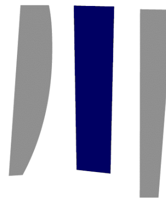

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Investment issues in South-Eastern Europe

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Investment issues in South-Eastern Europe

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1. Introduction

South-Eastern Europe has experienced falling or stagnant economic activity in the past decade. One key element of the economic stagnation is a low level of saving and investment. These are respectively only one-half and two-thirds of the figure seen in the more successful transition economies in Central Europe. We have chosen to focus this paper on this particular issue because it has not received the attention it deserves. This does not mean that the low level of savings and investment is necessarily the determining factor behind the poor economic performance in the region. Other elements, such as war and civil unrest, are clearly also critical.

Any quantitative analysis of South-Eastern Europe's economies is fraught with difficulties that should not be ignored. The quality of economic data is poor, and gaps in the availability of data has often forced us to resort to estimates and assumptions. Private sector saving, to take one example, can only be derived as a residual from the savings-investment equation. Published economic data only covers the official economy, sometimes comprising only half of all actual economic activity. Despite these well-known caveats, there is enough available data to apply a more systematic approach, and not to rely entirely on anecdotal evidence. Large disparities across countries means that generalised conclusions must in the end be treated with some caution, but the data on investment and saving does tell a simple and consistent story for the region. This can then serve as a basic framework on which a broader and more nuanced discussion on economic development can be built.

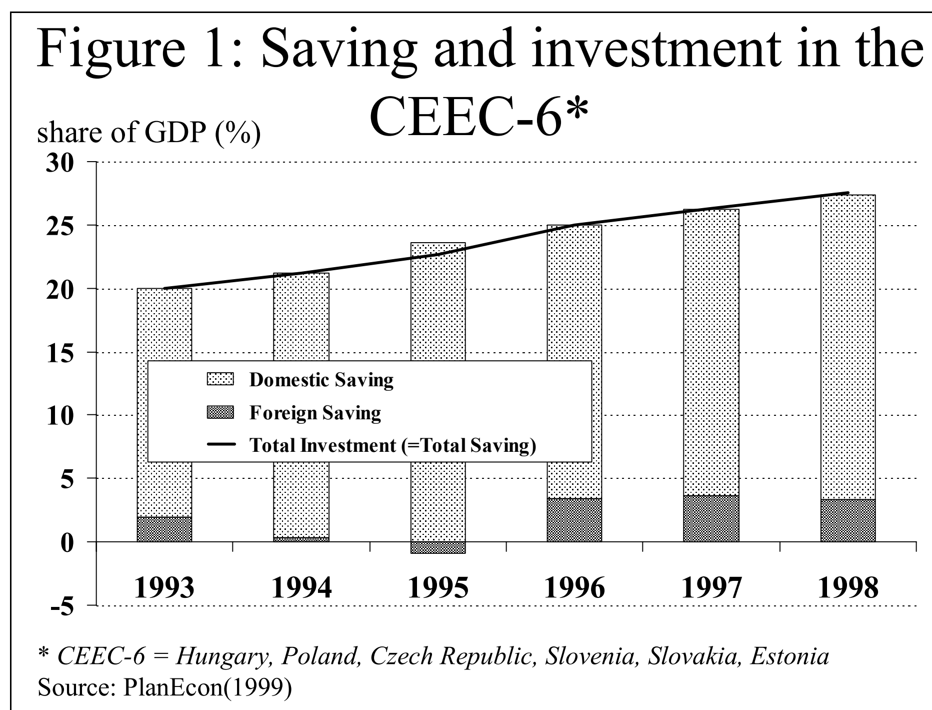
The paper is organised as follows: The next section reviews the recent trends in investment rates in South-Eastern Europe (SEE). The low level of investment in the region emerges clearly from this discussion. To explain the low investment rates, we then look at the other side of the savings-investment identity in section 3. In particular, we split savings into a foreign component, a government component, and a domestic private sector component. The key weakness is the poor private sector savings rate. Indeed, very large capital inflows into the region are needed to close the domestic savings-investment gap, even though investment is at low levels to begin with. In the following three sections we discuss the key components of savings in turn to see where gains may come from in the future. We argue that increasing corporate retained earnings is the key short to medium term solution. Some policy measures to achieve this goal are briefly outlined[1].

[1] For background information, the paper draws on a wide body of analysis on the region produced over the past year, including World Bank (1999), Gligorov (1999), EBRD (1999), PlanEcon (1999) and EU and World Bank (1999).

2. Savings and investment in South-Eastern Europe

Following a sharp initial decline in output at the outset of this decade, many countries in South-Eastern Europe have failed to show the kind of rebound observed in the more successful transition economies. GDP in Poland -- the most successful of the transition economies, was 20% larger in 1998 than at its previous late-1980s peak. FR Yugoslavia's economy – at the other end of the spectrum -- stood at less than half its peak one decade ago[2]. A string of post-disintegration wars in the former Yugoslav republics account for some of the economic stagnation in the region, but failure to transform domestic economies and institutions are at least of equal importance.

Since they serve as a natural benchmark, it is useful to continue the comparison with the better performing transition economies (while always bearing in mind the data issues referred to in the introduction). For the purpose of this discussion, a key feature in the success of this latter group has been the strong growth in fixed investment. In Poland, Hungary, Slovenia, Estonia, the Czech Republic and Slovakia (which we summarise as the CEEC-6), investment has increased as a share of GDP from a relatively low level towards a healthy 28% of GDP (PlanEcon, 1999). This is illustrated in Figure 1. Domestic savings have also been rising, leaving foreign saving (i.e. the current account deficit) at around 4% of GDP in recent years. Furthermore, thanks to an overall favourable attitude in these countries towards foreign participation in privatisation programmes, foreign direct investment (FDI) has financed more than two-thirds of the current account deficit, limiting the accumulation of foreign debt.



FDI and foreign ownership of privatised industries have speeded up the restructuring of CEEC companies, providing needed know-how, foreign market access and corporate governance. However, it is important to note that FDI, averaging just over 3% of GDP in

[2] For a discussion on the economic impact on FR Yugoslavia from the Kosovo conflict, see for instance Dinkic, ed. (1999).

1996-98, has remained a relatively modest share of investment (EBRD, 1999).

Table 1: FDI in CEECs

USD million	**1995**	**1996**	**1997**	**1998**	**1999*f***	***1996-98 % of GDP***
Czech Republic	2,500	1,400	1,300	2,500	3,500	*3.1*
Estonia	199	111	130	575	350	*5.8*
Hungary	4,500	2,000	1,700	1,500	1,600	*3.8*
Poland	1,100	2,800	3,000	6,600	6,500	*2.9*
Slovakia	202	251	177	508	500	*1.6*
Slovenia	170	178	295	154	na	*1.1*
CEEC-6 Total	**8,987**	**7,268**	**7,445**	**12,978**	**13,000**	***3.1***

Source: Transition Report, EBRD 1999

Admittedly, there are large differences between different CEECs. Some countries that have not encouraged substantial foreign participation in privatisation, such as Slovakia and Slovenia, have experienced only limited FDI inflows. Others, such as the Baltic states, have managed to attract FDI equivalent to 5%-7% of GDP. As a result of the small and extremely open nature of these economies, the Baltics have become fertile breeding ground for so called “outward processing”; low-cost outsourcing of manufacturing and assembly by multinational companies, especially from Sweden and Finland. The Baltic countries have also benefited from their close proximity to their Nordic neighbours, skilled labour forces and reasonably functional infrastructure. It is also important to stress that FDI levels have as a rule peaked at the height of privatisation programs. In early privatisers such as Hungary, FDI peaked at 10% of GDP in 1995 and has since fallen to just over 3% of GDP in 1998-99. In Estonia, FDI peaked at 11% of GDP in 1998, and has fallen to around 7% of GDP in 1999. In countries where privatisation programs were introduced more gradually, FDI remain close to peak levels, but the gradual nature of the programs also mean that these peaks are lower. In Poland, for example, FDI stood at just over 4% in 1998 and 1999.

When compared with the more successful transition economies, and indeed with other fast-growing middle income countries, South-Eastern Europe has a very low investment ratio. Aggregate investment in the SEE-7 countries (comprising Albania, Bosnia and Herzegovina, FR Yugoslavia, FYR Macedonia, Bulgaria, Romania and Croatia) has crept up at a slow pace, from around 15% of GDP in early 1990s to about 20% today. This is some 8 percentage points below the more advanced Central and Eastern European Countries. As illustrated by table 2, there are substantial differences across the SEE-7 countries. Investment stands at around 25% of GDP in Croatia, which is almost in line with other CEECs. Bosnia and Herzegovina also has a very high investment ratio due to substantial inflows of international aid. It seems unlikely that sustained economic growth will be achieved unless the region’s investment rate is raised substantially.

Table 2: Domestic investment in South-Eastern Europe

Share of GDP, %	1995	1996	1997	1998	1999*f*
Albania	15.0	14.3	9.9	10.0	10.5
Bosnia and Herzegovina	12.0	19.2	26.1	30.0	35.1
Bulgaria	15.7	13.9	11.8	12.3	13.2
Croatia	18.4	23.9	25.2	24.7	24.7
FR Yugoslavia	13.3	13.1	16.6	16.6	17.4
FYR Macedonia	13.9	13.2	13.3	13.3	14.0
Romania	21.4	21.3	19.2	19.6	19.4
SEE-7 GDP-weighted average	**17.9**	**19.2**	**19.1**	**19.3**	**19.8**

Source: PlanEcon (1999)

Note: Investment as a share of GDP is taken from PlanEcon (1999) with the exception of Bosnia and Herzegovina, which is an estimate based on tentative data on investment growth rates, also from PlanEcon.

To find reasons for the low level of investment we can turn to the other side of the national accounts identity which states that total investment must equal total savings. More specifically, we can split the sources of finance (savings) into its constituent elements as follows:

Total Investment	=	**Foreign Saving** *(current account deficit)*	+	**Government Saving** *(budget surplus plus public investment)*	+	**Private Saving** *(corporate and households)*

This equation states that total investment in the economy must equal total saving, which consists of foreign saving (the current account deficit), government saving (the budget balance plus public investment) and private saving (corporate profits and household saving).

The government affects the savings-investment equation in two ways. On the one hand, the budget deficit (surplus) decreases (increases) saving by the private sector. It does this through the impact of government borrowing on interest rates. On the other hand, the government itself is responsible for investment. This includes roads, public buildings such as schools and hospitals, and environmental protection (e.g. flood control).[3] Thus, the net impact of the government on the investment equation, is equal to the government balance plus public investment. Although budget deficits do exist in the region, they are largely the same order of magnitude as public investment (around 4% of GDP) and the net impact has remained close to zero for the region as a whole. The region is, in fact, close to the so-called "golden-rule" that governments can borrow to fund investment, but that current expenditures should be covered with tax receipts.

Table 3 shows each of these categories of saving for the countries of South-East Europe (see also figure 2 for the overview picture of the region). A first striking feature is the large role for foreign saving. These, equal to the current account deficit, have been around 7% of GDP

[3] Note that public investment in this context means strictly investment by the government and its agencies, and does not include the investment of companies under government ownership (such as railways companies).

in recent years[4], or more than one-third of the total. The above equation tells us that this foreign capital has been needed to fill the large domestic savings-investment gap, even though the level of investment has been low to begin with.

Table 3: Breakdown of savings

Share of GDP, %	1995	1996	1997	1998	1999*f*
Albania	**15.0**	**14.3**	**9.9**	**10.0**	**10.5**
Domestic private saving	9.9	12.8	6.3	8.8	4.6
Government saving	-2.1	-7.6	-8.6	-5.2	-8.8
Foreign saving	7.3	9.1	12.2	6.3	14.6
Bosnia and Herzegovina	**12.0**	**19.2**	**26.1**	**30.0**	**35.1**
Domestic private saving	-0.7	-7.9	-8.1	0.1	11.3
Government saving	2.4	-0.2	3.2	3.0	4.0
Foreign saving	10.3	27.3	31.0	26.9	19.8
Bulgaria	**15.7**	**13.9**	**11.8**	**12.3**	**13.2**
Domestic private saving	20.1	24.2	16.4	6.3	4.3
Government saving	-4.9	-9.1	-0.4	3.7	2.9
Foreign saving	0.5	-1.2	-4.2	2.3	6.0
Croatia	**18.4**	**23.9**	**25.2**	**24.7**	**24.7**
Domestic private saving	8.9	14.6	9.9	12.4	17.1
Government saving	2.7	4.9	3.3	5.2	1.4
Foreign saving	6.8	4.4	12.1	7.1	6.2
FR Yugoslavia	**13.3**	**13.1**	**16.6**	**16.6**	**17.4**
Domestic private saving	5.4	12.2	6.0	14.9	19.6
Government saving	-0.1	-7.1	-1.3	-6.4	-11.2
Foreign saving	8.0	8.0	12.0	8.0	9.0
FYR Macedonia	**13.9**	**13.2**	**13.3**	**13.3**	**14.0**
Domestic private saving	6.3	3.5	2.5	2.8	9.7
Government saving	1.9	2.4	2.5	1.2	-4.7
Foreign saving	5.7	7.3	8.3	9.3	9.0
Romania	**21.4**	**21.3**	**19.2**	**19.6**	**19.4**
Domestic private saving	15.2	14.6	13.3	13.8	13.6
Government saving	1.4	-0.6	-0.3	-2.2	0.3
Foreign saving	4.9	7.3	6.2	7.9	5.5
SEE-7 GDP-weighted average	**17.9**	**19.2**	**19.1**	**19.3**	**19.8**
Domestic private saving	11.6	13.9	10.2	11.7	13.8
Government saving	0.7	-1.4	0.3	-0.3	-1.3
Foreign saving	5.6	6.7	8.6	7.9	7.3

Source: PlanEcon (1999), EBRD (1999), IMF(1999), Gligorov, V. (1999) and own estimates

Note: Table 3 is compiled from different data sources. Total savings equals total investment, which comes from Table 2. Data on savings are from EBRD (1999) with the exception of data for FR Yugoslavia, which is estimated on the basis of PlanEcon (1999) and Gligorov (1999) sources. Domestic private saving is calculated as a residual from the other data available. In light of the often poor quality of data used, the table should be used with some caution as to its precision.

[4] The national accounts tell us that foreign savings must be equal to the current account deficit, regardless of the origional purpose for any particular capital inflow.

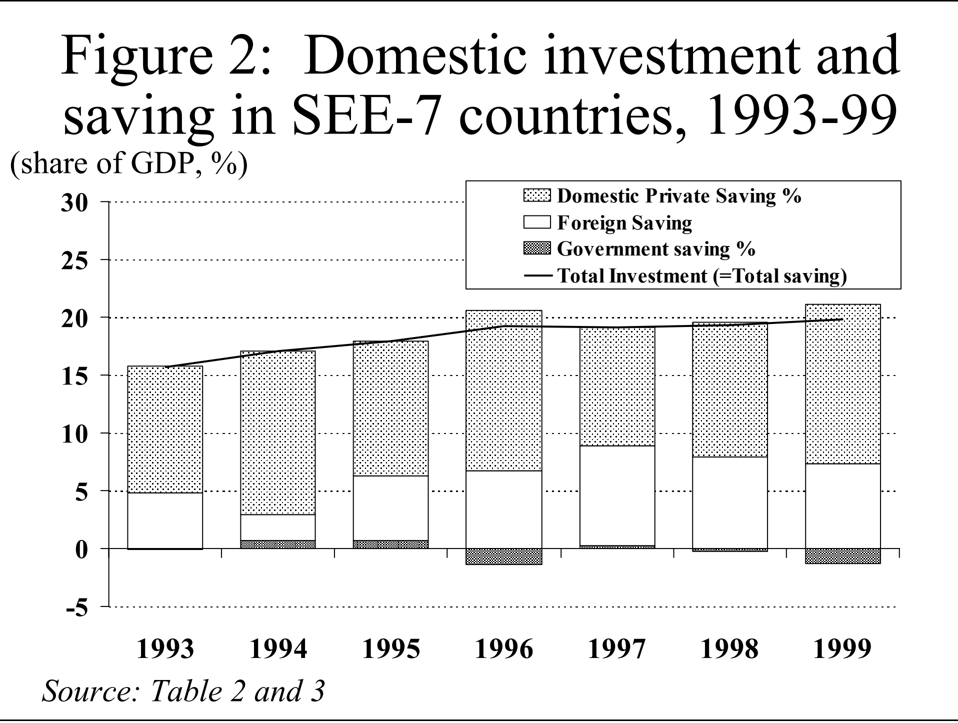


Figure 2: Domestic investment and saving in SEE-7 countries, 1993-99

Source: Table 2 and 3

The main source of low domestic saving is the third element of the above identity - low private sector saving, both in the form of household saving and corporate profits. *Household saving* is depressed by declining real income levels and inadequate means of saving and store of value. Macroeconomic instability, including periods of high inflation and steeply negative real interest rates, discourage saving through the banking system. Institutional financial sector weaknesses add to these disincentives. An extreme example is the collapse of the pyramid schemes in Albania, which has been accompanied by a decline in private sector saving that has yet to recover. *Corporate saving* – at least as recorded in company accounts - is equally depressed in South-Eastern Europe by the unstable macroeconomic environment and the difficult tax and regulatory environment in which companies operate. Unclear property rights make it uncertain who owns future profits, while current profits are often siphoned off by high and arbitrary profit taxes.

In the following three sections we look in some more detail at each of the main components of the savings-investment equation and consider where improvements are possible in the future.

3. Foreign savings and the particular role of foreign direct investment

Foreign savings enter a country via foreign borrowing or through equity investments by non-residents. Much discussion of South-Eastern Europe has focused on equity investments and on the possibility of increasing foreign direct investment. This is a natural response to the rapidly growing foreign indebtedness of the region.

The level of FDI was in fact slow to take off in South-Eastern Europe, but has risen notably in recent years (see Figure 3). In 1998, FDI rose to over 4% of GDP on average for the SEE-

6.[5] FDI inflows are expected to moderate towards 3% this year, close to the CEEC average seen before. Table 4 gives more detail at the country level. Thus, somewhat contrary to expectations, FDI inflows to SEE countries are not only as high as the CEEC average, but also relatively evenly distributed across countries. Most SEE countries receive FDI of around 2% to 3% of GDP. The notable exception is Bosnia and Herzegovina, where substantial aid-related FDI in combination with a still very low level of economic activity has generated a higher – but also very erratic – ratio of FDI to GDP.

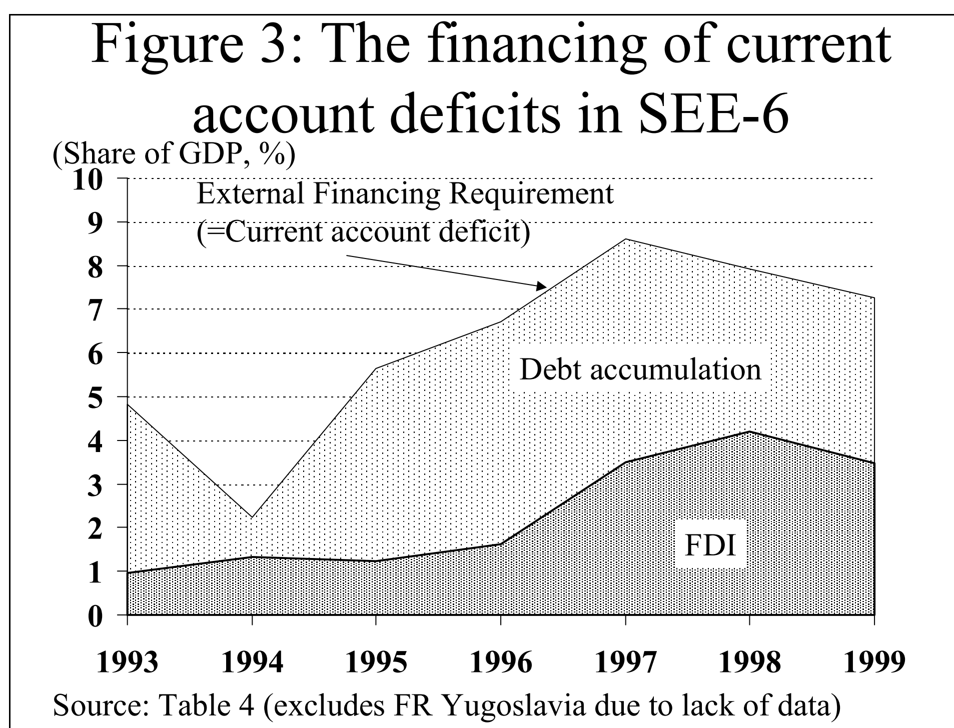


Table 4: FDI in South-Eastern Europe

USD million	**1995**	**1996**	**1997**	**1998**	**1999*f***	***1996-98 % of GDP***
Albania	89	97	42	45	43	*2.3*
Bosnia and Herzegovina	0	0	504	100	60	*5.7*
Bulgaria	82	100	497	401	700	*3.2*
Croatia	83	529	346	854	750	*2.8*
FYR Macedonia	13	12	18	175	30	*2.0*
Romania	417	263	1,224	2,040	1,345	*3.2*
SEE-6 Total	**684**	**1,001**	**2,631**	**3,615**	**2,928**	***3.1***

Source: EBRD (1999)

It should be possible to encourage higher FDI inflows into the region through accelerated privatisation programmes, market liberalisation and strengthened property rights. However, it is unlikely that substantially higher FDI would be a major element in raising the overall investment ratio in South-Eastern Europe. Since current account deficits in SEE countries are on average larger than in CEECs (almost double as a percentage of GDP), an increase in FDI would be needed merely to limit the accumulation of foreign debt, which is currently

[5] FR Yugoslavia is excluded from this figure due to the lack of data.

above sustainable levels. Even if FDI flows were doubled, to 6% of GDP, it is thus not certain that this would substantially increase the aggregate level of investment.

It may also be the case that the region is not a particularly attractive location for FDI. The region's aggregate GDP only amounts to just over 1% of that of the EU, and about 60% of this is due to Croatia and Romania. As domestic markets, the SEE-7 countries do not add up to that of Greece alone. This means that FDI flows to SEE countries may aim at outward processing rather than domestic market. Whether the SEE countries will be able to exploit this as well as has been seen in the Baltics (to continue our earlier comparison) is uncertain, however. The SEE countries have both a lower level of human and physical capital and greater geographic isolation. It is interesting to note that even Greece has had difficulty attracting FDI outside the tourist industry, due, amongst other factors, to its location and the region's economic fragmentation.

4. Public investment

In an environment of supportive macroeconomic policies, well-selected public infrastructure investment raises the return on private investment. It is not obvious, however, that there is a need to increase this type of investment substantially in South-Eastern Europe. Public investment levels in middle-income countries vary from around 3% of GDP in Latin America to 6% of GDP in some Asian countries. This variability is also present in the lower-income EU countries, ranging from around 3% of GDP in Greece to around 5% of GDP in Portugal.

Averaging around 4%-5% of GDP, public investment in South-Eastern Europe is not low for middle income countries, although there are important exceptions to the average. Several years of weak public finances have reduced public investment in Bulgaria to less than 2% of GDP, while public investment is substantially higher than the regional average in Bosnia and Herzegovina due to the inflow of foreign aid. Since overall investment levels in South-Eastern Europe are lower than in comparable countries, the public sector share of total investment is very high, in excess of 25%.[6] Although the infrastructure capital stock is on average in a poor state following years of economic decline and mismanagement, it is not clear that a substantial increase in public investment is justified.

A key issue is how any increased public spending would be funded.[7] Weak public institutions and excessive tax burdens limit the scope for substantially higher government revenues. While there is some scope for reduced expenditures to the military and unprofitable state enterprises, it is likely that these cuts would have to be matched by tax cuts to discourage widespread tax evasion.

On the other hand, a fiscal expansion (i.e. funding greater investment via a larger budget deficit) – something that could be considered appropriate in response to an external shock such as the war in Kosovo – may be counter-productive if it undermines confidence in public policy. Government finances in the region are stretched and debt levels are high. Monetisation of fiscal deficits in the past raise the likelihood that investors would react negatively to excessive fiscal expansion, with the result that foreign and domestic private investment is reduced.

[6] Those countries with high public investment, such as in East Asia, usually have high levels of total investment. Normally public investment is about 1/6 of the total.
[7] There is also the issue of the rate at which sound projects can be prepared and implemented.

Foreign aid financing of public investment would avoid an unsustainable fiscal expansion, though it is probably only in Kosovo where large volumes of funds will be forthcoming[8]. However, here there is the different risk of generating an aid dependency. Large foreign aid inflows risk to push up real wages and exchange rates, thus undermining private sector competitiveness. The weak growth of the private sector in Bosnia and Herzegovina despite rapid reconstruction of public infrastructure shows that it is important to find an appropriate balance between the two.

It follows immediately from this discussion that the alternative approach of increasing private savings via a budget surplus is also very limited. On balance, there appears to be little scope for a substantial impact on the national savings-investment relationship by the government.

5. Private investment

5.1. Increasing corporate savings

That leaves private sector investment and savings. We have already seen that these are critically weak at the present time. What could be done? Let us look once more for possible lessons from the better performing transition economies. At the outset of the transition process, it was widely believed that rapid restructuring of the banking sector was needed to channel household savings to investment. This concern turned out to be somewhat misplaced. In economies where household savings are low and banking systems are dysfunctional, one should not expect a massive transfer of savings through traditional channels of bank intermediation. The strong growth in the financing of corporate investment was achieved through market reforms such as price and labour market liberalisation and the introduction of highly competitive exchange rates. This tended to raise the profitability of the corporate sector, with the exception of some crumbling, permanently unprofitable state enterprises. Lacking any substantial access to bank borrowing, the emerging private sector relied primarily on retained earnings to finance investment.[9]

The situation of delayed transition in South-Eastern Europe means that the experience of the more northerly countries remains relevant. For the region a strategy aiming to raise corporate savings in this way would have to contain a number of key macroeconomic and structural measures:

- _Liberalisation and limited government:_ One reason for low corporate profitability in relatively unreformed transition economies is the excessive and often arbitrary intervention by governments. This includes price controls, high tax rates and regulatory obstacles to corporate restructuring. It is for instance often difficult for companies to shed labour when weighted down by excess capacity. All these factors tend to keep profits low or negative. If authorities subsidise unprofitable enterprises -- for instance through the banking system as is often the case – while heavily taxing profitable ones, this furthermore generates an incentive for enterprises to remain unprofitable. Reforms

[8] For a more detailed discussion on the financing of reconstruction in Kosovo, see for instance Dixon (1999) and EU and World Bank (1999).

[9] In fact corporate profits also play a key role in more advanced economies. Data for OECD countries show that the ratio of retained earnings to corporate investment averages around 3/4.

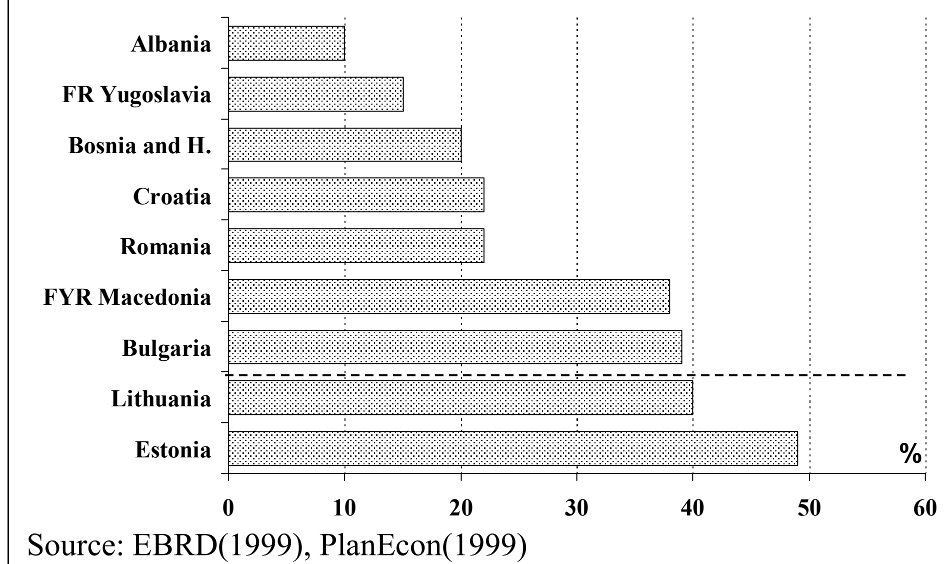
that would simplify the regulatory environment for enterprises and reduce the taxation on profits would go a long way in boosting the profitability of the corporate sector.

- *Macroeconomic and fiscal stability:* An environment of macroeconomic stability, including sustainable government finances and low inflation, is a key component in corporate profitability. Macroeconomic instability makes liquid assets more vulnerable to sudden bursts of inflation, while investment is also discouraged by its more uncertain future profitability.

- *Privatisation:* Unclear property rights affect both the level of profitability and the incentive to invest. State enterprises are often not subject to effective corporate governance by outside owners. This means that managers may have little incentive to make profits. Similarly, unclear property rights create disincentives to investment, since the beneficiaries of future profits are equally unknown. Effective external private ownership is a key element in establishing corporate governance, and profit-maximising behaviour by management that is accountable to the owners.

5.2. Developing international market opportunities

Even with the reforms set out above, turning higher profits into corporate investment must be motivated by market opportunities, either domestically or abroad. In South-Eastern Europe, there is relatively little of either. Not only are domestic markets small, but export markets are limited due to trade barriers. Figure 4 illustrates how closed the SEE economies are. Economies of such limited size as those in South-Eastern Europe are typically more open than large economies. Again, a comparison with the Baltic countries is appropriate. Exports are equivalent to 50% of GDP in Estonia and 40% of GDP in Lithuania. While the share of exports to GDP is almost as large in FYR Macedonia and Bulgaria, it is substantially lower in all of the other SEE countries.



Though the region's isolation from the rest of Europe can explain some of the low export ratios, a striking element is the very low level of economic integration between the SEE countries themselves. Except for a few cases of historically based trade links between FR Yugoslavia on the one hand and FYR Macedonia and Bosnia and Herzegovina on the other, trade in the region is largely undeveloped (Gligorov et al, 1999). History plays a key role in the low level of regional integration. As former CMEA countries, Romania and Bulgaria in particular diverted much of their trade towards the Soviet Union and other CMEA members. Albania and Yugoslavia were less integrated into this framework (EBRD, 1999). Once CMEA trade collapsed in the early 1990s, most of its members redirected their trade towards the EU market, instead of trying to develop the small regional market. Today Albania only conducts around one-tenth of its official trade with the region. In conjunction with its low overall trade-to-GDP ratio, this makes official intra-regional trade virtually irrelevant for Albania's economy. Croatia, another relatively closed economy, conducts around 20% of its trade with the region. Croatia is squeezed between its severed ties with much of the former Yugoslavia on the one hand, and its troubled relationship with the EU on the other.

This discussion leads to at least one further policy requirement:

- *Liberalisation of foreign trade:* Since local markets in South-Eastern Europe are small and fragmented and offer little scope for supporting the development of a manufacturing sector, access to foreign – and in particular EU – export markets is necessary. It is noteworthy that the sectors that dominate the exports of the region are those that traditionally run into substantial trade barriers from the EU side: agricultural products, raw materials and relatively low-technology manufacturing such as textiles and footwear.

5.3. Investment by utilities

Special attention should also be given to one area of corporate investment where the state is particularly implicated. *Utilities* (such as railways, energy and water management) should in principle be able to finance investment from their own fees or from borrowing backed by their own assets and revenue streams. However, poor management, weak balance sheets, and insufficient independence means that many of these companies nevertheless rely on government guarantees and budgetary transfers, thus adding to the accumulation of public debt. This means that the progressive restructuring of utilities should be a key element in raising the level of investment in South-Eastern Europe. The resulting enhanced infrastructure may have many of the positive effects on the investment behaviour of the private sector that is seen for "pure" public investment (e.g. public roads).

In order to boost this type of investment there should be a progressive process whereby these utilities are restructured and gain independence from the state. A key short-term element is likely to be tariff adjustments to increase revenues and profitability. Aiming to increase internal financing of infrastructure investment, this strategy is the same as that for the rest of the corporate sector. Indeed, once the long-term financial feasibility of utilities has been established, and a sound regulatory environment is in place, private sector involvement in these sectors will become feasible. However, with the exception of telecoms, utilities should not be expected to obtain substantial financing through privatisation and FDI for quite some time, due to legal complexities and the region's substantial market uncertainties.

6. Conclusions

The experience of high-growth in CEECs and other emerging market economies does strongly suggest that higher saving and investment ratios are key to successful economic development in South-Eastern Europe. However, not all components of saving can be expected to rise markedly from current levels. At around 7% of GDP, foreign saving is stretched to the limit and higher FDI inflows are required only to change the composition of capital inflows rather than to increase them. Raising domestic saving is also associated with limitations. Weak government finances and the need to reduce tax rates further means that the scope for much higher government saving is limited. At the same time, high unemployment rates and low income levels limit the scope for increased household savings, at least in the short term. Macroeconomic uncertainty and the absence of functioning financial intermediation also limits the scope for channelling household saving to corporate investment. Weak property rights and weak accounting standards make it nearly impossible to assess credit risk, which is a key factor behind the region-wide lack of effective financial intermediation.

The best means of raising private saving and investment levels in this environment is to raise corporate profitability. Corporate saving -- the internal financing of corporate investment from retained earnings – overcomes the problem of low household saving rates, dysfunctional financial intermediation and lack of credit risk information. In the highly diverse "region" of South-Eastern Europe, post-war reconstruction programs similar to that in Bosnia and Herzegovina are likely to be the exception rather than the rule. Aid-financed reconstruction of housing and infrastructure reconstruction may be a necessary requirement for restoring some sense of economic normality in war-torn Kosovo. The rest of the region, however, needs to make progress on structural reforms rather than aid inspired public spending programmes.

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