



Defense Reform, Modernization & Military Cooperation in Southeastern Europe

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Slovenia

Croatia

Bosnia

Albania

The Former Yugoslav Republic of Macedonia

Romania

Bulgaria

The Republic of Serbia
The Republic of Montenegro
The Republic of Kosovo

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Preface

This project was prepared for, and supported with a generous grant from, the Kokkalis Foundation of Athens, Greece. The fundamental aims were to develop a deeper understanding of the defense reform and modernization challenges facing key Southeast European countries, to identify priorities they need to press forward with to improve their individual candidacies for NATO (and eventual EU) membership, to spotlight operational adjustments and equipment needs that might render their militaries better able to cooperate with NATO forces, and to assess the opportunities for (and importance of) defense industrial reform as a core component of the overall restructuring process. The project was conducted during a period of enormous change in each of the countries under study (especially in the defense planning realm), and the analysis contained in this report is based upon a thorough examination of current plans and proposals developed by each country in its effort to forward defense reform and modernization. The analysis is based as well on numerous interviews with key officials in the national security policy communities of each country, with officials at NATO Headquarters directly responsible for coordination with candidate nations, and with U.S. and other NATO country officials charged with monitoring defense trends among Southeast European states.

Obviously, a study of this scope is the product of many individuals, all of whom have spent considerable time and effort to help produce the final product. All-important field research and interviews in the several countries under study, as well as at NATO and in Washington, DC, was conducted by IFPA officers and senior staff members, most notably, Jacquelyn Davis, Charles Perry, Robert Pfaltzgraff, Michael Sweeney, and Andrew

Winner. In the conduct of basic research and in the drafting of final country chapters, they were ably assisted by (in alphabetical order) Madhavi Chavali, Ian Jefferson, Kelley Reese, Laura Sitea, Elizabeth Tencza, and Georgi Tsekov, all of whom are (or recently were) members of IFPA's professional research staff. Additional insights with regard to official Greek perspectives on defense reform in Southeast Europe were provided by Thanos Dokos, director of studies at the Hellenic Foundation for European and Foreign Policy. Helpful guidance throughout the project was provided by Dimitris Keredis and Chris Sfatos, both of the Kokkalis Foundation. Christian Hoffman at IFPA was responsible for the overall graphic design and layout of the report.

EXECUTIVE SUMMARY

This study examines the defense reform, restructuring, and modernization plans and programs of seven countries in Southeastern Europe – namely, Albania, Bosnia-Herzegovina, Bulgaria, Croatia, the Former Yugoslav Republic of Macedonia (FYROM), Romania, and Slovenia. Based on extensive field and archival research, including trips to the countries in question, interviews with key government and private sector participants in the various national defense planning communities, and on-site visits to selected military units and defense industries, the study provides an in-depth analysis of the scope, pace, and prospects for defense reform and modernization in each of the seven countries. It examines their country-specific plans, the political and socio-economic contexts within which these plans will (or will not) move forward, and the procurement priorities to which they give rise. The discussion of procurement priorities, moreover, will include information on those that are likely to be met via purchases from indigenous defense industry and those that will require buys from outside, particularly NATO, countries. To the extent that such industries exist, the study goes on to provide a comprehensive look at the defense industries of each country, examining the linkage between reform in the defense industrial sector and defense reform overall. For each country, the report briefly reviews the defense industrial sector as a whole, as well as the merits of individual companies of importance, offering insights into the long-term viability of defense industrial assets in the countries being studied and the potential they may have for attracting foreign direct investment (FDI). Finally, the study examines the prospects for NATO membership of the seven, particularly in the run-up to the November 2002

NATO summit in Prague. Conclusions and recommendations are then offered with regard to future defense sales to (and potential industrial cooperation with) each country.

Of the nine countries that will be considered for NATO membership at the Alliance's Prague summit in November 2002, five are in Southeastern Europe – Albania, Bulgaria, FYROM, Romania, and Slovenia. Their current candidacy status reflects the fact that all have identified NATO (and eventually EU) membership as key to their long-term security, and that each of these states is now pursuing (some more successfully than others) a wide-ranging reform and modernization of their defense structures and policies, largely so as to render them NATO-compatible. In fact, all five candidates from Southeastern Europe are in the midst of a second phase of reform and restructuring, the first phase of which began with the dissolution of the Warsaw Pact and the breakup of Yugoslavia. With the accession of Poland, Hungary, and the Czech Republic to NATO at the Washington summit in 1999 and the creation of the Membership Action Plan (MAP) process for aspiring members, the pace and scope of reform and modernization entered a second, and more focused, phase. In addition, the internal political changes in Croatia and Yugoslavia in the past two years have meant that reform and restructuring has begun to accelerate in Croatia and Bosnia as well.

DEFENSE REFORM/RESTRUCTURING – PACE, PLANS, AND FUTURE PRIORITIES

While all seven countries covered in this study have undertaken some defense reform, restructuring, and modernization tasks, they each have

unique starting points and challenges. They also each have differing political impetus and resource bases from which to accomplish these tasks. As a result, the pace and scope of reform and modernization, as well as priority tasks for the future, have varied widely among the seven.

Slovenia

The country that has made the most progress, in part because it has had the easiest circumstances under which to reform of the seven, is Slovenia. The circumstances that have eased Slovenia's reform and modernization plans are its relatively strong economy – the wealthiest in Central and Southeastern Europe on a GDP per capita basis – and the fact that Slovenia began by building up its armed forces without having to tear down old structures first. It did this by building on the territorial defense units that existed during the Yugoslav days and creating a long term funding stream for military procurement – the Basic Development Program (BDP). Originally slated to cover procurement necessary to build the armed forces from 1994 through 2003, the \$600 million BDP fund recently was augmented by \$270 million and extended through 2007. This fund, it is important to note, is in addition to the annual budget of the Ministry of Defense (MOD), which includes as well a small slice for procurement.

The priority areas for procurement are command, control, communications, computers and intelligence (C4I), helicopters, artillery, light armor, and air defense. Given the well-developed plans for building the Slovenian Armed Forces (SAF) and the availability of funds, opportunities exist for sales by Western defense firms over the relative near-term, although the comparatively small size of the Slovenian military means that the overall scale of such purchases will be limited. As an example of the types of purchases that Slovenia has made, it was among the first countries in Southeastern Europe to purchase and install an Air Sovereignty Operations Center (ASOC), and it did so using its own procurement funds and not U.S. military assistance grant money, as was the case with most other countries in this region. The ASOC, which serves as a much-needed airspace management and control node, has been operational since 1999, and will eventually be linked to NATO.

The center-left Liberal Democrat-led coalition government that took over in October 2000 has

taken the original plans for building up the SAF and updated and streamlined them considerably. This was done partly in response to advice from the United States and NATO during the MAP review process and partly on the basis of an independent MOD analysis, both of which led to the conclusion that the force structure Slovenia was initially putting in place was too large to be maintained at an adequate level of readiness. The result is an ongoing reduction and restructuring of the SAF that should be complete by 2004. At that point, the SAF will have a peacetime strength of approximately 7,000 and a wartime strength of no more than 30,000. The peacetime strength, moreover, will be a mix of 4,100 professionals and 3,000 conscripts, although the MOD is beginning to examine the politically sensitive issue of going to an all-volunteer (professional) force at some point in the future.

Bulgaria

Bulgaria has a strongly pro-Western security orientation with NATO and EU membership identified as vital to the state's security. Key to this orientation was the election of a truly reform-minded government in 1997 led by the Union of Democratic Forces (UDF) party. Over the course of 1998 and 1999, that government, with support from a comprehensive U.S.-funded defense assessment, adopted a series of strategy and national security planning documents, including an operational roadmap – commonly-known as Plan 2004 – for the wholesale reform and reorganization of the Bulgarian Armed Forces (BAF). Plan 2004's primary objective is the creation of a smaller, more mobile, NATO-interoperable, and professional military force under civilian control with high levels of operational readiness. The transition to a fully professional force may take up to fifteen years, but by 2004 Bulgaria hopes to have a force that is 70% professional and 30% conscripts. The Plan also states that Bulgaria intends to be invited to join NATO in 2002.

To achieve the force size and structure envisioned in the Plan, further dramatic cuts in end-strength, to 45,000 by 2003, are mandated, and a shift in defense budget allocations will be sought to reduce personnel costs from half of the budget to just over a quarter. These reductions in overall force levels are supposed to generate savings that can then be used for the procurement of NATO-compatible equipment. However, given

the near-term costs of downsizing and reintegrating demobilized soldiers into society, savings are not anticipated to be available for major equipment purposes until 2007 at the earliest and, more likely, not before 2010. In the meantime, any procurement under Plan 2004 will focus almost entirely on the modernization of C4I systems and associated infrastructure, including further work to set in place an ASOC.

The main constraints on Bulgaria moving more quickly and comprehensively in reforming and restructuring its military are economic. Once the UDF-led coalition put the country on an IMF-approved path of economic reform, the primary issue then became whether Bulgaria could divert sufficient resources to downsize and modernize its military in a politically-acceptable manner – namely, making sure that the combined effects of IMF-mandated austerity measures and the costs of defense reform initiatives (including the return of former soldiers to the civilian economy) were not too painful for the society at large. Maintaining public support has proved, in fact, to be a difficult task, and a new government led by ex-monarch Simeon II's National Movement was elected in June 2001 on a platform of improving living conditions for the average Bulgarian, something that may well require more of a shift in the guns/butter mix in favor of the latter. That said, Simeon's party still fully favors integration with the West and early membership in NATO and the EU for Bulgaria, and there are no signs yet that it might back away from the Plan 2004 reform agenda in any serious way.

Romania

Like Bulgaria, Romania is in the midst of a new push to downsize and modernize its armed forces. Unlike Bulgaria, however, Romania was politically committed to NATO membership from early on, as evidenced by its being the first country to join the Alliance's Partnership for Peace (PfP) program in 1994. Yet, despite Romania's strongly pro-NATO posture, plans to reform and modernize its sizeable armed forces have often been frustrated and pushed off by political and economic realities. So, too, the actual legal framework for Romania's restructuring plans was only really put in place in 1998 after Bucharest received an in-depth U.S. defense assessment (similar to that done for Bulgaria) and began NATO's MAP process in earnest. The key documents produced

as a result – the National Security Strategy, the Defense White Paper, and the Multi-Annual Planning Cycle (the 2001 version of which is referred to as MPC01) – clearly list NATO accession as the primary goal, and lay out a fairly well-conceived resource allocation plan for longer-term reform.

As is the case for Bulgaria, one of the primary challenges for Romania is the task of downsizing a force-in-being that was far too large and designed for a different era before a more effective and potent force structure, better attuned to the missions of the future, can be put in place. That said, under the left-of-center, Social Democratic-led government elected in November 2000, personnel reductions have been accelerated to achieve a newly-conceived Program Force 2003 in which peacetime military forces are to number no more than 112,000 by 2003, a very substantial drawdown indeed from the active force of 340,000 that existed in 1990. In addition to a reduction in overall numbers, Romania must also restructure within that top line, as it still has a bloated officer corps, too few NCOs, and an over-reliance on conscripts. The latest efforts to speed the downsizing process, therefore, have included welcome moves to freeze conscription and to retire additional general officers. In addition, Romania is proceeding with more aggressive efforts to reorganize military units to align with NATO's preferred corps/brigade formulation, to train units earmarked for potential duty in peace support operations (PSOs) and Article 5 collective defense missions in accordance with NATO standards and procedures, and to field a modern, responsive C4I architecture, to include completion of the region's most advanced ASOC. As with both Slovenia and Bulgaria, Romania has also committed to making a larger percentage of its force professional.

Yet, Romania's downsizing and restructuring – again, much like Bulgaria's – has been painful politically, and, much to the consternation of NATO and the more staunch reformers within the Romanian government, many plans for defense reform already on the books have taken far too long to implement, or have not been implemented at all, due to domestic resistance. A particular problem for Romania in recent years has been its inability to curb adequately current procurement to save for longer-term investment, a problem tied in large part to the leverage of Romania's still sizable, and as of yet mostly unreformed, defense industry (see below for more details). The sav-

ings from foregoing current procurement were supposed to help finance the downsizing and restructuring, so this issue could certainly slow (if not derail) key aspects of Romania's program for near-term defense reform. In addition, despite Romania's acceptance of U.S. and NATO recommendations at least at the diplomatic level, Bucharest has continued to pursue big ticket items (such as attack helicopters and transport aircraft) at the expense of military basics recommended by Washington and Brussels. Nonetheless, with the economy now growing at a pace not seen since the mid-1990s, a far stronger governing coalition with a near-majority in parliament, and an able, well-informed defense minister, Romania has shown definite signs of moving ahead more effectively in 2001 and 2002, to include a strengthening of domestic support for the military reforms needed to secure an invitation to NATO.

Albania

With the chaos from Kosovo mitigated by NATO's intervention and with a much-improved domestic political and economic scene (compared to that which prevailed during and immediately after the infamous 1997 crash of pyramid investment schemes), Albania has recently made considerable progress in at least planning for military reform and restructuring. This is, however, only a relative improvement over earlier times, and Albania represents a decided drop-off from the potential of Slovenia, Bulgaria, and Romania in terms of the eventual acquisition of NATO-compatible and useful forces. Albania's defense plans, formalized in early 2000 with the passage of a National Security Strategy and a National Defense Policy, focus on consolidating civilian control, improving the quality of life for the military, streamlining command and control, and outlining basic roles and missions for a restructured Albanian Armed Forces (AAF). Drawing on the concepts and principles set forth in both documents, defense officials in Tirana have developed a Ten Year Implementation Plan 2000-2009, which provides a more detailed blueprint for transforming the AAF into a more modern, more capable, Western-oriented military. Similar to the restructuring plans developed in Bulgaria and Romania, Albania's Implementation Plan is divided into two phases, with downsizing and restructuring in the first half (2000-2004) and modernization/procurement in the second (2005-2009).

As for manpower cuts, the Plan calls for reductions in the AAF's wartime strength from 232,000 to 120,000 and in its peacetime strength from 43,000 to 31,000 by 2004. Again, as in Bulgaria and Romania, these reductions will be accompanied by a fundamental restructuring of the ranks, with a significant diminution of the officer corps coupled with step-level increases in non-commissioned officers (NCOs) and in volunteers (vice conscripts). Concurrent with these adjustments in personnel, there will be a wholesale reduction in and restructuring of AAF units to render them more NATO-compatible structures and to develop, in particular, more responsive rapid reaction and commando forces capable of participating in NATO-led PSOs. This will require, in turn, a far greater emphasis than before on NATO-standard training and logistical support, requirements that have led the Albanians to create for the first time a real Training Command and a Logistics Command. Over the longer-term (i.e., post-2004), the AAF, similar to its counterparts in the three countries discussed above, will need to field a more modern C4I system and a more fully developed ASOC, with a broader focus in Albania's case on coastal surveillance.

The real challenge in achieving the goals set out in the Implementation Plan is funding. Even garnering the funds necessary to support basic improvements in the quality of military life – improvements that are viewed (especially in the areas of compensation and housing) as vital to the success of the Plan as a whole – will be difficult, let alone the more ambitious modernization projects foreseen in the second half of the plan. Officials in Tirana have called for military expenditures to rise from \$51 million in 2000 to \$105 million in 2004, but such an increase will likely be a considerable reach, given projected regional and global economic trends. And even if the goal of \$105 million is achieved, U.S. and Allied defense planners note that unnecessary expenditures on a still oversized military infrastructure could drain funds from more important modernization projects, unless tough political decisions on additional base closures and the like are taken soon. The key to such decisions, in turn, will rest on the degree to which the political stability that Albania has enjoyed in the past few years – and recent signs of stable macroeconomic growth – can be sustained, and on Albania's ongoing ability to avoid being

drawn into cross-border conflicts involving ethnic Albanian insurgents.

Croatia

For much of its independence, Croatia was not interested in military reform and modernization along NATO-endorsed lines because it was fighting a war both within its borders and in neighboring Bosnia. Once that came to an end in 1995, the imperative that drove the rapid build-up of a Croatian national army dissipated, and at least the possibility of some degree of defense reform could be considered. However, with the Tudjman-dominated political structure still in place until 2000, there was in fact little incentive to pursue such reform during that time, beyond limited steps toward demobilization beginning in 1996. Yet, once a reformist governing coalition took power in January 2000, Croatia began cooperating on several fronts with the West, including efforts to move closer to NATO and the EU. Croatia still possesses an oversized and patchwork defense system, pulled together under international embargoes from 1991-1995, and modernized and reformed only to a limited degree based on advice given by U.S. defense contractors. Nonetheless, the prospects for a more far-reaching restructuring of the military are now brighter than ever before.

Having only recently joined NATO's PfP program and declared its intention to become a candidate for membership, Croatia has just begun what will likely be a long and difficult road to restructure and reform its wartime-based military. Indeed, it is only in the earliest stages of this effort, with the overarching Law on Defense only brought before the parliament for debate in autumn 2001. For the moment, therefore, Croatia does not have in hand

any of the multiyear, detailed plans for defense reform that other states in Southeastern Europe have already produced, nor has it had the advantage of continuous NATO feedback on proposed defense adjustments through the MAP process that began after the Washington summit. Zagreb, nonetheless, did recently receive a U.S. defense assessment that will provide it an important baseline for restructuring and reform initiatives, though economic, and possibly some political, constraints will likely make the restructuring/reform process a long one.

While Croatia has demobilized from a wartime footing (bringing peacetime military end-strength from 120,000 to 57,000), current plans call for a peacetime strength, after restructuring, of no more than 20-25,000. So, too, eventual modernization and rationalization of the military's equipment, while urgent, will probably not take place in any serious way until the new force structure is in place and adequate resources can be generated from a national budget that is deeply in debt. All that said, Croatia's relatively small size, the nascent (and still limited) nature of the defense infrastructure now in place, and the favored position Zagreb enjoys in some influential quarters of Europe may very well help it make progress on modernization and reform that is faster than that of other states in Southeastern Europe.

Former Yugoslav Republic of Macedonia (FYROM)

FYROM began from a very low base in terms of defense development, starting with virtually nothing after the federal Yugoslav People's Army withdrew most of the military equipment that had been deployed on what became FYROM

Defense Improvement Plans in Southeastern Europe

Country	Fy2000 Defense Budget (US\$ Millions)	Planned Peacetime Military End-Strength	Date For End-Strength Goal	Major Procurement Beginning
Albania	51	31,000	2004	2005-2009
Bosnia	246.8†	15,060	2004	‡
Bulgaria	316	45,000	2004	2006-2010
Croatia	575	30,000	2004	2004
FYROM	83.3	13,700	2006	2001
Romania	941	140,000	2003	2003-2007
Slovenia	353.6	7,700	2004	present to 2007

† Combined 1999 RS and Federation military budgets

‡ All procurement handled as part of U.S. Train and Equip program in accordance with Dayton Accords and associated arms control agreements

territory. Despite this start from almost scratch and its very limited resources, FYROM's leadership made reasonable progress throughout the 1990s, forming the Armed Forces of the Republic of Macedonia (ARM) in 1995 and outlining fairly sound (if nevertheless ambitious) plans for military modernization over the longer term. Much of this early success, however, was squandered once the simmering ethnic antipathy between the Slav and ethnic Albanian populations turned into open civil war in 2001.

Prior to the outbreak of domestic conflict, FYROM had begun developing the appropriate documents and plans for building a modern, NATO-compatible military, beginning with a Defense White Paper in 1998. Its plans and programs were tailored to NATO compatibility and membership, and the ARM's main missions were the protection of FYROM's citizens and the defense of its territorial integrity and sovereignty. The working assumption in the White Paper and related defense planning documents was that threats would emanate from outside the country. The events of spring 2001, however, changed those assumptions, and basically stalled defense reform plans both on the uniformed and the civilian sides of the defense establishment, as the ARM had to shift suddenly to counterinsurgency operations. Whether and when FYROM can really extract itself from the concerns of civil war and refocus on restructuring for the longer-term future is unclear. If and when it does, FYROM still will need to reaffirm and solidify its initial plans, which envisioned a 13,700 active-duty force divided into two corps by 2006. These numbers and structures, it is worth noting, are more in line with NATO recommendations than earlier plans, which called for force levels closer to 24,000.

Acquisition plans were also thrown up in the air by the ethnic Albanian insurgency, with long-term plans being put on the back burner in favor of purchases that would help immediately with counterinsurgency missions, such as helicopter gunships and multipurpose helicopters acquired from Ukraine. But FYROM's difficulties go well beyond those tied to a deferral of previously-planned defense reform and modernization, for it is still unclear whether or not FYROM can even get back on track as a unified political entity. Skopje, unfortunately, now has most of the markings of a failed state, and it must be placed for the time

being at the bottom of the list in Southeastern Europe in terms of promising futures.

Bosnia-Herzegovina

Largely due to ongoing domestic political schisms, Bosnia-Herzegovina has the unfortunate honor of being at the bottom of the heap, along with FYROM, in terms of any prospects for meaningful defense reform and modernization. Even though the 1995 Dayton Accords stopped the fighting in the country, the governing structures and procedures set up by those agreements, combined with the ongoing influence of hard-line political parties within each of the three former warring factions, have resulted in almost no movement toward the establishment of a unified state. As a result, formal military planning for an integrated, reformed, and modernized military has yet to move ahead in any serious way. Exacerbating the political ossification, moreover, is a poorly performing economy, despite high levels of international assistance. This, in part, is a result of the continuing split of the country into two almost self-governing entities, the Muslim-Croat Federation and the ethnic Serb Republika Srpska (RS). It is also the result of still pervasive levels of corruption both at the governmental level and within the civilian economy as a whole.

Some minimal movement toward the creation of a unified military, it is true, had been made in 2000 under the auspices of the Standing Committee on Military Matters (SCMM), but that was quickly brought to a halt in early 2001, as the Bosnian Croats pulled out of the Federation government and declared self-rule. The SCMM was designed to bring together the RS army and the Federation army at the top levels. Sometime in 2000, it was also supposed to become an effective state-level institution, but progress, as noted already, was limited at best. A draft state-level security policy was unveiled in May 2001, but nothing has moved forward because of the Croat separatist movement, and even if the Federation were healed it is not at all clear that the RS will be interested in seeing such an entity take on more power and responsibility. Even the most optimistic and interested party, the commander of the Federation army, does not believe that a joint army is possible before 2005, and that prognosis appears to be wildly optimistic. In the meantime, the Federation army is being trained and equipped mainly through the U.S.-sponsored "train and

equip” program, while the RS army remains trapped in time, both in terms of equipment and doctrine, as an offshoot of the old Yugoslav People’s Army.

DEFENSE INDUSTRIES – CAPACITY, ROLE, AND OPPORTUNITIES

The defense industries in these seven countries have undergone significant restructuring over the past decade, to some degree mirroring the changes in the militaries of the countries, and they are slated to undergo even more consolidation and modernization in the years ahead. Prime drivers for the vast changes within the defense industrial sectors are threefold: 1) the change-over to market economies; 2) the significant downsizing and restructuring of the region’s militaries, bringing with it a sudden decline in domestic orders; and 3) the loss of traditional export markets due to political changes within the region (the breakup of Yugoslavia) and/or because the desire to join Western institutions has limited sales to rogue states. The ongoing consolidation, privatization, and modernization of these industries, however, provides opportunities for outside involvement and investment, particularly in countries where the governments are interested in retaining an active defense industry and are therefore soliciting foreign investment and encouraging joint ventures. As some of the larger states described above, such as Romania and Bulgaria, move into the second phase of their military restructuring, they will also be procuring more significant amounts of defense products and services, and they will likely look first to domestic industry to fill these requirements or at least a key portion thereof. Hence, foreign vendors who have succeeded in establishing a recognized presence in these countries, preferably via some form of partnership with a local firm, will be all the better positioned to benefit both from in-country purchases and from those that must be made from suppliers based outside the country in question.

At the broadest level, the defense industries of Southeastern Europe can be grouped into three categories. In the first are those of Romania and Bulgaria, which are well-established and remain quite sizable, but are still in need of significant reform, privatization, and investment. The governments in both countries are interested in maintaining a fairly broad set of domestic capa-

bilities to produce defense goods and services, and therefore will be actively soliciting FDI and procurement. In addition, the domestic markets in Bulgaria and, more especially, in Romania have the potential to support some reasonable degree of domestic defense industry over the long run. They offer as well quite competent repair and maintenance facilities, which might serve in time as useful regional centers for such activities, especially as both countries become better able to handle NATO-standard weapons platforms and associated military equipment.

In Bulgaria, specifically, the military industrial complex (commonly known as the VPK) has traditionally been viewed as integral part of the national industry writ large, accounting in its heyday for over 10 percent of the GDP and employing over 500,000 people (some 115,000 directly, and the remainder in a more supporting role). Over the past decade, after multiple downsizings and restructurings, approximately two-thirds of the defense industrial sector overall has been privatized, and no more than 30,000 people working for twenty-five key companies are now thought to be directly engaged in defense production activities. Nevertheless, the Bulgarian government retains a strong interest in sustaining and revitalizing those enterprises that remain. Some companies (including those involved in military repair) remain under full government control, and the government maintains sizeable shares in a number of the more important privatized firms, sometimes including what is called a “golden share” allowing it to block certain corporate decisions. Whether and how to gain, maintain, and operate these “golden shares”, it should be admitted, has been a point of some debate within the Bulgarian government, and that debate has tended to work against the articulation of a clear and common vision for the future of the industry as a whole. So, too, even if this issue is resolved, the industry faces another challenge in the 2003-2005 timeframe when many of the Russian (and, to a lesser extent, Ukrainian) licenses that it possesses to manufacture and maintain Soviet-era equipment expire. Yet, whatever happens on the “golden share” and license fronts, the government will do all that it can to protect those industries that it considers to be “crown jewels”, such as VMZ and TEREM Corporation. Such enterprises will represent prime opportunities for foreign investment, as the government

seeks to secure for them both capital and technology inflows from more advanced companies, particularly from those based in NATO countries.

With some 120 firms employing (on paper at least) more than 95,000 workers, Romania maintains a diverse but bloated defense industrial sector, currently operating at anywhere from between 5 to 20 percent capacity, depending on the company in question. A legacy of years of economic and defense autarky under the former communist regime, the Romanian defense industrial sector desperately needs to be downsized and rationalized. Though increasingly open to private investment, most of the key companies are still owned by the state, and represent a drain on scarce government resources. Privatization remains in its early stages, and the government – while realizing the need for reform in this sector – wishes to retain a sizable and capable defense industry to support the military and provide export opportunities. Both the opportunity for, and the political incentive to facilitate, FDI in a range of Romanian defense firms can be expected to grow as these companies move further along the road toward privatization. This should be the case, especially with respect to nine large enterprises (eight factories and one shipyard) run by the Army Arsenal holding company and the twelve firms run by the Romarm holding company.

However, as with the reform and restructuring of the military, Bucharest has been better at producing plans than at implementing them, and true defense industrial reform and consolidation has been slow in coming. Because of the symbiotic relationship between the military and the defense industry, the Ministry of National Defense (MoND) remained for some time very cautious about downsizing and privatization schemes for companies considered real strategic assets, and, at least until quite recently, it has pressed the government to maintain, at minimum, a “golden share” in such companies once they were privatized. That said, pressures to encourage and extend the economic growth of 2001 and to prepare more aggressively for NATO membership are pushing Bucharest to leave behind past reservations over privatizing key firms and to accelerate the restructuring of the defense industrial sector. The large infrastructure, skilled workers, low salary requirements, and comparatively low energy

prices associated with this particular sector of the Romanian economy make it a potentially attractive arena for targeted investments by defense companies in NATO countries, and the MoND can now be expected to look upon such investments with considerable favor, especially if they were to come with offers of some degree of technology transfer.

The second grouping of Southeast European defense industries would include those found in the former Yugoslav republics of Slovenia and Croatia. Both are small countries with what will end up being small militaries that will, as a result, sustain only minimal internal markets, unquestionably too small to support on their own any sizable degree of domestic defense production. In addition, the breakup of Yugoslavia has deprived those industries that did exist at the time in both countries of most of their traditional markets, which used to be almost entirely internal. Given their vastly differing political situations up until recently, however, Slovenia is well ahead of Croatia in terms of the restructuring, privatization, and, where possible, conversion or diversification of its defense industrial sector. Over the past decade, Slovenia has evolved from having a defense industry in the classic, narrowest sense to having a variety of industries that retain a small (well less than 50 percent in terms of revenues) defense product and services component. Virtually all of the industries in Slovenia are fully privatized or open to privatization, and many are seeking both new export markets and foreign investment or partnerships. Among the more prominent firms now operating in the defense sector are STO Ravne (a subgroup of which produces, among other things, a variety of high-quality artillery/gun barrels and parts, as well as a range of APC and tank upgrades) and Fotona, a leading European producer of military (and medical) opto-electronic devices. Croatia may follow Slovenia's path, but it is over five years behind, due to the war in Bosnia and then the post-war policies of the Tadjman government. During the war, a state-owned arms and procurement entity, RH Alan, coordinated all research, development, production, and imports. RH Alan is now refocusing to link up Croatia's small number of domestic producers with foreign partners for exports, investment, joint ventures, and offsets (when the Croatian Armed Forces must turn to foreign producers for their purchases). So

far, Croatian industries, like those in Slovenia, are focusing on niche markets (such as tank upgrades), but it is yet to be seen whether they can develop adequate export markets to remain solvent.

The third grouping of defense industries among the countries under study would include those of Albania, Bosnia-Herzegovina, and FYROM. Because of the political situations in Bosnia and FYROM and because of the economic difficulties in all three, the prospects for any restructuring that might result in profitable and viable defense industries remain rather dim for the moment. Despite recent signs of economic growth, Albania, for example, remains an extremely poor country by European standards, with one-half of its GDP still being produced by the agricultural sector. In communist days, Albania pursued to a large extent a policy of autarky in the defense production arena, but what industry there is today remains largely first-generation, with little high-technology or skilled human capital. Moreover, Albania's overall poor infrastructure has served as a brake on FDI and industrial growth more generally, and corruption and safety issues continue to hinder foreign interest in Albanian companies, regardless of the industry. Those defense-minded firms that are still up and running focus primarily on producing small arms and ammunition, and, while the government hopes to be able to use them to help resupply the AAF, there are not likely to any major, sustained orders – even for relatively unsophisticated items – until the post-2004 phase of the Ten Year Implementation Plan.

FYROM's industry, even before the civil strife, was tiny, technologically obsolete, and lacking in capacity to meet even the rather limited needs of FYROM's recently-established military. During the Yugoslav days, not much defense industry was even located on FYROM territory, and no new industry in this sector has sprung up since the country's independence. There are a number of contributing factors for this situation, notable among them being the lack (initially at least) of a high-demand local market, FYROM's overall economic weakness, and, most importantly, the instability of the Western Balkans as a whole, which has discouraged FDI in FYROM as in Albania and Bosnia-Herzegovina. As of now, the largest defense-oriented industry that exists in the country is Eurokompozit, a part of the larger Euroinvest Holding Group. This company primarily

manufactures light weapons under license using Yugoslav technology. However, the future of Eurokompozit, or, for that matter, any other industry of merit, is for now a hostage to the larger political-economic picture, which is, itself, a hostage to the unfolding drama of ethnic Albanian-Slav relations.

By contrast, before the breakup of Yugoslavia, Bosnia-Herzegovina was home to most of the country's defense industry. With some 65 military factories employing more than 40,000 workers, the Bosnian-based defense industrial sector was one the most productive sectors of the pre-war economy, with export earnings of about \$2 billion during the 1980s. However, the war destroyed or damaged most of this industry. That portion which survived the war flourished during the civil hostilities, producing small arms and ammunition for the warring factions. For the most part, however, these factories closed down after the Dayton Accords, although some have begun to produce again on a small scale, exporting ammunition and mines to the tune of some \$10 million in 2000. Two companies, in particular, stand out – Binas (which produces a NATO-standard 40mm shell) and Igman (which produces pistols and a range of ammunition products). As with the rest of the state, however, the overall political situation makes long-term planning difficult, and ongoing corruption and accounting problems rightly limit the interest of foreign investors.

NATO INTEGRATION AND MEMBERSHIP

In November 2002, the NATO heads of state will meet in Prague to decide whether to invite more countries to join the Alliance. Five countries in southeastern Europe are hoping to be invited, but, realistically, some are going to be disappointed. The NATO decision about who to invite in the second wave of enlargement will be based largely on political considerations, but the degree to which the aspiring members have reformed, restructured, and modernized their militaries to be compatible with NATO standards certainly will be a key input into the decision making process. Predicting NATO membership invitations is always fraught with hazards as was evidenced in 1997, when it appeared right up until the summit that Romania and Slovenia would be invited to join along with the Czech Republic, Hungary,

and Poland. However, considering current levels of defense reform and restructuring, along with political, economic, and geopolitical dynamics now in train, in each of the seven Southeast European countries under study, this is how the bidding shapes up as of early 2002.

Slovenia is the top candidate for NATO membership of any of the aspiring states, including Slovakia and the Baltic states. Unless the Alliance opts to invite no candidates in 2002, Ljubljana can count on an invitation. The reasons for this are three. First, Slovenia was on the short list in 1997 along with Romania, and was bumped off primarily because Washington wanted to keep enlargement limited to see how the Alliance would function with new members. Since 1997, and particularly since October 2000 with the new government, Slovenia has become an even stronger candidate. Politically and economically, it was ready in 1997. Since then, the new government, and particularly the new MOD, has begun to make progress on implementing the well-designed plans for reform and restructuring that they have had on the books. Barring a political catastrophe, Slovenia will be invited to join NATO in Prague.

The candidacies of Bulgaria and Romania are much less certain. Bulgaria, which was not seriously considered in 1997 because its government at the time was not interested, has now done an about-face, and, in the eyes of many Allied officials, it has overtaken Romania somewhat as the favored larger state from Southeastern Europe. Its defense reform and downsizing still have some way to go, but Bulgaria has picked up political points and supporters for its prompt cooperation with NATO during the Kosovo operation, and advocates of a more sizable enlargement in 2002 are looking seriously at Sofia. Romania, on the short list in 1997, has fallen back a bit. Until very recently, domestic political squabbles and economic problems, combined with a near chronic inability to implement reform plans with the same enthusiasm with which such plans were developed, have led to frustrations at NATO. As noted earlier, however, steps taken over the past year by the Social Democratic-led government elected in November 2000 appear to have put Romania back on track, and to have bolstered its candidacy. That said, neither Bulgaria nor Romania is likely to be invited to join NATO without the other, so the choice in November 2002 will probably be both or none, with Bucharest, assuming a posi-

tive decision in that regard, riding a bit on Sofia's coattails.

Albania and FYROM are both officially candidates for NATO membership, but neither stands a chance of being invited in 2002. Albania has been in PfP since early on, has been involved in NATO's Planning and Review Process (PARP) since 1996, and has been involved in the MAP process since its inception, but it simply has too far to go to be invited in the near term. FYROM is in a similar (if not worse) situation, exacerbated now by the political unrest in the country. While NATO now has an ongoing peacekeeping operation in FYROM, it is highly unlikely that the Alliance will want to formally include Skopje in its collective defense arrangements anytime soon.

Croatia may eventually become a candidate for NATO membership, but the war in Bosnia and the policies of Franjo Tudjman held up its integration with the Alliance until his death and the election of a reform government in January 2000. Since then, Croatia has made significant progress, joining PfP in June 2001 and applying to join the MAP process later in 2001. In May 2001, Zagreb was also invited to attend the meeting of the Vilnius nine (the formal NATO aspirants) as an observer. If Croatia can clear up the few issues it has regarding refugee return and forwarding former army officers to the International Criminal Tribunal for Yugoslavia, it should formally become a candidate in the next one to two years. Finally, Bosnia is simply not under consideration. NATO's peacekeeping mission there continues and will likely continue for years to come, and that is likely to be the closest affiliation with the Alliance that Sarajevo can expect for at least the next five years.

CONCLUSIONS AND RECOMMENDATIONS

For NATO-based firms looking at whether there are business opportunities related to defense goods and services in Southeastern Europe, then, the picture is an interesting one. Opportunities do exist both for sales and for investment as all seven of these states continue, at varying rates, to reform and modernize their militaries and their defense industries. The opportunities differ, however, from those in established NATO markets because of the significant restructuring taking place in these militaries and in their associated defense industries. Whereas purchases in NATO

countries are incremental and designed to build on relatively well-established force structures, those made by Southeast European states will support wholesale changes in the structure and capabilities of their armed forces. Moreover, the reform and restructuring of the defense industries in these countries has opened up significant opportunities for investment, often at a sizable discount, as governments seek FDI, technology transfer, and expanded markets to keep key portions of their defense industries alive.

All that said, the markets for sales will not be large other than, perhaps, in such countries as Romania, which hopes to maintain (in regional terms) a relatively large force structure, and Bulgaria, which, together with Romania, has traditionally fielded fairly robust, high-tech military capabilities. In addition, other than in Slovenia, most of the larger purchases are likely to be pushed to the out years – after 2004 at the earliest, due to budgetary constraints. However, this does not mean that companies wanting to get in on the market can wait until that point to become engaged. Since the markets are small in each of these countries and since the connections between military modernization, procurement, defense industry reform and modernization, and overall economic growth are so tight, involvement and investment in almost any aspect of the market early on will reap dividends down the road when larger purchases are considered. This is true, especially with regard to industrial sectors – e.g., telecommunications, electronics, transportation, and infrastructure development – that are likely to have direct military spin-offs and/or are key facilitating capabilities for military operations. The requirement for offsets in almost every country covered also shows the strong linkage between defense procurement and defense industry and overall economic health. Countries and companies that help bolster overall reform efforts and provide economic opportunities in almost any sector, therefore, will be looked upon more favorably when future procurement decisions are made.

More specifically, companies interested in penetrating markets in Southeastern Europe should consider the following types of strategies, singly or in combination:

- *Establish Joint Ventures That Create Long-term Market Access.* Many firms in Southeast European defense industrial

sectors lack long-term viable markets. Their domestic markets have shrunk, and most of their former foreign markets have either disappeared as well or are no longer politically acceptable. Even if there are opportunities to sell domestically, these contracts alone will not suffice for long-term viability. In fact, significant purchases in many of these countries are sufficiently far in the future that companies need alternative near-term markets to survive. Joint ventures that provide new and on-going access to politically acceptable export markets – whether in NATO countries or elsewhere – hold the potential to sustain Southeast European firms and to build political goodwill for the future. Such ventures, moreover, do not necessarily have to be in the defense field. Market and revenue-generating ventures that support the civilian side of an industry with defense capabilities or potential would be sufficient to keep firms viable and to retain skilled workers for times when domestic defense markets rebound.

- *Consider Direct Investment and Subcontracting Options.* Even if new markets are not available, companies should consider some degree of direct investment, particularly in the more viable and stable industries in such countries as Slovenia, Bulgaria, and Romania. These could be in the civilian sector, in the defense sector, or in a mix of the two. In Bulgaria and Romania, moreover, attention should be paid to the option of investing in or bringing business to the rather well-developed military repair and maintenance sectors, as they are relatively competitive and could emerge in time as regional centers of excellence, serving a wider client base. Investment, it should be remembered, will be counted at a higher rate than direct purchases for future offset agreements, and it is a good way to establish an in-country presence on the ground, providing political connections and political capital as well.
- *Direct Sales in Areas of High Interest to NATO.* While purchases over the next several years will likely be minimal in most of the countries under study, companies would generate goodwill both in various

national capitals and in Brussels by offering sales that directly meet NATO requirements for the countries in question as outlined in their MAPs. In particular, almost all countries are focusing on C4I architectures at the strategic, operational, and tactical levels. Fulfilling these requirements with NATO-compatible systems could produce benefits by helping Southeast European countries meet priority goals as proposed by NATO and by NATO member countries that are providing direct advice on modernization plans (via, for example, planning teams seconded to the MODs and General Staffs of the countries in question).

- ***Lobby for Changes at NATO That Benefit Southeast European Industry.*** Companies can gain advantage by being seen as a friend of Southeastern Europe at NATO. While lobbying, say, for more open bidding processes that could bring in Southeast European industries may at first seem to be self-defeating, it should rather be looked at as part of a broader strategy to bolster that company's bidding prospects for NATO and NATO-country contracts. If bidding processes are opened and the company in question has ties into several Southeast European defense firms, it may then have a number of new, different, and potentially lower-cost ways to meet bid requirements. Success on this front, again, would also open doors later on in the competition for sales to the restructured militaries of Southeastern Europe.
- ***Be a National Champion for Appropriate Ties with Southeast European Countries.*** Companies seriously considering longer-term ties to the countries of Southeastern Europe should also be seen as leaders within their own country in promoting those ties. Toward that end, efforts could be made, for example, to organize defense industry trips and defense reform-oriented conferences and workshops that could provide useful forums for establishing Southeast European contacts and for clarifying emerging market opportunities. Companies seeking wider entry into Southeast European countries should also take the lead in pushing for government-to-government cooperation in defense reform and modernization and

for unofficial or semi-official "track two" activities and discussions. This could include hosting or sponsoring high-level dialogues on such as issues as interoperability, joint/combined operations and training, and defense cooperation at the broader policy level that would bring together NATO state experts with those from the target countries. These are low-cost, goodwill gestures that will be seen as an expression of interest in the well-being of the Southeast European countries so engaged, regardless of whether sales or investment can take place in the near-term.