Seas and the initialling of a Community Readmission Agreement. But results have fallen short of expectations in the key areas of organised crime, corruption, judicial system and public administration reform. Since Albania wishes to progress on its path towards the EU, it is crucial that it demonstrates political will, determination and the capacity to address the key issues identified in this report without delay.

BOSNIA AND HERZEGOVINA

The 16 priority reforms identified in the Feasibility Study relate to BiH's current political situation, to its economic perspectives and to its progress on meeting the technical requirements of the Stabilisation and Association process (SAP).

On those of the 16 points relating to the political situation, progress has been moderate. Government at State level remains under-developed, while tensions between State and Entities still affect government business and reform. Public administration reform has just begun. On respecting human rights provisions and the conditionality associated with the International Criminal Tribunal on former Yugoslavia (ICTY), limited progress has been recorded since end 2003. The Feasibility Study suggested that "a new [reform] dynamic may be emerging within the BiH body politic". Further sustained reform efforts are needed to make this a reality and to ensure that progress made in state-building is not reversed.

The Feasibility Study further pointed out that "economic growth coupled with the reduction of wasteful expenditure would provide the resources for the institutional reform BiH needs". BiH faces major economic challenges. As international assistance declines, private investment must be the motor for growth. However, government needs to do its part by establishing a framework favouring investment and enterprise and by effective management of the funds at its disposal. For this reason, the Feasibility Study highlighted the adoption and implementation of a State-level budget law, the recording of all income accruing to public authorities and the implementation of the statistics law as measures which could be achieved in 2004. On budgetary issues some progress has been made, but reliable statistics, the basis of all effective policy-making, remain worryingly elusive. The short-term steps highlighted in the Feasibility Study must be complemented by further decisive structural reform if BiH is to avoid further economic distress.

In terms of meeting the technical SAP requirements, the judgement of the Feasibility Study remains valid: "... a pattern of intermittent progress, interspersed with areas where crucial reform has not been completed, or in some cases even begun". Thus, recent successes in areas such as Council of Ministers' approval of an Action Plan for Feasibility Study issues, first BiH convictions for human trafficking and initial steps in setting up the Indirect Tax Authority are diminished by failures in other areas. No point relevant to this section has yet been fully completed. Moreover, it remains a concern that in too many areas where progress has been achieved, that progress has come only thanks to international pressure.

For its part, the EU will deploy all means at its disposal to support BiH reform, ranging from technical and financial support to meet *acquis* standards, guidance from the EU Special Representative and actions under the European Security and Defence Policy (ESDP) to ensure a stable environment in which reform can proceed. As soon as it ascertains that significant progress has been made in meeting the 16 requirements established in the Feasibility Study, the European Commission will decide on a recommendation for a Council decision to open SAA negotiations. Conversely, if progress is insufficient, the Commission will not be in a position to recommend proceeding with such negotiations. Only BiH can ensure success. By successfully addressing the 16 priority points during 2004, BiH would reinforce a dynamic in part established by the Feasibility Study and would create the confidence both at home and abroad that it can address an ever wider and more demanding reform agenda.

FORMER YUGOSLAV REPUBLIC OF MACEDONIA

While constrained by a difficult budgetary and economic situation, the former Yugoslav Republic of Macedonia has made efforts in 2003 to progress in the Stabilisation and Association process. In many areas, the reform process is still in its infancy and will need further efforts to be converted into concrete changes and bring the expected benefits.

The political situation has remained generally stable, building on process initiated in 2001 at Ohrid which remains crucial to ensure the development of the former Yugoslav Republic of Macedonia as a unitary and multiethnic state. The support of the International Community, in particular through the EU-led military operation “*Concordia*” and the new Police Mission “*Proxima*”, has been critical in supporting gradual stabilisation. Consolidating stability calls for continued effort from the Government to implement fully the Framework Agreement and to strengthen the rule of law, as well as for commitment and sense of responsibility from all components of the population. Preparatory efforts need to be accelerated and enhanced for the implementation of the decentralisation process.

Many challenges still lie ahead, whether on decentralisation, good governance, reform of the security sector or the rule of law. Implementing the reforms will also imply strengthening administrative capacity, by transforming the public administration into a modern and accountable public service. Remaining on track in facing these challenges should enable the country to shift progressively its focus from stabilisation to association.

The former Yugoslav Republic of Macedonia has been successful in maintaining a stable macro-economic framework and joined the World Trade Organisation. However, the economic situation, and notably serious weaknesses in functioning of the economy, business climate, competitiveness and enforcement of property rights, is increasingly a challenge for the country’s successful transition. Foreign direct investment has been particularly low, and is likely to increase significantly only if institutional and political stability continue to improve and reforms are pushed forward. Serious progress in establishing the rule of law will also be crucial.

The Stabilisation and Association process has benefited from the support of all political parties and efforts have been made to make it the framework for Government actions. A National Action Plan to follow up the recommendations set in last year’s report has confirmed the will to go ahead. Further efforts and resources are needed to sustain reform. The entry into force of the Stabilisation and Association Agreement will lead to a greater co-operation between the EU and the country. The presentation by the EU of a European Partnership should provide the basis for focussing efforts to move forward on the reform agenda.

SERBIA AND MONTENEGRO

Progress in Serbia and Montenegro since the last annual Report has been mixed. The adoption of the Constitutional Charter was an achievement in its own right, but its implementation is still incomplete. Continued disagreements about the interpretation and implementation of the new constitutional arrangements reflect the lack of overall consensus on the future of the State Union. This lack of consensus weakens the joint institutions and policies which are indispensable for progress with political and economic reforms and for developing Serbia and Montenegro’s relations with the EU. The constitutional problems and protracted party political disputes in both republics have contributed to the slow pace of reform in many key areas.

Republican institutions showed resilience and stability following the assassination of Serbian Prime Minister Djindjic. The ensuing state of emergency, while of great assistance to the Serbian government in combating the immediate threat posed by organised crime, affected, however, the respect for human rights and for the rule of law.

The level of progress in political reforms has varied: steady progress in army reform; further progress in the areas of minority rights and regional co-operation; slower than hoped-for reform of the police and judiciary. Efforts have been made to deal with the legacy of the past but this remains an outstanding challenge. Serbia and Montenegro is still failing to comply with its international obligations concerning co-operation with the International Criminal Tribunal for the former Yugoslavia (ICTY).

Economic stability has been preserved. However, the pace of structural reforms has slowed considerably, mainly due to the political disputes that have hampered the functioning of the institutions.

There was some progress on the European reform agenda in the framework of the Stabilisation and Association process (SAP). To speed up the reform process and to further deepen EU reform advice, an Enhanced Permanent Dialogue was established in July 2003, upon the Commission's suggestion, to build on the work of the previous Consultative Task Force meetings. The recommendations of both serve as reform guidelines and benchmarks.

Following the adoption of the Constitutional Charter and of the Internal Market and Trade Action Plan in August 2003, the Commission decided in September 2003 to begin work on its Stabilisation and Association Agreement Feasibility Report. The Feasibility Report looks into the possibility to open negotiations on a Stabilisation and Association Agreement on the basis of a number of criteria: the degree of compliance with SAP political and economic conditions, the overall functioning of the State Union, the existence of a single trade policy and a single market, progress on sectoral reforms and on those institutions at the state level necessary to implement an SAA.

The Feasibility Report was postponed in order to give the authorities more time to address the remaining key issues, including in particular political conditionality, constitutional issues and the Action Plan.

KOSOVO⁴⁴

The UN key decision to operationalise the Standards for Kosovo, and the launch – although amidst difficulties – of the Dialogue between Pristina and Belgrade on issues of common concern were the main developments over the reporting period.

Just at the time when the direct dialogue between Pristina and Belgrade seemed to be finally on track and the Kosovo standards implementation plan was about to be finalised, the ethnically motivated violent incidents that occurred in March 2004 marked a serious setback to the establishment of a secure, democratic and multi-ethnic Kosovo.

Over the reporting period, the performance of the Provisional Institutions of Self-Government (PISG) and public administration has started to improve, but deficiencies still need to be addressed with determination. The transfer of non-reserved competences from the United Nations Interim Administration Mission in Kosovo (UNMIK) to the PISG was completed by

⁴⁴ As defined by UN Security Council Resolution 1244

the end of 2003. Now the PISG need to make full use of the transferred competencies to take greater responsibility for the reforms and their implementation under the ultimate responsibility of UNMIK, which in addition holds the reserved powers. The late and inadequate reaction of the PISG to the events of March 2004 raises serious concerns. The rule of law needs to be strengthened, in particular as regards effective implementation and enforcement of the legislation.

While some efforts were made, notably in the second half of 2003, substantial and sustainable return of displaced persons to Kosovo was hampered by the unfavourable socio-economic conditions and precarious security situation. The March 2004 violent incidents have led to the forced displacement of members of minority communities and have exacerbated the climate of insecurity with a very adverse impact on the overall process of returns.

Despite some improvements, the economic situation remains a cause for concern: Kosovo's economy is still heavily dependent on foreign aid and remittances and is far from being viable. Unemployment is high and likely to increase, thus creating fertile soil for social and political unrest. Privatisation of socially owned enterprises and restructuring of public utilities have not advanced satisfactorily. The management of public finances need to be more efficient and transparent.

Over the reporting period, progress has taken place in setting Kosovo's European perspective through the implementation of the Stabilisation and Association process Tracking Mechanism (STM). The Commission has provided to the Kosovo authorities policy advice on a number of sectors with a view to supporting EU compatible reforms. At the same time, the STM process reinforces and strengthens the work being done on the Standards for Kosovo.

The European perspective means that Kosovo people will be able to benefit from the peace and prosperity that the process of European integration has secured in a free and democratic manner throughout most of the continent. To achieve this aim, Kosovo needs to be firmly anchored in the Stabilisation and Association process. However, the March 2004 incidents shows that the people of Kosovo and the PISG need to engage seriously in the process.