CENTRE OF PLANNING AND ECONOMIC RESEARCH

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RITSA PANAGIOTOU

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Transition, Growth, and Prospects for EU Accession

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PREFACE

This book presents an analysis of the economies of the Western Balkan countries, focusing on issues of their transition process, their search for growth and stability, and the prospects of their accession to the European Union. After the tumultuous 1990s, a period that witnessed the disintegration of Yugoslavia, destructive military conflicts, ethnic tensions, refugee turmoil, nationalistic policies, sanctions and embargoes, the countries of the region chose the path of transition, through political and economic reforms. It has been a slow and arduous process, but one that ultimately led to stability and peace in the region, as well as closer links to the European Union.

However, just as the Western Balkan countries were consolidating their hard-earned progress, new, extremely unfavorable circumstances confronted the region. The Eurozone crisis in general and the crisis in Greece (a crucial trade and investment partner for these countries) in particular, have created extremely difficult conditions for the Western Balkan countries and their accession prospects. In addition to the negative economic environment, the Western Balkan countries are confronted with the European Union's growing "enlargement fatigue". Crucially, enlargement fatigue is matched by an emergent "evaluation fatigue", as local populations tire of the endless cycles of assessment linked to the EU's conditionality and accession criteria.

All the above factors make both the economic reform process and the EU accession path all the more difficult, and the Western Balkan countries may find themselves in the waiting room of the EU for a long time. However, as this study proposes, there is no other viable option for these countries than to rise to the ultimate challenge of staying on their reform and consolidation path, despite the extremely unfavorable international conditions, and despite the growing enlarge-

ment and evaluation fatigue. In an area of such high volatility, the alternative could be a return to instability, insecurity and uncertainty.

Professor PANAGIOTIS G. KORLIRAS
Chairman of the Board
and Scientific Director

CENTRE OF PLANNING
AND ECONOMIC RESEARCH (KEPE)

July 2012

The objective of this study is to analyse the long and arduous process of radical economic and political transformation that brought the Western Balkan countries from a state of economic backwardness, political instability and international isolation, to the doorstep of the EU. The study is separated into two parts. Part I presents an analytical overview of the economies of the Western Balkans, from the communist period to today. The analysis includes a brief overview of the countries' communist legacy and an examination of the transition period which followed the collapse of the communist structures. It also discusses the impact of the global economic crisis –especially the prospect of contagion from the crisis in Greece– on the economies of the region. Part II analyses the course and depth of relations of the European Union with the countries of the Western Balkan region. The discussion includes an overview of the various phases of EU policy towards the region since the early 1990s, an analysis of the Stabilisation and Association Process, and an examination of the current status of bilateral relations between the EU and the individual Western Balkan states. The study concludes with an evaluation of the overall accession process and an appraisal of the prospects of full integration of these countries into the EU.

The countries under examination are the Western Balkan countries that are partners in the Stabilisation and Association Process, namely Albania, Bosnia-Herzegovina, Croatia, the Former Yugoslav Republic of Macedonia, Montenegro and Serbia. The study also does not include a discussion of the accession process of Slovenia, who became a full member of the EU in 2004, or Bulgaria and Romania, who joined in 2007.

The author would like to thank the two anonymous referees for their helpful comments and insights on the issues discussed in this study, Mrs Soultanakis for her careful editing of the text, as well as all those who helped bring this work to publication. All errors, omissions and mistakes in this study are the author's own.

RITSA PANAGIOTOU

July 2012

TABLE OF CONTENTS

CHAPTER 7

THE WESTERN BALKANS' EU PERSPECTIVE: AN APPRAISAL

LIST OF TABLES AND FIGURES

INTRODUCTION

Since the fall of the Berlin Wall in November 1989, the transition to market economy and multiparty democracy has been a much more difficult challenge for the countries of the Western Balkan region than for those of Central and Eastern Europe. The 1990s were a period of extreme instability in the region, which witnessed the disintegration of Yugoslavia, destructive military conflicts, ethnic tensions, refugee turmoil, nationalistic and inward-looking rhetoric and policies, sanctions and embargoes, culminating in NATO's attack on Serbia in the spring of 1999. During this period, political and economic reform was not remotely on the agenda. Moreover, the Western world's focus on the more advanced transition economies encouraged the perpetuation of a "two-speed transition", whereby countries such as Poland, Hungary, the Czech Republic and the Baltic States moved rapidly on their transformation path, while the Balkan countries languished in a vicious circle of ethnic violence, economic underdevelopment, political and social turmoil, and international isolation.

During this turbulent period, the European Union's (EU) policy towards the countries of the Western Balkans was not focussed and coherent, despite geographical proximity and implicit European interest in the stability of the region. The EU was notoriously absent from constructive policy-making in the Western Balkans, and it was unable to formulate a clear policy and respond to the series of challenges that emerged from the region. It was only in the late 1990s, and especially following the NATO bombing of Serbia in 1999, that the EU acknowledged the necessity of a more "hands on" approach to the Balkan region and the creation of a strategy which would draw these countries closer to the prospect of European integration. This realisation gave birth to what was to become the backbone of the EU's policy towards the Western Balkans, namely the Stabilisation and Association Process. The aim of the Stabilisation and Association Process –which also offered the prospect of membership in the EU– was to support the countries of the Western Balkans in their efforts to foster peace, democracy, respect for human rights, political stability and economic prosperity. At the core of this strategy was the project of "Europeanisation" of the region, which would anchor the countries of the Western Balkans firmly into the values and institutional structures of the European community. Ultimately, attachment to the EU was meant not only to act as a catalyst for reform, but also to ensure that this path would become irreversible, and to make conflict, extreme nationalism, ethnic strife and war in the region "inconceivable".

From the very beginning it was clear that the transition process as well as the integration of the Western Balkan countries into the EU would be an entirely different process than that which led to the accession of the other formerly communist states. The integration of the Western Balkan countries presented a unique set of challenges and difficulties due to the heavy inheritance of the region – an inheritance which was largely linked to the violent break-up of the former Yugoslav state. Thus, in addition to the difficulties associated with fulfilling the necessary political and economic criteria for EU accession, the successor states of the former Yugoslavia also had to overcome a legacy of violence and inherent mistrust, in order to move forward on the path of individual progress combined with regional cooperation.

The pursuit of radical economic and political transformation that brought the Western Balkan countries from a state of economic backwardness, political instability and international isolation, to the doorstep of the EU, was a long and arduous process. This process is the object of this study, which is separated into two parts. Part I presents an analytical overview of the economies of the Western Balkans, from the communist period to today. Chapter 1 will present the background to the transitions pursued by these countries, by briefly examining their communist legacy: almost all the difficulties faced in the transition period can be traced to these countries' communist inheritance. Chapter 2 proceeds with an examination of the transition period which followed the collapse of the communist structures. It analyses the challenges faced and the accomplishments achieved as these countries endeavoured to radically transform their political and economic systems. Clearly one cannot begin to understand the issues involved in the Western Balkans' accession process without having an insight and an appreciation of the course these countries have followed over the past two decades. Chapter 3 discusses the impact of the global economic crisis –especially the prospect of contagion from the crisis in Greece– on the economies of the region. Since these newly-stabilised economies are particularly vulnerable to the fallout from the crisis, the new realities threaten not only to reverse the significant progress achieved, but also to slow down the enlargement process.

Part II analyses the course and depth of relations of the European Union with the countries of the Western Balkan region. Following a discussion in Chapter 4 of the various phases of EU policy towards the Western Balkan countries since the early 1990s, Chapter 5 proceeds with an analysis of the Stabilisation and Association Process. The Stabilisation and Association Process represented a breakthrough in European relations vis-à-vis the Western Balkans, not only because it was the Union's first coherent and constructive policy for the region, but also because it offered the prospect of accession to the EU upon fulfilment of a specific set of criteria. Chapter 6 analyses the current status of bilateral relations between the EU and the individual Western Balkan states, including their progress in fulfilling the stringent accession criteria. The study concludes with an evaluation of the overall accession process and an appraisal of the prospects of full integration of these countries into the EU. It attempts to draw some conclusions on how the enlargement process –already a difficult challenge due to the legacy of the region– will be further affected by extremely unfavourable exogenous circumstances, namely the repercussions of the global economic crisis and the Greek sovereign debt crisis. Clearly there is a lot at stake for both sides of the EU-Western Balkans relationship. The Western Balkans are the European Union's final frontier, and the prospect of enlarging the EU to include these hitherto warring countries is undoubtedly a major challenge. In light of the deteriorating international environment, it remains to be seen whether the momentum of the enlargement process can be maintained.

The countries under examination are the Western Balkan countries that are partners in the Stabilisation and Association Process. In this context, the term "Western Balkans" –which is used throughout the study– encompasses Albania and all the successor states of the Socialist Federal Republic of Yugoslavia (SFRY) except Slovenia: namely Bosnia-Herzegovina, Croatia, the Former Yugoslav Republic of Macedonia, Montenegro and Serbia. Slovenia –which was the most advanced of the constituent republics of SFRY and has been a member of the EU since 2004 and the Eurozone since 2007– benefited from two crucial factors: peace and geography. The fact that Slovenia escaped from the disintegrating Yugoslav state relatively painlessly and enjoyed a favourable location next to prosperous EU countries (Italy and Austria) contributed to Slovenia's rapid success. This was in contrast to the fate of the other countries in the region that experienced the full destructive force of the country's disintegration, as well as international isolation. The study also does not include a discussion of the accession process of Bulgaria and Romania, which became full members of the EU in 2007.

PART I

THE ECONOMIES OF THE WESTERN BALKAN REGION: THE ROAD TO TRANSITION

In the early 1990s, while the countries of Central and Eastern Europe were pursuing their political and economic transitions –from single-party rule to democracy, and from centrally planned to market economies– the countries of the Western Balkans were exceptionally unprepared for the demands of transition. The region's inability to follow the path and pace of transition set by the more advanced Central and Eastern European countries was due to a combination of two factors: inheritance and circumstance. Thus, on the one hand the countries inherited a system so uniquely dysfunctional that a total overhaul of all major public institutions was needed before the transition could be launched (as was the case in Albania). On the other, the circumstances were such that instead of focusing on state-building and the necessary transition steps, the countries were distracted by the repercussions of the violent break-up of Yugoslavia. In both cases, these factors translated into an extremely complicated, problematic and difficult transformation process.

CHAPTER 1

BACKGROUND TO CHANGE

1.1. Albania

When the communist system collapsed, Albania was defined as the poorest country in Europe. Its extreme poverty can be attributed mainly to Enver Hoxha's particularly rigorous adoption of the Stalinist model of development. This model, based on the principle of national autarky, self-reliance and unprecedented isolation from the world economy, was to be the crux of the country's economic policy throughout the entire communist period.[1] The government nationalised all industries, transformed foreign trade into a government monopoly, brought almost all domestic trade under state control and banned land sales and transfers. Due to the inconvertibility of the Albanian currency, exports determined imports and the state determined the official exchange rate.[2] State ownership and regulation of business, the lack of private property and price fixing were also aspects of the economic system from 1975 to 1990. Over the years, Albania progressively withdrew from the international economic system and all international economic institutions: in succession, Hoxha severed trade and economic association with Yugoslavia, the Soviet Union and finally China. After the split from China in 1978 Albania was cut off almost entirely from the rest of the world, and refused all foreign aid or investment.[3]

In parallel, Albania was ruled by one of the most rigid and oppressive dictatorships within the entire communist bloc, exhibiting an unprecedented combination

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1 M. Kaser, "Albania under and after Enver Hoxha", *East European Economies: Slow Growth in the 1980s,* vol.3: *Country Studies on Eastern Europe and Yugoslavia*, Joint Economic Committee, Congress of the United States, Washington, D.C. March 1986.

2 G. Brancati, "The Albanian Economy during the Communist Regime", in T. Perna et al., *Passage to the West*, Publishing House of IFAW, Tirana, 1996.

3 O. Sjoberg, "The Albanian Economy in the 1980s: Coping with a Centralised System", in O. Sjoberg and M. Wyzan (eds), *Economic Change in the Balkan States: Albania, Bulgaria, Romania and Yugoslavia,* Pinter Publishers, London 1991.

of repression and isolation.[4] The political system was characterised by a complete subjugation of basic human and political rights: freedom of expression was stomped, political and civic pluralism and democratic institutions were forbidden, free movement of people and information (media, literature, art) was prohibited, all religious institutions or even beliefs were strictly forbidden and no international organisations were allowed in the country.[5] The only international organisation that Albania joined and did not withdraw from was the United Nations; even development organisations such as the World Health Organisation were abandoned. Albania was cut off from any kind of political, economic and cultural links with the outside world, and the leadership cultivated an atmosphere of xenophobia and paranoia towards all things foreign. The regime's claim that the country was surrounded by "external enemies" was used to justify economic hardships, isolation as well as the regime's control over every aspect of life.[6]

The country's self-imposed and unprecedented isolation left a legacy of political passivity, as Albanians had no points of reference apart from those given by the regime. Albania did not share in the revolutionary experiences of the other centrally planned economies that led to the collapse of communist regimes in Central and Eastern Europe in 1989. Due to the country's extreme isolation, many Albanians did not even know that the Berlin Wall had fallen. The lack of a democratic liberal elite and dissident intellectual groups as initiators and leaders of the democratic movement was one of the crucial features distinguishing Albania from other formerly communist countries. It is extremely difficult for democratic ideals and procedures to take root in a society with such an extreme experience of repression and isolation. This legacy of mistrust, lack of community and any concept of civil society are evident in Albania even today. The difficulty in overcoming this legacy has been one of the key features of Albania's transition; it has also been one of the main impediments to its attempts to achieve the democratic credentials necessary for admission to the EU.[7]

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[4] M. Bogdani and J. Loughlin, *Albania and the European Union: The Tumultuous Journey towards Integration and Accession,* I.B Tauris, London, 2009, p. 24.

[5] P.R. Prifti, *Socialist Albania since 1944: Domestic and Foreign Developments*, MIT Press, Cambridge MA, 1978.

[6] An example of this extreme paranoia was the building of tens of thousands of concrete bunkers as the country prepared for "attack from abroad", mainly from its "two biggest enemies – Soviet revisionism and American imperialism". Bogdani and Loughlin, *op. cit.*, p. 25.

[7] R. Panagiotou, "Albania and the EU: From Isolation to Integration", *Journal of Balkan and Near East Studies*, 13 (3) September 2011, pp. 358-361.

However, Albania's negative historical legacy is not limited to the communist era: even before the communist period Albania had never experienced a genuinely democratic system. In fact, throughout its history Albania has had no experience with even the rudiments of democratic procedures. This is a crucial distinction between the Visegrad countries[8] and those that had been within the Ottoman Empire: the Visegrad countries had –to a greater or lesser extent– shared a number of the experiences of West European states, such as the Renaissance, the Reformation, industrialisation and urbanisation, and they never entirely broke their ties with the West. Albania, however, had been a part of the Ottoman Empire for 500 years, after which it experienced the authoritarian monarchy of King Zog, followed by almost five decades of communist rule which further intensified the economic, political and cultural divergences between Albania and the rest of Europe.[9]

Thus, Albania's difficulties in its transition process are inextricably linked to this unique combination of centuries of Ottoman rule and decades of extremely isolationist communist rule, the *leitmotif* of both being a legacy of no democratic experience. Thus, unlike other former communist countries, which had developed civil societies before the communist era and could draw on their past experiences when building post-communist societies, Albania had no such experience or point of reference. Albania had the longest distance to travel from a rigid isolationist Stalinist regime to democracy, and its task of "catching up" with the West was immense and daunting.[10] Albania thus started its transition from an extremely low level: not only was it the poorest country in Europe, but it also had to make up for years of inertia, introversion and lack of any experimentation with reform compared to the other centrally planned economies of Central and Eastern Europe.[11] Considering the unprecedented level of Albania's isolation from the international political and economic scene, it is hardly surprising that it was the last of the Central and East European countries to embark upon its "dual transformation", aiming to achieve political democratisation and economic reform.[12]

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[8] The Visegrad countries are Poland, Hungary, the Czech Republic and Slovakia.

[9] D. Hall, *Albania and the Albanians*, Pinter Reference, London 1994, p. 185.

[10] E. Biberaj, *Albania in Transition: The Rocky Road to Democracy*, Westview Press, 1998, p. 149.

[11] G. Antonelli (ed.), *The Transition to Market Economy in Albania*, Instituto di Recerca sulla Dinamica dei Sistemi Economici (IDSE), Milan, 1992, p.6; G. Pashko, "The Albanian Economy at the beginning of the 1990s", in O. Sjoberg and M. Wyzan (eds), pp. 143-144.

[12] G. Pridham, *The Dynamics of Democratisation: A Comparative Approach*, Continuum, London and NY, 2000, p. 181.

1.2. The Socialist Federal Republic of Yugoslavia (SFRY)

1.2.1. Ethnic and Regional Diversity: The Complexity of the Jigsaw

The Socialist Federal Republic of Yugoslavia has been described as a country with two alphabets, three religions, four languages, five nations and six federal states. Josip Broz Tito, Yugoslavia's leader throughout the post war era until his death in 1980, had created an intricate structure of political weights and balances to try to satisfy the different constituent parts of the multinational country. The Socialist Federal Republic of Yugoslavia was formally a decentralised federation, with significant autonomy granted to its six republics (Bosnia-Herzegovina, Croatia, Socialist Republic of Macedonia, Montenegro, Slovenia, and Serbia) and to the two autonomous provinces that existed within Serbia, namely Vojvodina and Kosovo. As far as the institutions of the federal state were concerned, the executive consisted of the Presidency and the Federal Executive Council. Tito held the office of President until his death in 1980, when the position was abolished as an individual office and replaced by a collective presidency. There were nine members of the State Presidency – one from each of the constituent republics, one each from Vojvodina and Kosovo and one *ex officio* member. The office rotated annually among the eight full members, who could serve up to two consecutive 5-year terms.[13]

The federalist structure of Yugoslavia was a concession to the nationally segmented character of the Yugoslav population, to whom it provided a parallel structure of relatively independent Republican apparatuses. But republics were not synonymous with nations: only Slovenia was ethnically homogeneous. Croatia had a significant Serb minority, Serbia a significant Croatian minority, Bosnia-Herzegovina was predominantly Muslim but had both Serb and Croatian minorities, SR Macedonia had Albanian minorities, Vojvodina had a sizeable Hungarian population and Kosovo had a majority Albanian population. Occasionally ethnic animosities found outlets within the boundaries of a specific republic. A continuous tension was present between the better-off Slovenians and Croatians and the other national groups, particularly the Serbs. In Croatia resentments became so great that in 1971 Croatian nationalists pushed their

[13] A. Pavkovic, "Multiculturalism as a prelude to state fragmentation: The case of Yugoslavia", *Journal of Southern Europe and the Balkans*, 3, 2, 2001, pp. 132-134.

cause to the point of declaring their right to secede.[14] The ensuing crackdown led to constitutional changes in 1974, which distributed more power to the republics at the expense of the federal centre.

TABLE 1
Gross Social Product per capita in the Socialist Federal Republic of Yugoslavia
(Slovenia=100, unless otherwise indicated)

Republic or province	1952	1965	1974	1980	1989	1997*	1999**
Slovenia	100.0	100.0	100.0	100.0	100.0	100.0	10,078
Croatia	66.7	65.8	62.5	64.1	64.1	48.0	6,464
Vojvodina	49.1	60.9	58.0	57.1	59.6	24.3	6,006
Serbia proper	56.7	52.2	48.0	49.5	52.0	18.9	5,243
Serbia incl. Vojvodina and Kosovo	51.5	50.0	45.0	45.5	46.0	17.1	4,632
Montenegro	48.5	41.3	34.0	39.9	36.9	16.1	3,716
Bosnia and Herzegovina	52.6	39.1	33.0	33.3	34.3	10.2	3,461
Macedonia	39.2	36.4	34.0	33.8	33.3	20.3	3,359
Kosovo	25.7	19.6	16.0	14.1	12.6	5.1	1,272

Source: OECD data.

* Data refer to gross material product per capita for Serbia, Montenegro, Vojvodina and Kosovo, and GDP per capita for other countries.
** Data are actual GDP per capita (in dollars at the then-current exchange rate).

Ethnic diversity, unequal regional development and great economic disparity between the republics were crucial factors contributing to the centrifugal forces which ultimately led to the unravelling and disintegration of Yugoslavia. Economic prosperity and rates of growth were highest in Slovenia and Croatia, and weakest in Kosovo and SR Macedonia.[15] Over the years, the more advanced republics resented being the "motor" of development, constrained by the needs of the less-developed republics. Slovenia in particular, which was the most developed republic of Yugoslavia by far –with six or seven times the GDP

[14] S. L. Burg, *Conflict and Cohesion in Socialist Yugoslavia: Decision-making since 1966* (Princeton: Princeton University Press), 1983, p. 53.

[15] F. Singleton, "Objectives and Methods of Economic Policies in Yugoslavia 1970-1980", in A. Nove, H. H. Hohmann, and G. Seidenstecher (eds), *The East European Economies in the 1970s*, London: Butterworths, 1982, p. 289.

per capita of the least developed region, Kosovo– felt especially threatened by its obligation to channel its national funds into less developed parts of the country. Economic differentiation tended to increase over time, mainly because of a considerably higher birth rate among the poor ethnic groups than among the richer ones. New jobs did not become available to meet increased supplies of labour; thus Slovenia, the richest republic, with one of the lowest birth rates increased its advantage, while Kosovo, the poorest region, with one of the highest birth rates, experienced an income decline relative to the national average.[16] The preceding Table 1 illustrates the regional differences in gross social product across the republics and provinces in SFR Yugoslavia over a period of about 4 decades.

1.2.2. The Yugoslav Economic Model: Self-managed Socialism

Yugoslavia was foremost among the new socialist states that emerged after the Second World War to apply the typical Soviet-type centralised system of planning and management. As early as 1946, nationalisation had progressed in the sectors of industry, mining, transport, banking and wholesale trade, while in 1947 the first five-year plan was launched. However, Yugoslavia experienced a severe crisis after Tito's break with the Soviet Union in 1948 and the country's expulsion from the Cominform, which precipitated the need for an alternative approach. Tito's famous speech of 26 June, 1950 on the creation of workers' councils can be considered the start of what came to be known as the "Yugoslav model of market socialism", or "self-managed socialism".[17] Over the next decades, the Yugoslav leadership was to implement policies which aimed at departing from the traditional Soviet model, but without abandoning some of the most essential features of socialism – primarily a one-party political system and non-private ownership of the majority of the economy and means of production.

A series of laws were passed starting in 1950 aimed at promoting the autonomy of the firm and the decentralisation of management within it. The objective of the new policies was to increase the economic and legal independence of

[16] J. Lovenduski and J. Woodall, *Politics and Society in Eastern Europe* (London: Macmillan), 1987, p. 161.

[17] N. Vagionis, W. Kafouros, and R. Panagiotou, "The Systemic Transformation of the Balkan Countries and the Repercussions on Economic Relations with Greece" (Athens: Centre for Planning and Economic Research), 2005 (in Greek), pp. 46-52.

enterprises so that the management of the national economy could be freed of as much bureaucracy and red tape as possible.[18] Enterprises that had hitherto relied on central directives suddenly had to rely on their own resources, powers and incentives. The principle of workers' self-management was based on the creation of workers' councils, which were charged with the formal responsibility for enacting policies on production, personnel, wages and investment.[19] Moreover, enterprises were allowed to retain a percentage of their profits, had the right to hire and dismiss workers, and to determine (within relative margins) the prices for their products. The central premise of this system was that each individual within the enterprise would have a material interest in the prosperity of the whole unit, providing a strong basis for the harmonisation of social interests.[20]

In the early days of the system of self-management, enterprises were eager and able to respond to the needs of a market characterised by very acute shortages and pent-up demand. This practice of focusing merely on quantity of output worked well during this early period, when neither quality nor variety of products were considered important. Very soon, however, as the market slowly became saturated the system proved unable to respond to the relationship between supply and demand as well as to the gradual shift towards demand for better quality and greater product diversity.[21]

Far-reaching reforms were launched in the early 1960s, which *inter alia* introduced elements of macroeconomic management, whereby monetary and fiscal policies were made responsible for stability and growth.[22] The Banking Act of 1965 established that with the exception of the National Bank, all other banks could operate independently and even compete against each other.[23] The reform of 1965 also inaugurated what has been described as a "polycentric" economic structure.

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[18] D. Bilandzic, *Management of the Yugoslav Economy, 1945-1966* (Belgrade: Yugoslav Trade Unions), 1967, pp. 45-48.

[19] E. Comisso, *Workers Control under Plan and Market: Implications of Yugoslav Self-Management* (New York: Yale University Press), 1979, p. 36; W. Brus, *Socialist Ownership and Political Systems* (London: Routledge and Kegan Paul), 1975, p. 33.

[20] D. Gorupic (ed.), *The enterprise and the development of the Yugoslav economic system*, Economic Institute of Zagreb, Zagreb, 1974, p. 72.

[21] B. Horvat, "Yugoslav Economic Policy in the Post-War Period: Problems, Ideas, Institutional Developments", *American Economic Review*, 61 (3), 1971, p. 91.

[22] J. Moravec (ed.), *25 years of the Yugoslav economy*, Yugoslav Trade Unions, Belgrade 1972, pp. 234-245.

[23] D. Granick, *Enterprise Guidance in Eastern Europe. A Comparison of Four Socialist Economies*, Princeton University Press, Princeton, 1975, p. 328.

Central control was so reduced that the centre was split into many decision-making units, and enterprises themselves were further split into self-managing work units, each with its own workers' council. The enterprises also acquired greater autonomy over their own financial affairs: they were no longer dependent upon central and local government, but could approach Republican Investment Banks.

During this time, SFR Yugoslavia was also the only socialist country to have privileged international economic and political relations. Unlike the Soviet Union and its six East European allies, Yugoslavia was not a member of the Council for Mutual Economic Assistance (CMEA) but joined the Non-Aligned Movement in 1961. Due to Yugoslavia's neutrality and its leading role in the Non-Aligned Movement, Yugoslav companies exported to both Western and Eastern markets, and carried out construction of numerous major infrastructure and industrial projects in Africa, Europe and Asia. Moreover, Yugoslavia was one of the founding members of the IMF and the World Bank, and became a member of the General Agreement on Tariffs and Trade (GATT) in 1966. Yugoslavia also had a privileged relationship with the European Economic Community (EEC): the 1967 *Declaration of Relations between the SFRY and the European Economic Community* was the first official document regulating relations between the two parties and creating the framework for future economic relations. Two trade agreements were signed in the following years, which granted Yugoslavia privileged access to European markets, and the country was also included in the EEC's General Scheme of Preferences in 1971. Finally, in 1980, Yugoslavia signed the most important, wide-ranging trade and economic cooperation agreement with the EEC: the agreement abolished almost all customs duties and quantitative restrictions, and introduced cooperation in areas of trade, finance, industry, agriculture science and social policy. In 1987 an additional protocol was signed on trade, along with the second financial protocol for the period 1987-1991. These agreements greatly contributed towards intensifying economic and political relations between Yugoslavia and the EEC in the 1970s and 1980s. They also facilitated a significant increase in Yugoslavia's trade with the EEC countries: during the period 1968-1977, Yugoslavia's exports to the EEC tripled, while its imports rose by almost four and a half times.

However, despite significant advantages bestowed by Yugoslavia's enhanced relations with the West, and its experiment with "market socialism", the Yugoslav model also had severe endemic weaknesses, which were exacerbated over time.[24] Firstly, the system perpetuated the misallocation of investment

[24] D. Gorupic, *op. cit.*, p. 72; R. Stojanovic (ed.), *The functioning of the Yugoslav economy*,

and the inefficient use of funding.[25] For example, workers had no reason to reject investments as long as they were financed by bank loans, since this would enhance the productivity of their enterprise and increase their wages. This implied that investment projects could be undertaken by enterprises which were already financially robust and benefited the workers employed there, instead of being directed towards sectors which either possessed greater comparative advantages or promoted social welfare more readily. Thus, large and wealthy enterprises grew larger and wealthier while others, including those with inherent financial difficulties, reached a state of collapse from which it was impossible to recover.[26] Also, after 1961, when the determination of wages was left entirely within the jurisdiction of enterprises, the nominal increase in wages was 20% per annum, while the annual growth of industrial labour productivity was 5.5% in the 1960s and 3.5% during the period 1971-1975.[27]

After 1965 price controls were lifted from more than 50% of manufactured goods, leading to a steady increase in inflation over the next years.[28] Measured by the Yugoslav Retail Price Index, inflation had been around 3 percent in the 1950s, leapt to 34 percent in 1965, and settled down again to 11 percent in 1970. Throughout the 1970s, however, it took off again and rose to 47 percent in 1981.[29] Moreover, since from 1965 enterprises were granted full rights in determining the size of their labour force, dismissing part of it if the financial circumstances required it, Yugoslavia had the dubious distinction of being the only socialist country exhibiting both inflation and unemployment.[30]

Finally, the transformation of the banking system into a collection of about fifty five independent "business banks", left the federal authorities with control of reserve regulations and rediscounting procedures only. At the same time these banks were being controlled by those enterprises investing equity capital and placing their deposits with them. The effectiveness of the above, together

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M.E. Sharpe, Armonk, N.Y., 1982, p. 125.

[25] W. Kafouros, "The Prerequisites and Requirements for Self-Management: The Case of Yugoslavia", Research Paper no. 77, School of Business and Public Administration, Charles Sturt University - Mitchell, Australia, 1991.

[26] R. Stojanovic, *op. cit.*, p. 125.

[27] L. Sirc, "The Industrial Enterprise in Yugoslavia", in Ian Jeffries (ed.), *The Industrial Enterprise in Eastern Europe,* Praeger Publishers, New York, 1981, p. 148.

[28] Granick, *op. cit.*, p. 345.

[29] F. Singleton, *op. cit.*, p. 284.

[30] S. Woodward, *Socialist Unemployment: The Political Economy of Yugoslavia, 1945-1990*, Princeton University Press, Princeton, 1995.

with Yugoslavia's opening to foreign investment and imports in 1967 (the first socialist country to do so) and the subsequent permission to export profits, resulted in a turnaround of the balance of payments from a positive 1.8% of gross trade imports in 1965 to a deficit of 16.5% in 1970.[31]

The decentralisation of authority which was pursued in the late 1960s led to many important political developments and decisions being taken at the level of the republics, and not at the federal. This devolution of power was legalised in the 1974 Constitution, which *inter alia* strengthened the rights and responsibilities of republics and autonomous provinces in virtually all economic areas, including prices, income distribution, taxation, employment, social security, foreign trade and even borrowing abroad with the federation as the warrant.[32] Thus, an inconsistent distribution of power developed: the main decisions were made at the level of the member states, but some important powers – the ruling party, the central bank, the military – were maintained at the federal level and were run as if in a centralised state.

By the mid 1970s the Yugoslav government was faced with ever fewer policy choices. The domestic economic difficulties were exacerbated by the disadvantageous international trading position in which Yugoslavia found itself. Formally outside the main East European trading block (the Council for Mutual Economic Assistance - CMEA or Comecon), Yugoslavia had built upon the pre-war trading patterns developed with Central and Western Europe. Since 1965, industry had displaced agriculture as the main source of export wealth, and the foreign currency remittances of the 1.85 million Yugoslav living in Western Europe demonstrated the importance of "invisibles" to the balance of payments.[33] The fact that Yugoslavs were allowed to emigrate freely since the early 1960s resulted in many finding work in Western Europe, notably Germany. Between 1961 and 1971, the number of guest workers from Yugoslavia to West Germany increased from 16,000 to 410,000. Yugoslavia became even more dependent on invisible receipts from the West, and Western capital had come to play a very important role in the economy. Besides loans from the World Bank governments and other private banking consortia since 1967, inward investment was possible under partnership agreements permitting foreign firms to own 49 percent of the equity of Yugoslav concerns. World economic recession, the oil crisis, unemployment among Yugoslavs working abroad, and the de-

[31] Granick, *op. cit.*, p. 328.

[32] J.R. Lampe, *Yugoslavia as History: Twice there was a Country*, Cambridge University Press, Cambridge, 2000, pp. 286-87.

[33] D. Wilson, *Tito's Yugoslavia*, Cambridge University Press, Cambridge, 1980, pp. 174-177.

cline of the tourist industry augmented the balance of payments problems with the West. Yugoslavia's external debt increased from less than US$2 billion in 1970 to US$14 billion in 1979, and, following the second oil shock, to US$18 billion in 1980.

1.2.3. From Perpetual Crisis to Collapse

The country was put to a severe test in the early 1980s when it proved unable to service its foreign debt. To a great extent, the economy had been propped up by a combination of state subsidies, foreign borrowing, and remittances from Yugoslavs working abroad. Once foreign support began to dry up, and debts became due, investment dropped sharply and the economy went into a prolonged stagnation. Under the pressure of mounting financial problems and the inability of the government to fulfil its debt repayment obligations, several IMF-sponsored austerity programmes were implemented from 1981 onwards. Further economic reforms were launched in 1982, but they proved to be slow, inefficient, non-innovative and did not achieve effective change in the functioning of the Yugoslav economic system. The crisis dragged on for a whole decade, leading eventually to the collapse of the economy and the unravelling of the country. At the end of the 1980s, output had hardly grown at all: in 1989 Yugoslavia's GDP was approximately at the level it had been in 1979. Unemployment increased significantly and inflation was increasing year after year, reaching about 100% in 1988.[34]

Hopes that the country might embark on radical free-market reforms had been raised by the appointment –with strong backing from the West– of Ante Markovic as Yugoslavia's Prime Minister in March 1989. As the socialist systems in Central and Eastern Europe were collapsing one by one, a far-reaching reform programme was adopted in Yugoslavia. Stabilisation was the first task, because prices were rising at hyperinflationary levels by the end of 1989. The Yugoslav Dinar was pegged to the German mark, at the rate of 7:1 and was made freely convertible. Inflation fell quickly and foreign exchange reserves increased dramatically. Other fundamental reforms included a reform of enterprises, which effectively abolished the inefficient and expensive self-management system and

[34] V. Gligorov, "Socialism and the Disintegration of SFR Yugoslavia", in M. Mrak, M. Rojec, and C. Silva-Jauregui (eds), *Slovenia: From Yugoslavia to the European Union*, The World Bank, Washington, D.C, 2004, p. 22.

led to a significant inflow of investment, and a reform of the banking system, which restored the independence of the banks from local political groups.[35]

However, there was no political consensus for Markovic's reform programme, and it stalled because of opposition from the various republics who were not committed to a federal solution to the country's economic predicament. Also contributing to the economic failure of the reform programme was the fact that strong centrifugal forces were already pulling the country apart irreversibly. Negotiations between the six Yugoslav republics to redefine the shape of the republic into a looser confederation were pursued throughout the winter of 1990-1991. These talks were inconclusive, however, and on June 25 Slovenia and Croatia declared their independence. The following day, on June 26, the Yugoslav People's Army (JNA) intervened militarily in Slovenia, signalling the actual beginning of the Yugoslav wars.[36] Naturally, all attempts to perform serious economic transformation within a federal framework were abandoned, as the country broke up and descended into a cycle of violence which was to characterise the region for almost a decade.[37]

In closing this discussion concerning the legacy of the Socialist Federal Republic of Yugoslavia, certain conclusions are particularly important and relevant as they influenced the successor states' later development path and transition. The first observation is that Yugoslavia's movement towards a self-managed economy did not totally succeed in evading problems associated with the centralised model of planning and management, and perhaps even added a few more.[38] Over the years the Yugoslav model of self-managed socialism was a *sui generis* system on some levels, yet it also displayed many of the systemic features (and weaknesses) inherent in other centrally planned economies: these included inefficient allocation of investment and labour, and an underdeveloped private sector (the social sector contributed as much as 86.2 percent of Gross Social Product in 1989).[39]

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[35] M. Dinkic, *The Economics of Destruction: Can it happen to you?*, VIN, Belgrade, 1995, p. 30.

[36] See S. Woodward, *Balkan Tragedy: Chaos and Dissolution after the Cold War*, Brookings Institution, Washington, D.C, 1995; C. Bennett, *Yugoslavia's Bloody Collapse: Causes, Course and Consequences*, Hurst, London, 1995; R. Rich, "Recognition of States: The Collapse of Yugoslavia and the Soviet Union", *European Journal of International Law*, IV, 1: 36-65. 1993.

[37] See also I. Jeffries, *The former Yugoslavia at the turn of the twenty-first century: A guide to the economies in transition*, Routledge, London, 2002; M. Glenny, *The Fall of Yugoslavia: The Third Balkan War*, Penguin Books. London, 1992.

[38] M. Uvalic, *Investment and property rights in Yugoslavia – The long transition to a market economy*, Cambridge University Press, Cambridge, 1992, p. 206.

[39] *Ibid.*, p. 207.

Added to the problems the Yugoslavian economy shared with the other socialist countries, were the inherent flaws in the system of self-management which ultimately led to the collapse of the system.[40] Despite being freed from the rigidities of the plan, enterprises were not run by rational economic criteria but according to the self-interest of workers. Workers were naturally predisposed to consider their own short-term benefits rather than the long term profitability of the enterprise.[41] Moreover, enterprise autonomy did not mean that employees and local and regional authorities were willing to accept some of the unpleasant side effects of the market, such as closing of loss-making enterprises, budget constraints and wage controls.

Finally, in addition to the above problems, the federal government faced an extremely challenging regional policy: it had to keep the various nations in harmony, and to balance the interests of the six republics and two regions, all of whom had different levels of development. Regional economic policy thus received more attention than it had in other East European states, but special regional aid and levy grant systems provided little evidence that regional inequalities had been levelled and were no longer politically contentious.[42] Ultimately, unequal regional development and great economic diversity between the republics contributed to the centrifugal forces that undermined the cohesion of the federation and ultimately led to the disintegration of the country itself.

[40] D.A. Dyker, "The Crisis in Yugoslav Self-Management", *The Contemporary Review*, vol. 242, 1983, p. 12.

[41] S. R. Sacks, *Self-Management and Efficiency: Large Corporations in Yugoslavia* (London: Allen and Unwin), 1983, pp. 39-40.

[42] Comisso, *op. cit.*, p. 55.

CHAPTER 2

THE TRANSITION PROCESS: HEAVY LEGACY, SIGNIFICANT PROGRESS

Each country's path towards integration into the EU is inextricably linked to the country's transition course. The transition course, in turn, has been –and continues to be– informed by a combination of factors that are entrenched in the country's political, historical, economic and socio-cultural legacies. Some of these determinants are inherent in the communist legacy, while others have their roots in the depths of history; they have all contributed to making the transition process truly unique and distinctive, and therefore play an important role in the attempts to join the EU. With the exception of Albania, all the Western Balkan states had to face a triple transition. From single party to democracy, from centrally planned to market economy, and from constituent republics of a federal state to independent countries. The successor states to the Yugoslav federation had to create the infrastructure necessary for a new state, from the bottom up. When the economic transition began, the structures of the federal state had collapsed and had to be replaced by newly created ones –a venture which required time, capital, and know-how.[43]

2.1. Albania

2.1.1. First Period of Successful Change

As discussed above, when the communist system collapsed, Albania was defined as the poorest, most isolated and most repressive country in Europe; in 1991, GDP fell by 28 percent (Table 2). The first democratically elected government led by Sali Berisha assumed office in April 1992. It immediately

[43] V. Heuberger, H. Riegler and H. Vidovic, *At the crossroads: Disaster or normalisation? The Yugoslav successor states in the 1990s* (Frankfurt am Main: Peter Lang), 1999, p. 121.

launched an ambitious programme of economic reform, aimed at halting economic deterioration and putting the country on the path toward a market economy. Key elements of the reform programme included price and exchange system liberalisation, fiscal consolidation, monetary restraint, trade liberalisation and measures to control the budget deficit.[44] These measures were complemented by a comprehensive package of structural reforms, including acceleration of the privatisation process, enterprise and financial sector reform, and creation of the legal framework for a market economy and private sector activity.

The initial phase of the transition process saw speedy progress, placing Albania among the most advanced former communist countries in terms of the rate and intensity of reforms.[45] During the period 1993-1996 Albania experienced an annual GDP growth rate of almost 10 percent, while prices and trade were almost entirely liberalised. Tight monetary and fiscal policies led to significant macroeconomic stability, whereby external balances were reduced sharply and Albania's currency, the lek, stabilised.[46] The speed and vigor of private entrepreneurial response to Albania's opening and liberalising was better than expected: over a three-year period, about 70 percent of the economy was privatised. The economy was boosted in 1995 with the signing of an agreement with a consortium of 41 western banks to resolve the $500 million debt Albania had inherited from the communist period.[47] By 1996 monthly wages had increased, shortages were almost totally eliminated and private markets were thriving in many cities. Moreover, during these first few years, democratic institutions were successfully set up and a democratic legal framework was installed. After decades of isolation, Albania joined many international institutions such as the Council of Europe, the International Monetary Fund, the World Bank and the European Bank for Reconstruction and Development.

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[44] M. Blejer *et al.*, "Albania: From isolation toward reform", IMF Occasional Paper no. 98, *International Monetary Fund,* Washington D.C., September 1992; A. Aslund and O. Sjoberg, "Privatisation and Transition to a Market Economy in Albania", *Communist Economies and Economic Transformation*, 4,1, 1992, pp. 135-140.

[45] M. Muco, "An Overview of the Economic Reform in Albania", in T. Perna *et al.*, *Passage to the West*, Publishing House of IFAW, Tirana, 1996, pp. 57-58.

[46] "Albania: Recent Economic Developments", IMF Staff Country Report no. 99/69, International Monetary Fund*,* Washington D.C., July 1999, p. 20.

[47] European Bank for Reconstruction and Development, *Transition Report 1996*, EBRD, London.

At this point, Albania was considered a special case of successful transition, particularly since this significant progress was achieved at a time when most of the region was embroiled in conflict in the wake of the dissolution of Yugoslavia. However, by early 1996 progress had stalled, as it became clear that many crucial issues –such as structural reforms, especially in the critical area of banking– had not been properly addressed, and that the good performance of the economy was not built on solid foundations.[48] The approach of parliamentary elections in May 1996 led the government to indulge in significant pre-election wage increases and to put off introduction of a VAT, with the result that the budget deficit and inflation began to rise again.[49] Troubles escalated further towards the end of the year with the rapid growth of the pyramid schemes, which exposed a dangerous combination of factors: an absence of strong institutions and good governance on the one hand, and a susceptible public with a poor understanding of the market economy and investment operations on the other.[50]

2.1.2. The Bubble Bursts: The Crisis of 1997

By January 1997 the pyramid schemes were estimated to have accumulated $2 billion and represented a large proportion of national capital: at their peak, the nominal value of the pyramid schemes' liabilities amounted to almost half of the country's GDP.[51] Thousands of people had invested all their household finances in them, some having sold everything they had –properties, houses, farms and belongings. The collapse of the pyramid schemes in early 1997 produced violent unrest and anarchy, the breakdown of civil order and state authority, and brought the country to the brink of a civil war in which some 2,000 people were killed. Violent protests broke out in many cities, leading to an armed revolt, as hundreds of people robbed army depots and military bases and took large amounts of ammunition and weapons (almost one million kalashnikovs

[48] A. Clunies-Ross and P. Sudar (eds), *Albania's Economy in Transition and Turmoil, 1990-97*, Ashgate, Aldershot, 1998, pp. 9-11.

[49] European Bank for Reconstruction and Development, *Transition Report 1997*, London.

[50] J. Pettifer and M. Vickers, *Albania: From Anarchy to a Balkan Identity*, Hurst and Company, London, 1997.

[51] C. Jarvis, "The rise and fall of the pyramid schemes in Albania", IMF Working Paper, *International Monetary Fund*, Washington D.C., July 1999.

fell into the hands of civilians). Uncontrolled rioting led to massive destruction of social property and productive equipment, prompting the evacuation of foreign nationals and mass emigration of Albanians.[52]

A new hope for stability emerged following the election of Pandeli Majko as Prime Minister in October 1998. The country had to start at "ground zero" in its attempts to stabilise and protect the economy, as the devastating unrest had reversed much of the economic progress that had been accomplished in the short transition period. Albania had gone from being a "success case" to total economic and political paralysis: the crisis had led to increased poverty and economic hardship, illustrated by an 10.2 percent contraction in GDP growth, increased unemployment, a 50% decline in the value of the lek, a surge in inflation to 33.2 percent and the withdrawal of foreign direct investment and aid inflows. Moreover, the collapse of the pyramid schemes and the violent fallout highlighted the weakness of the new democratic institutions and their inability to handle a crisis of such magnitude. The IMF agreed a $12 million post-conflict recovery loan, and international donors pledged to assist in recovery from the economic crisis.

A second IMF-backed stabilisation programme was introduced in 1997, which restored macroeconomic stability through a tight monetary policy-based direct control of the minimum deposit rate. The Bank of Albania aimed at a 2-4 percent target range for inflation, while the exchange rate was allowed to float. Government expenditure was reduced by eliminating subsidies to state enterprises, and the budget deficit consequently fell from 10 percent of GDP in 1996 to 5.4 percent of GDP in 1999. Overseas remittances played a very important role in stabilising the economy: by 1998, remittances from Albanians working abroad, mostly Italy and Greece, amounted to $452 million. As foreign aid inflows and overseas remittances recovered, the crisis abated and inflation was brought under control. By 1999, the rate of inflation had fallen to 0.4 percent from previous highs of 33 percent in 1997 and 21 percent in 1998.

Just as the situation appeared to be stabilising, the outbreak of the Kosovo crisis in 1998 –which culminated in the NATO bombing of Yugoslavia in March 1999– added new uncertainties to the sustainability of Albania's recovery. Albania was particularly tested as hundreds of thousands of Kosovar refugees spilled into the country: in a three-month period, from March through May 1999,

[52] D. Vaughan-Whitehead, *Albania in Crisis: The Predictable Fall of the Shining Star*, Edward Elgar (International Labour Organisation), London, 1999, pp. 191-220.

Albania received and accommodated almost 500,000 refugees from Kosovo.[53] There were serious concerns as to how Albania –with extremely limited resources and inadequate transportation and health infrastructure– would respond to the needs of thousands of refugees and prevent a humanitarian catastrophe, especially in light of its own recent devastating crisis.[54] The strain on the state was eased significantly by the fact that a large part of the Albanian population accommodated thousands of refugees in their own houses. Thus, by maintaining a reserved official position vis-à-vis the crisis, and by managing to take in thousands of refugees without tremendous negative long-term repercussions, Albania avoided a potentially precarious situation. It preserved the balance necessary in order to avoid getting pulled into the vortex of ethnic violence that opposed the ethnic Albanians and the Serbs in Kosovo, which would further destabilise its society as well as the entire region.

2.1.3. Stability Achieved

Having avoided getting embroiled in a regional conflict, over the next few years Albania made progress in various areas of economic activity, especially trade liberalisation and privatization. In 2000 it became a member of the World Trade Organisation (WTO), while the EU granted Albania a duty free access to most Albanian exports with some conditions for textile and agricultural products.[55] The privatisation process was advanced, especially in the telecommunication, power and banking sectors: in July 2000 the mobile phone company AMC was sold to foreign investors and in January 2001, following an international tender, the second mobile phone company was sold to a consortium of British and Greek companies.[56] Progress was also achieved in attracting FDI: investment flows increased from US$41 million in 1999 to US$143 million in

[53] R. Kondaj, "Management of Refugee Crisis in Albania during the 1999 Kosovo Conflict", *Croatian Medical Journal*, 43 (2) 2002, p. 190.

[54] For a thorough analysis of the Kosovo crisis and its aftermath see also F. Bieber and Z. Daskalovski (eds), *Understanding the War in Kosovo*, Frank Cass, 2003; P. Sklias and S. Roukanas, "Development in post-conflict Kosovo", *South-Eastern Europe Journal of Economics*, 2, 2007.

[55] Commission Staff Working Paper, *Albania: Stabilisation and Association Report 2003*, Brussels 26 March 2003.

[56] Commission of the European Communities, *The Western Balkans in Transition*, Directorate General for Economic and Financial Affairs, Brussels, January 2003.

2000 and US$207 million in 2001. On a per capita basis, however, FDI in Albania was still one of the lowest in the region.[57] GDP growth rates averaged around 5 percent between 2001 and 2006, while through restrictive monetary and fiscal policies inflation remained low at around 3 percent.

TABLE 2
Albania, Economic Indicators

	1991	1993	1996	1997	2000	2003	2007	2008	2009	2010
GDP (% change)	-28.0	9.6	9.1	-10.2	7.3	5.7	6.0	7.5	3.3	3.5
GDP per capita ($US)	399.7	444.5	983.7	700.7	1,190	1,852.2	3,393.5	4,102	3,819.5	3,716.2
Unemployment (%)	8.9	22.3	12.3	14.9	16.8	15.5	13.2	12.5	12.6	12.5
Consumer price inflation (%)	35.7	85.0	12.7	33.2	1.2	2.3	2.9	3.5	2.2	3.6
Current account balance (% of GDP)	-13.1	1.7	-5.6	-10.1	-3.7	-4.9	-10.4	-15.3	-13.5	-11.8
External debt (% of GDP)	n/a	n/a	n/a	84.6	69.6	60.7	53.8	55.1	59.8	58.2

Source: IMF *World Economic Outlook*, September 2011; EBRD *Transition Report 2010*.

Since launching its transition Albania has made considerable progress in achieving a stable macroeconomic framework with solid growth rates, reduced external balances, and a stable currency. Compared to all the other countries in the region, Albania has the highest percentage of private sector share of GDP (75% in 2010); however, the state retains control over key enterprises in the oil, energy and insurance sectors, and a number of important privatisations in these sectors remain on hold. The Albanian government was planning to finalise the privatisation of most public properties by the end of 2010, but due to unfavourable market conditions plans have been delayed. Another necessity is the improvement of the quality of infrastructure, especially transport and electric power.

[57] *World Investment Report 2010*, United Nations Conference on Trade and Development. See also V. Nakuci and K. Zizo, “Foreign Direct Investment – The promoter of growth in the Albanian economy”, *South-East Europe Review*, 1/2006, p. 105.

2.2. Bosnia-Herzegovina

2.2.1. 1991-1995: In the Eye of the Storm

Since rising to power in 1986, Slobodan Milosevic's promotion of Serb nationalism fuelled ethnic strife in the multi-cultural Yugoslav federal state. Slovenia and Croatia both declared independence from Yugoslavia in June 1991. By late September 1991, Bosnian Serb Radovan Karadzic's Serbian Democratic Party (SDS) had declared four self-proclaimed "Serb Autonomous Regions" (SAR) in Bosnia. In October 1991, the Bosnian Serbs announced the formation within Bosnia of a "Serbian Republic of Bosnia-Herzegovina" that would have its own constitution and parliamentary assembly. In January 1992, Karadzic publicly proclaimed a fully independent "Republic of the Serbian People in Bosnia-Herzegovina", while the Croat leaders declared an autonomous "Croatian Community of Hercegovina-Bosnia". On March 1, 1992, the Bosnian Government held a referendum on independence, which received overwhelming support from the Muslim and Croatian communities. Bosnia's parliament declared the republic's independence on 5 April, 1992. However, this move was opposed by Serb representatives, who had voted in their own referendum in November 1991 in favor of remaining in Yugoslavia. Intense fighting started after the declaration of independence: Bosnian Serbs, supported by Serbian forces from within and outside Bosnia, responded with armed force in an effort to partition the republic along ethnic lines, thus irreversibly shattering the hitherto functioning multicultural Bosnian society. Bosnia and Herzegovina's independence was recognised by the United States and the European Community on 6-7, April 1992, and Bosnia and Herzegovina was admitted to the United Nations the following month. Initially, the Muslim and Croat communities were allied in their common fight against the Serbs, but open hostilities broke out between them following the announcement of the Vance-Owen plan to divide the country in 1993. This "conflict within a conflict" was resolved through the creation of the Muslim-Croat Federation in March 1994 which eventually became the Federation of Bosnia-Herzegovina (FbiH).

The war in Bosnia officially ended on 21 November, 1995, when Croatia's Tudjman, Serbia's Milosevic and Bosnia-Herzegvina's Izetbegovic agreed to the terms of the Dayton Peace Agreement, which was formally signed on December 14, 1995 in Paris.[58] In the treaty text, all parties agreed to respect each other's sovereign equality, to cooperate fully with the Security Council, to settle disputes by peaceful means, and to grant refugees the right to return home safely and regain any lost property. The agreement sealed the division of the country, with 51 percent of the territory held by FbiH and 49 percent held by the Serb Republic (Republika Srpska - RS). A new constitution was created which established Bosnia-Herzegovina as a federal state, composed of FbiH and RS as two partner entities with considerable independence. Within the new state, the national government had a parliament, a rotating presidency (eight month terms, held equally by a Bosniak, a Croat and a Serb) a constitutional court and a central bank. The central government was responsible for foreign policy, foreign trade, common and international communication, air traffic control, monetary policy, citizenship and immigration. Most power, however, was devolved to the two federal units: in effect, the federal entities held most of the functions of a nation state within their own territories, including their own parliaments, police forces and armies. The new state was built around the concept of ethnic separateness, while the three-member presidency of BiH reflected this ethnic division. Today, Bosnia-Herzegovina has a population of 4.6 million, and is home to Muslim Bosniaks (48% of the population), Orthodox Serbs (37%) and Roman Catholic Croats (14%).

The Dayton agreement of 1995 ended over three years of intense warfare in Bosnia-Herzegovina. The war in Bosnia resulted in material devastation and human suffering on a scale not seen in Europe since the Second World War, with an estimated 200,000 people killed, more than 2 million displaced and rendered homeless –more than half the pre-war population– and a large part of the economy destroyed. The conflict involved ethnic cleansing, and a number of atrocities were committed –worst of all the Srebrenica massacre in 1995, when an estimated 8,000 Bosniak men and boys were killed by the army of the Republika Srpska and other paramilitary units, despite the presence of 400 armed Dutch peacekeepers in the area. Approximately one-fifth of the housing stock, two-fifths of hospitals, three-quarters of school buildings and half the industrial plants had been destroyed. Industrial output fell to 5 percent of the pre-war level, electricity and coal production fell to 10 percent, livestock fell to

[58] A Peace Implementation Council was established to monitor the reconstruction programme, with a steering board composed of representatives from the G-7 states, Russia and the EU. A high representative was appointed by the UN to supervise the peace agreement and the process of reconstruction.

30 percent and per capita income had fallen to just 20 percent of the pre-war level. The World Bank estimated that $5.1 billion would be required to meet the reconstruction needs of the country, and organised a donors' conference to secure pledges of aid for a four-year programme of economic reconstruction.

BiH joined the IMF in December 1995 and was the first country to make use of the resources of the Emergency Post-Conflict Fund. The economic strategy agreed between the IMF and the respective governments of BiH, FBiH and RS was based on the adoption of a fixed exchange rate as a "nominal anchor" to underpin price stability, the observance of strict fiscal discipline and reliance on large inflows of concessional financial assistance in the form of grants and loans from abroad. In April 1996 BiH joined the World Bank and agreed an exceptional refinancing plan which involved a new concessional loan with a five-year grace period and a thirty-year repayment schedule. Under the Dayton agreement, the central government budget was financed from the budgets of the two federal entities, the largest part of which was spent on paying interest on the country's international debt. Agreements to restructure BiH's share of the former Yugoslav debt owed to the Paris and London Clubs of international banks were not reached until December 1997, by which time the total outstanding external debt had reached the equivalent of 90 percent of GDP, and payment arrears totaled $2.4 billion.

2.2.2. Macroeconomic Stabilisation Following the Dayton Agreement

Following parliamentary elections in November 1997, a new coalition government –led by Milorad Dodik from the small party of Independent Social Democrats– came to power. A set of new economic laws called the "Quick Start Package" was adopted to establish trade policy, customs policies and tariffs. A central bank of B-H was established, whose governor was appointed by the IMF, and a new currency, the Convertible Mark (KM) was introduced to replace the Bosnian dinar. The KM was pegged to the German mark and later to the euro through a classical currency board, under which the central bank was not permitted to issue new money unless it was backed by foreign currency reserves. The deficit was partly covered by a Stand-by Agreement with the IMF in 1998, by inflows of international aid and by remittances from family members working abroad.

By 1999 some progress had been achieved: privatisation had begun, BiH was under a single customs administration, taxes and excises had been harmonised between the two entities and illegal fiscal practices had declined. However, the task of creating a single economic space had not been completed – there was no unified labour market, no unified capital market, and the state lacked a unified border service. Economic activities were under the control of political parties, while public services still needed to be reformed. The serious problems of smuggling, tax evasion, widespread corruption and fraud had not been addressed. Essentially, the entity governments were unwilling to agree on the unification of the state, and politicians in both states continued to obstruct reform. In reviewing the 1998 Stand-by agreement, the IMF warned that donor funding was diminishing significantly and that the expenditure plans of the governments were not sustainable. The IMF called for substantial reduction in military expenditure and budgetary transfers to war invalids. It further advised the federal government that structural reform must be prioritised, especially concerning the privatisation of banks and enterprises, and reform of the labour market and the payments and tax systems.

TABLE 3

Bosnia-Herzegovina, Economic Indicators

	1998	2000	2003	2006	2007	2008	2009	2010
GDP (% change)	9.5	4.3	3.8	5.9	6.2	5.7	-2.9	0.7
GDP per capita ($US)	1,433.7	1,468.8	2,197.0	3,153.6	3,891.3	4,733.4	4,366.9	4,241.8
Unemployment (%)	32.2	31.1	35.1	31.1	29.0	23.4	25.0	27.2
Consumer price inflation (%)	n/a	2.8	0.5	6.1	1.5	7.4	-0.4	2.1
Current account balance (% of GDP)	-6.6	-8.7	-19.2	-7.9	-10.7	-14.3	-6.2	-5.6
External debt (% of GDP)	54.4	56.1	28.1	21.8	32.8	31.1	35.9	39.7

Source: IMF *World Economic Outlook*, September 2011; EBRD *Transition Report 2010*.

2.2.3. Developments after 2000

The democratic transitions that took place in other countries of the Western Balkans following the end of the Kosovo war were not reflected in BiH, which remained politically unstable, racked by economic scandals and widespread corruption. General elections held in October 2002 demonstrated the continued wide support for the main nationalist parties, which won in all three parliaments. However, despite all the difficulties associated with a fragmented political system, economic growth averaged about 5 percent per annum between 2000 and 2007 (Table 3). The existence of the currency board, managed by the strong and independent central bank ensured price stability. Customs and indirect taxation were unified at the state level, a nationwide VAT system was introduced in 2006 which supported the creation of a single market within the country, while exports increased as comprehensive regional free trade agreements came into effect.

However, the economy still suffers from a number of critical problems. Most notably, structural reforms have been slow, and the economy has been too reliant on outside donor funding. According to the EBRD transition indicators, BiH is the least reformed country in the region (Table 10).[59] The private sector accounts for 60 percent of GDP (the lowest in the region, with Serbia), while the privatisation process has virtually come to a standstill in recent years, depriving the entities of much-needed privatisation revenues (particularly in FBiH). Figures for unemployment range between 25-35 percent, and it is estimated that more than 30 percent of the population lives in poverty. The main difficulty has been that the state-level institutions are too weak and fragmented to carry out the policies needed to complete the transition to a market economy. As donor funding has diminished, pressure on the government budget has increased. The lack of a single budgetary authority has undermined the ability of the government to control expenditure. Separate ministries of finance exist at entity and cantonal levels, and many other non-budgetary bodies such as municipalities and off-budget funds can authorise public expenditure. Furthermore, plans to transfer police and defense functions from the entities to the state-level institutions, to expand municipal investment, to ensure ethnic diversity at all levels of the civil service and to raise public investment have put further pressure on the government budget. BiH remains a fractured economy: the fact that the central

[59] European Bank for Reconstruction and Development, *Transition Report* 2010, EBRD, London.

government is weak, and effective power remains with the two federal state entities, means that many of the institutional reforms needed to create a functioning market economy have not been implemented.

2.3. Croatia

2.3.1. The War of Independence

In 1990 Croatia held general elections in which the anti-communist HDZ (Croatian Democratic Union) took the majority of seats in the legislature (Sabor) at the expense of the League of Communists of Croatia (LCC). Franjo Tudjman was elected president of Croatia. President Tudjman appointed a Croatian Serb as Vice-President, in an attempt to reassure the ethnic Serbs who were concerned about his nationalistic tendencies. It did little good however, and the Serbs living near the border of Bosnia-Herzegovina – where Serbs constituted the majority ethnic group – held a referendum in which they proposed autonomy for themselves. By December 1990, Serbs living in Serb-dominated areas had issued declarations of independence, and by the following October three Serbian Autonomous Regions (SARs) had been established in Croatia.

Although the central communist party of Yugoslavia was determined to keep Yugoslavia a united country, it proved unable to do so in the face of the strengthening centrifugal forces. In December 1990 Croatia's Sabor adopted a new constitution, allowing itself the right to secede from the federal republic as well as authority over its own armed forces. The following March, the Sabor determined that its own legislature would preempt federal legislation, while in April the country formed its own national guard. Finally, on 19 May, a referendum was held in which 94 percent of the voters declared that they preferred that Croatia become a sovereign entity.[60] Most Croatian Serbs boycotted the referendum.

Just over a month after the referendum, on 25 June, Croatia officially declared its independence from Yugoslavia, and in so doing triggered the start of the war. Whereas Slovenia's declaration of independence had stimulated a 10-day military confrontation, followed by acceptance from the part of the central leadership, due to Croatia's substantial Serb population, Belgrade was not willing to allow Croatia to secede without a fight. Following Croatia's declaration of

[60] M. Schuman, *Nations in Transition: Croatia*, Facts on File books, New York, 2004, pp. 43-45.

independence, the Yugoslav People's Army (JNA) joined with Serbian troops to secure the Serb sections of Slavonia, and by November they controlled almost one third of Croatia. In September, the United Nations imposed an embargo on arms shipments to the former Yugoslavia. Although periodic cease fires were called, fighting continued throughout the fall. In December 1991 Germany became the first European nation to recognise the independence of Croatia. A ceasefire, brokered by the EU and the UN came into effect on 1 January 1992, international recognition of the state followed soon after, and Croatia gained admission to the UN in May. Although the ceasefire temporarily froze the division of the country, most of the breakaway areas were returned to the control of the central government following a large-scale military action in 1995 at which point most of the Serb population fled the Krajina region and became refugees in Serbia and Bosnia. Agreement was reached on the eventual return of eastern Slavonia to Croatia after a further two-year period under UN administration, completing the creation of the new Croatian state.[61]

2.3.2. Post-war Reconstruction, Economic Stabilisation

At the time of its independence, the Croatian economy was suffering from the cumulative effects of several factors. First, the loss of traditional domestic markets as a result of the disintegration of Yugoslavia as well as of the foreign markets due to the collapse of the economies of the former Soviet Union and Eastern Europe. Second, the cost of restructuring the economic system from self-managed socialism to market oriented capitalism. And finally, the devastation caused by the war and the subsequent strain on the economy. The war had caused massive damage to the economy –estimated at $37 billion– and an unprecedented destruction of housing, infrastructure, transportation networks, bridges, railway lines, hospitals and cities. Industrial output decreased by some 39 percent as a result of the destruction of vital industries.[62] Due to increased government expenditure during the war and the subsequent cost of reconstruction, the rate of inflation rose to 634 percent in 1992 and shot to 1,516 percent in

[61] M. Stanicic, "On the road to independence", in M. Stanicic (ed.), *Croatia on its way towards the EU,* Nomos Verlagsgesellschaft, Baden-Baden, 2002, pp. 21-24.

[62] D. Plestina, "Politics, Economics and War: Problems of Transition in Contemporary Croatia", Working Paper 5.15, Center for German and European Studies, University of California at Berkeley, June 1993.

1993 (Table 4). Unemployment rose to almost 20 percent, while the average net wage had fallen to US$ 70 per month, or about eight times, in less than three years.[63]

The first reform following political independence was established when the National Bank of Croatia, formerly part of the Yugoslav system of national banks, became the central monetary institution of Croatia. By the end of the year Croatia had implemented a reform which allowed it to achieve monetary independence through its own (temporary) currency, the Croatian dinar. After Croatia was admitted to the IMF in 1992 it negotiated a standby agreement which increased its international credit rating and gave it access to international capital markets. In October 1993 a stabilisation programme was introduced, which pegged the exchange rate to the German mark, introduced internal convertibility of the currency, lifted foreign exchange controls and imposed restrictive monetary and fiscal policies in order to combat inflation.[64] The success of the programme enabled the government to introduce a new currency, the kuna, in May 1994, which replaced the temporary Croatian dinar which was in use since independence. Croatia's international debtors agreed to restructure its foreign debt, and by the end of 1994 about $1.4 billion of reserves had been accumulated. The stabilisation programme led to a sharp fall in inflation to 2 percent by 1995, launching a sustained period of price stability. At the same time, there was a broad national consensus on the necessity to move closer to the EU, and one of the Croatian government's top priorities was to adjust its institutions to those of the EU as soon as possible.[65]

Between 1995 and 1997, GDP per capita increased by an annual average of almost 6 percent. The IMF agreed a $486 million Extended Funding Facility in 1997 which further ensured the international credibility of the government's economic policy. However, although Croatia was being praised in international circles for its success in achieving non-inflationary growth, difficulties were building beneath the surface. One of the main problems was the deterioration in the balance of payments: Croatia had introduced a liberal foreign trade regime,

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[63] European Bank for Reconstruction and Development, "Strategy for Croatia", BDS/CR/93-1, 16 April 1993, p. 19.

[64] Jurlin *et al.*, "An Analytical Approach to Economic Integration of Croatia into the European Union", Institute for International Relations, IMO, Zagreb, 1996.

[65] I. Sanader, "Croatia's Course of Action to Achieve EU Membership", Center for European Integration Studies, Rheinische Friedrich-Wilhelm's Universitet, Bonn, Discussion Paper C59, 1999.

dismantled import quotas and abolished non-tariff import restrictions, which encouraged imports, while low productivity and high unit labour costs made exports increasingly uncompetitive under the fixed exchange rate that underpinned the stabilisation policy. Moreover, the coastal tourism industry had not recovered from the shock of the war. Consequently, by 1997 Croatia's international debt had increased to 33 percent of GDP.

During this period, President Tudjman's fierce rhetoric against the International Criminal Tribunal on the Former Yugoslavia (ICTY) in the Hague overshadowed the record of actual cooperation and diminished the country's international standing. The authoritarianism of the Croatian Democratic Union (HDZ), while deemed acceptable during wartime, began to look increasingly anachronistic in the new international environment, as the economy stabilised and the neighbouring Central European countries began to engage in the process of European integration.

The economic recovery was interrupted in mid-1998 with the collapse of a number of medium-sized commercial banks. These had built up substantial non-performing debts as a result of bailing out local loss-making companies which were politically well-connected and which provided employment to their local populations. The banking crisis was heralded by the collapse of the Dubrovacka banka, which had made loans to local hotels in southern Dalmatia to keep them afloat, pending the recovery of the tourist industry. Two more bank collapses followed, and the Croatian National Bank stepped in as lender of last resort supported by the World Bank.[66] The banking crisis led to the re-imposition of a restrictive monetary policy and a tightening of credit conditions bringing the economic recovery to a temporary halt. In 1999, the economy contracted by 0.9 percent. A new banking law was introduced which gave greater supervisory powers to the Croatian National Bank, and in the following years almost all the commercial banks were sold to foreign investors, mainly Austrian and Italian banks, which came to control most of the banking sector in Croatia. [67]

[66] World Bank, *Croatia: A Policy Agenda for Reform and Growth*, 1999.

[67] K. Jurlin, "Croatia's economic development", in M. Stanicic (ed.), *Croatia on its way towards the EU,* Nomos Verlagsgesellschaft, Baden-Baden, 2002, pp. 47-50.

2.3.3. The Consolidation of Democracy and the Turn to Europe

The death of President Tudjman in December 1999 heralded a fundamental change in Croatian politics. Increasingly unpopular due to its record of corruption and close connection to ruthless tycoon capitalists, the HDZ was unable to fend off the challenge from the opposition parties. A six-party coalition government headed by the Social Democratic Party (SDP) led by Ivica Racan was returned to power in elections in January 2000, and Stipe Mesic, a veteran Croatian politician who had opposed Tudjman, won the presidential elections in February. The EU welcomed the new government, which it considered a necessary break with the past.[68]

The victory of the six-party coalition gave a new momentum to the reform process. Economic expansion was assisted by falling interest rates and a rapid growth of credit to both the business sector and households. The government initiated a major road building programme which boosted investment and had multiplier effects throughout the economy. By 2003, GDP growth peaked at 5.4 percent, underpinned by a recovery in the tourism industry. However, as in the past, the expansionary policy was brought to an end by the balance-of-payment constraint, as imports surged while exports remained stagnant and uncompetitive. The country's foreign debt rose dramatically, reaching 45 percent of GDP.

In March 2001 the IMF approved a three-year $486 million extended fund facility loan to Croatia, $158 million of which was available the same year. The credit was designed to help the government push ahead with structural reforms while meeting postwar expectations of higher living standards. In parallel, the country completed a $100 million financial and enterprise structural adjustment loan from the World Bank, which was to be used to help overhaul Croatia's banking system and restructure and privatize large public sector firms. In August 2004 the government requested a new Stand-by Agreement with the IMF for a loan of $141 million over 20 months. The request was approved, subject to a number of conditions: that the fiscal deficit be reduced from 4.5 percent in 2004 to 2.9 percent of GDP by 2007, that subsidies to the economy be reduced by 1.2 percent and that the public sector wage bill be reduced by 1.5 percent. In addition, the government was required to reduce its expenditure on defense, healthcare and social programmes and increase expenditure on education and

[68] M. Stanicic, "On the road to the EU", in M. Stanicic (ed.), *Croatia on its way towards the EU,* Nomos Verlagsgesellschaft, Baden-Baden, 2002, p. 77.

science. The government was also advised to reverse the changes recently made to pension indexation formula and ensure the sale of all remaining state-owned shares in private companies by mid-2005.

TABLE 4
Croatia, Economic Indicators

	1993	1997	2000	2003	2006	2008	2009	2010
GDP (% change)	-8.0	5.3	4.2	5.4	4.9	2.2	-5.8	-1.2
GDP per capita ($US)	2,771.4	4,400.3	4,909.5	7,690.6	11,234.8	15,758.0	14,324.2	13,775.9
Unemployment (%)	14.8	9.9	16.1	14.3	11.1	8.4	9.1	12.2
Consumer price inflation (%)	1,516.1	3.7	2.7	1.7	3.2	6.1	2.4	1.1
Current account balance (% of GDP)	4.6	-12.3	-2.2	-6.1	-6.6	-8.8	-5.2	-1.1
External debt (% of GDP)	n/a	33.1	33.8	45.2	34.8	28.5	34.5	40.6

Source: IMF *World Economic Outlook*, September 2011; EBRD *Transition Report 2010*.

Summarizing Croatia's performance, the country has achieved macroeconomic stability with low inflation, a steady exchange rate pegged to the euro and low interest rates. Economic growth has been maintained at relatively high levels averaging almost 5 percent per annum between 2001 and 2006, and unemployment is on a downward trend. It has long been considered among the most advanced of the transition countries, with a broadly liberalised economy, a relatively high level of sophistication in financial services, and a country where significant progress has been made on infrastructure reform. The main problems facing the Croatian economy are low export competitiveness and a slow rate of new business start-up. These problems are linked to the still-high level of state ownership of large parts of industry, albeit as minority shareholders in most cases, continued subsidies to large loss-making industries such as shipbuilding, and the highest share of government expenditure in GDP in the region. Low international competitiveness has led to a build-up of foreign debt and required the Croatian National Bank to impose severe restrictions on credit growth. Although the early reforms stabilised the economy and Croatia's model of national, state-led growth has achieved considerable success, it is doubtful whether this approach can be sustained without major improvements in productivity and business competitiveness. Croatia has benefited from a profitable tourist industry, but this has inherent capacity limits and may not be able to support continued growth in the long run.

FDI in Croatia increased nearly tenfold between 1993-2002, and it has been the most consistent Western Balkan country in terms of attracting FDI (Table 9). The first impressive rise was in 1996, when FDI reached US$ 510.8 million, up from US$ 114,2 million the year before. To a certain extent, this growth could be attributed to the signature of the Dayton Agreement, which signaled the end of the war and gave the green light to foreign investors. Throughout the 1990s, Germany was the top investor in Croatia, followed by Italy. In 1998 FDI almost doubled, while the year after FDI grew by about 60% due to the privatisation of Croatian Telecommunications (HT). After 2001 privatisation of the banking sector was accelerated, as stakes from Privredna Banka Zagreb were sold to IntensaBci and the EBRD, Rijecka Banka was sold to Erste Bank, HVB bought Splitska Banka and Charlemagne Ltd bought Nova Banka and Dubrovacka Banka. Despite the fact that a significant number of large enterprises had not yet been privatised, between 2003 and 2008 total FDI in Croatia amounted to US$19.7 billion. However, as will be discussed below, Croatia's reign as the champion of FDI in the region ended abruptly as a result of the economic crisis of 2009.

2.4. The Federal Republic of Yugoslavia (Serbia-Montenegro)

2.4.1. The Violent Unravelling of Yugoslavia

In April 1992, following the secession of Slovenia, Croatia, Bosnia and FYROM, a "rump" Yugoslavia was re-established by Serbia and Montenegro in the shape of the Federal Republic of Yugoslavia (FRY). FRY's constitution formally recognised the demise of the Socialist Federal Republic of Yugoslavia. Despite their active involvement in the wars in Slovenia, Croatia and Bosnia, neither Serbia nor Montenegro had experienced military operations on their own territory, nor had either of them faced any danger of military intervention from outside powers. In May 1992 the UN Security Council imposed economic sanctions on FRY because it had failed to cut support for the Serbian armed forces in Bosnia. The sanctions prohibited exports from FRY, and all imports except for food and medicine were banned. The sanctions regime was tightened in November, by banning the transit of selected goods through FRY and introducing a blockade of the Montenegrin coast. In April 1993, financial assets held abroad were frozen, and border monitors were put in place to ensure the effectiveness of the sanctions. One of the most crucial negative repercussions of the sanctions was the fact that they opened opportunities for smugglers to engage in sanction-breaking trade across Serbia's borders, leading to the emergence of powerful organised crime groups, which created a long-term negative impact on the Serbian economy and society.[69]

In addition to the damaging impact of sanctions, the joint effect of the collapse of inter-regional trade, loss of markets in neighbouring republics, an inflationary monetary policy (printing money to subsidise large state enterprises and to finance the war in Bosnia), the absence of structural reform and the general mismanagement of the economy were equally responsible for the deteriorating economic situation.[70] FR Yugoslavia experienced one of the deepest recessions among all transition economies, in parallel with what was the second highest and second longest hyperinflation ever recorded in economic history.[71] During 1991 inflation was still at a monthly rate of 10 percent, but in February 1992 it exceeded 50 percent, and in 1993 exploded as monthly rates went from 200 percent at the beginning of the year to 400 percent in June-July, 2000 percent in August- October, 20,000 in November, 180,000 percent in December, and finally an extraordinary 313,000,000 percent in January 1994.[72] By the end of 1993, price increases had virtually wiped out the value of dinar savings, while delays of a few days in paying wages or pensions reduced their value to near zero. The average monthly pension had increased to 10 billion dinars – which was worth less than one German mark – while the National Bank issued a banknote worth 500 billion dinars.[73] The dinar officially collapsed on

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[69] B. Begovic and B. Mijatovic (eds), *Corruption in Serbia*, Center for Liberal-Democratic Studies, Belgrade, 2001, p. 21.

[70] M. Uvalic, "The Disintegration of Yugoslavia: Its Costs and Benefits", *Communist Economies and Economic Transformation*, 5 (3), 1993, pp. 275-277.

[71] P. Petrovic, Z. Bogetic and Z. Vujosevic, "The Yugoslav Hyperinflation of 1992-1994: Causes, Dynamics and Money Supply Process", *Journal of Comparative Economics*, vol. 27, 1999, pp. 335-53.

[72] *Ibid.*, p. 340.

[73] "Economic Developments in FR Yugoslavia: A Country Report prepared for the United Nations Economic Commission for Europe", *CES MECON*, Belgrade, 1993.

6 January 1994 and the German mark briefly became legal tender for the payment of all financial transactions.[74]

Faced with the prospect of almost total economic collapse, the central bank introduced a radical stabilisation programme in January 1994, under which the currency was revalued and a fully convertible New Dinar was introduced, pegged at a ratio of 1:1 against the German mark.[75] The government ceased the inflationary financing of its deficit, the central bank introduced a tight monetary policy and new money was printed only in so far as it was backed by foreign reserves. The stabilisation policy produced immediate results: inflation was reduced to single digit levels in 1994, real GDP increased by about 6 percent during the same year, industrial production began to recover, while the real value of wages and pensions recovered from their disastrously low levels at the beginning of the year. However, the stabilisation proved to be unsustainable due to a lack of support from the international financial institutions, the lack of structural reforms and the lack of commitment of the government to the stabilisation policy. Inflation soon reappeared, reaching an annual rate of 72 percent in 1995 and 90 percent in 1996.

Trade sanctions against FRY were lifted following the signature of the Dayton agreement in 1995. This led to a surge of imports –spurred by pent-up demand– which resulted in an enormous current account deficit which reached $1.5 billion in 1997. However, FRY was still subject to an "outer wall" of sanctions that prohibited businesses and the government from accessing the international capital markets or receiving loans from the IMF to cover the ballooning payments deficit. The government had based its development strategy on the assumption that there would be a strong inflow of foreign capital to cover the trade deficit, but the outer wall of sanctions made the plan entirely dependent on privatisation revenues raised from the sales of assets to foreign investors. [76]

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[74] M. Uvalic, *Serbia's Transition: Towards a better future*, Palgrave Macmillan, 2010, pp. 53-61.

[75] D. Avramovic, "Reconstruction of the Monetary System and Economic Recovery in Yugoslavia, 1994: Analytic Framework, Results and Problems", *WIIW Research Report 216*, Vienna, 1995.

[76] P. Petrovic, "Sustainability of Economic Stabilisation in FR Yugoslavia and Importance of Resumption of Foreign Trade", in M. Crnobrnja and Z. Papic (eds), *The Costs of War in Former Yugoslavia*, Evropa Press, Peace and Crisis Management Foundation, Paris and Belgrade, 1996, pp. 169-172.

2.4.2. The Kosovo Crisis, the NATO Campaign, and the End of the Milosevic Regime

Since 1974 Kosovo, an autonomous province with a large ethnic Albanian majority, had established its own courts, police and territorial defense, as well as a vote in Yugoslavia's collective presidency. In March and April 1981, less than a year after Tito's death, there were student demonstrations in Kosovo in favour of the province being given the status of a full federal republic, within the Yugoslav federation. As the Kosovo Albanian demands for more autonomy mounted, the conditions of Serbs in Kosovo began to preoccupy mainstream opinion in Serbia. By the late 1980s the province had become the cornerstone of Serb nationalism, fuelled by politicians such as Slobodan Milosevic. Moreover, partly due to the local Albanians' high birth rate and partly to continued Serb emigration from Kosovo, by the late 1980s the Serbs' share in the province's total population had dropped to below 10 percent.

In March 1989 Serbia's Assembly adopted constitutional amendments that gave Serbian authorities in Belgrade direct control over Kosovo's police, courts and territorial defense. New laws, passed the same year, made it a crime for ethnic Albanians to buy or sell property without special permission of the authorities. Thousands of ethnic Albanians were dismissed from their jobs as doctors, teachers, police officers and key employees in state-owned firms and replaced with Serbs. The escalation of human rights violations in Kosovo during the 1990s was matched by an almost complete standstill of most economic activities: the agricultural kombinats almost entirely collapsed, and the livestock herds were reduced by about two-thirds.

The Democratic League of Kosovo (LDK) led the resistance to Serbian domination under the leadership of Ibrahim Rugova and had established a parallel underground government. Under Rugova's leadership the Albanian community boycotted the Yugoslav parliamentary elections and adopted a policy of non-violent resistance against the Serbian repression.[77] However, as repression intensified, many Albanians began turning towards groups advocating more aggressive forms of resistance. An underground paramilitary organisation, known as the Kosovo Liberation Army (KLA), was formed and commenced armed activity in 1996. The violence intensified over the next few years, and fueled by the

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[77] C. Cviic and P. Sanfey, *In Search of the Balkan Recovery: The Political and Economic Reemergence of South-Eastern Europe,* Hurst and Company, London, 2010. pp. 35-36.

collapse in law and ordering in Albania in 1997, broke out into open warfare between the KLA and the Serbian paramilitary police in 1998. After almost a year of low-intensity civil war, the Serbian and Albanian sides were brought together at a peace conference at Rambouillet in March 1999. The Yugoslav government delegation was presented with an ultimatum to sign the agreement drawn up by the international negotiators or face the use of force by NATO. Following the Yugoslav delegation's rejection of the agreement, NATO commenced bombing operations against Serbia on 24 March 1999, which continued with increasing intensity every day for the following 78 days. During the bombing campaign, NATO dropped more than 23,000 bombs and missiles. All of the NATO members were involved to some degree – with the exception of Greece.

In addition to the NATO campaign, in May 1999 the EU imposed a ban on sale of goods, services, technology and equipment to repair war damage in Serbia, froze funds, prohibited export finance and suspended commercial flights in and out of Belgrade. During the bombing campaign an unprecedented number of refugees fled Kosovo and took refuge in FYROM and Albania. It is estimated that 250,000 refugees fled to FYROM and almost 500,000 to Albania, destabilising the region further and stretching the resources of these already vulnerable economies. Unexpectedly, almost all the Kosovo Albanian refugees returned within a few weeks, and as they did a reverse wave of up to 250,000 Serbian refugees fled in the opposite direction, across the border and into Serbia, adding to the post-conflict turmoil. After Milosevic agreed to withdraw from Kosovo, a peace agreement was reached on June 11. Several days later, NATO forces entered Kosovo and took control of the major towns and cities. An international NATO/Russian peace keeping force, known as KFOR, was charged with maintaining security and supervising the disarmament of the KLA. UN Resolution 1244 on the ending of the war with Yugoslavia called for "substantial autonomy and meaningful self-government for Kosovo" within the context of the recognition of the "territorial integrity of Yugoslavia".

A massive international assistance effort was launched to deal with urgent priorities such as building a basic civil administration and restoring health and education services, reconstruct the province and to rebuild the destroyed housing, infrastructure, factories and public institutions. A new government for Kosovo was established under a Constitutional Framework that required Kosovo to align its legislation and practices with European standards and norms. While legally remaining a Serbian province, Kosovo became *de facto* independent from Serbia, with its own government, legal system, judiciary, public budget, taxes and customs administration. Following elections in November 2001, the new government's programme focused on economic development, institution building and regional and international cooperation.[78] Meanwhile, ethnic tensions and segregation along ethnic lines remained.

NATO's bombing campaign had a devastating impact and represented a major setback to economic development in the region in general, and Serbia in particular. In addition to the loss of many human lives, the conflict caused major destruction to a large part of the country's industrial capacities, as well as the transport, energy and communications infrastructure. As a result of this destruction, as well as the subsequent fall of domestic and foreign investment, the Serbian economy is estimated to have shrunk by about 18 percent in 1999 (Table 5). The estimates of the overall costs of the Kosovo conflict for FR Yugoslavia vary widely, ranging from US$30 billion to US$100 billion, the latter figure being the official estimate of the Yugoslav government while the former of the G17. According to the more realistic estimate of the G17, the direct costs incurred by physical damages were around US$4 billion, of which the major losses referred to the destruction of industrial capacities (around 70 percent of the physical damages), US$2.3 billion were losses of human capital, while the remaining US$23 billion were the losses of "potential GSP" provoked by physical damages, expected to be felt over the next ten years.[79]

By the end of 1999, FR Yugoslavia was perhaps in the worst condition of all the Western Balkan countries. It had an estimated GDP per capita of around US$1,444 in 1999, surpassing only Albania (US$1,106) but behind all the other countries in the region.[80] It was also among the transition economies that were lagging behind most in the implementation of market-oriented reforms. In the months following the end of the war, opposition to the Milosevic regime gathered strength, supported by financial and technical assistance from the West. Vojislav Kostunica's election to the Presidency in September 2000 was accompanied by massive anti-Milosevic protests and demonstrations, which culminated in a

[78] A. Yannis, "The international presence in Kosovo and regional security: the deep winter of UN Security Council Resolution 1244", in D. Sotiropoulos and T. Veremis (eds), *Is South-eastern Europe doomed to Instability?*, Frank Cass, London, 2002, pp. 181-186.

[79] G 17, *Final Account – Economic Consequences of NATO Bombing – Estimate of the Damage and finances required for the Economic Reconstruction of Yugoslavia*, M. Dinkic (ed.), G 17, Belgrade, 1999.

[80] Economist Intelligence Unit, Country Report - Yugoslavia (Serbia-Montenegro), 2000, London, EUI.

peaceful mass demonstration in Belgrade on 5 October. Crowds stormed the Federal parliament building and the state TV station, leading to the collapse of the Milosevic regime. Kostunica's victory in the presidential election was followed by the landslide victory of the Democratic Opposition of Serbia (DOS) in the Serbian parliamentary elections of December 2000. In January 2001, Zoran Djindjic, leader of the Democratic Party (DS) –a member of DOS, an 18-party alliance– became Prime Minister of Serbia. In early 2001 Milosevic and some of his associates were arrested and surrendered to the war crimes tribunal.

2.4.3. Economic Stabilisation Begins in 2000

The new coalition government that came to power in FR Yugoslavia at the end of 2000 had inherited a legacy of ten years of regional conflicts, isolation and economic mismanagement. It was confronted by a number of urgent problems, including reviving a stalled economy, restructuring socialist-era industrial enterprises, tackling corruption and organised crime, bringing under control and reforming the armed forces and the security agencies, and dealing with the large number of ethnic Serb refugees from Bosnia, Croatia and Kosovo. At the time, economic output stood at 50 percent of its 1989 level, infrastructure was devastated, recorded unemployment stood at almost 20 percent of the workforce, inflation ran at about 70 percent, average wages at about 140 DM a month, while the country's external position was burdened by a crushing debt that represented 241.6 percent of GDP. In addition to the pressing economic challenges, the new government had to deal with the problem of the extradition of war criminals as well as the increasing rift between Serbia and Montenegro.[81]

The new pro-reform government moved quickly to introduce a stabilisation programme, in the form of a comprehensive package of reforms which was developed in close consultation with the IMF and the World Bank.[82] The main aims of the policy were to reduce macroeconomic imbalances, restructure the economy, attract additional external assistance and reduce the country's debts. The reform programme involved the liberalisation of foreign exchange, trade

[81] B. Begovic and B. Mijatovic (eds), *Four Years of Transition in Serbia*, Center for Liberal-Democratic Studies, Belgrade, 2005, pp. 23-26.

[82] International Monetary Fund, "FR Yugoslavia – Request for Stand-by Arrangement", IMF, June 2001.

and prices, radical reform of public finances, restructuring of the banking system, and large-scale privatisation of state enterprises.

At the federal level, the stabilisation policy aimed to contain the current account deficit. This, together with the need to clear arrears of debt and to build up international reserves, implied a financing gap of US$10.7 billion for 2001, which the government hoped to cover through a combination of debt rescheduling, new concessional loans and transfers from international donors. Under a restrictive fiscal policy, the federal government budget was slashed, salaries in the federal administration and the army were frozen, investment expenditure was cut and military spending was brought under civilian control. Monetary policy was the responsibility of the National Bank of Yugoslavia (NBY) but since the Montenegrin and Kosovo governments had introduced the euro as their official currency, the remit of the NBY ran only as far as the borders of Serbia. The exchange rate was placed on a managed float, and the NBY permitted the exchange rate to depreciate to ensure external cost competitiveness and to build up external reserves. In cooperation with the IMF and the World Bank, the government introduced legislation in May 2001 to liberalise foreign trade by abolishing most quantitative restrictions on imports and introducing a new tariff schedule which reduced the average duty rate to 10 percent.

Fiscal reforms mostly concerned the republic governments. In Serbia, the government proposed a tax reform to simplify and reduce taxes. Public employment was to be reduced by 6 percent, while the overall aim was to reduce the Serbian government budget deficit to 3.2 percent of GDP. In Montenegro, expenditure cuts were also proposed in order to reduce the government budget deficit, which stood at 10.5 percent of GDP in 2000 and was exacerbated by weak tax collection. Measures were taken in Kosovo as well: one of the first actions was to remove all quantitative barriers to trade and introduce a single 10 percent import tariff which became the main source of government revenue. A Banking and Payments Authority was set up as a central bank, which established the German mark and later the euro as legal tender. A ministry of economy and finance was established to manage the budget and tax system.

The stabilisation policy resulted in a reduction in the rate of inflation from 80 percent in 2001 to 20 percent in 2002 and 3 percent in 2003 (Table 5).[83] The success of the policy increased the credibility of the government and boosted its popular support, enabling it to move politically against the remaining cent-

[83] World Bank, *Serbia and Montenegro – Republic of Serbia: An Agenda for Economic Growth and Employment,* Report no. 29258-YU, December 2004, Washington DC.

ers of power of the old regime. Western governments insisted that Slobodan Milosevic should be handed to the International Criminal Tribunal on the former Yugoslavia (ICTY) before they would provide aid for economic reconstruction. Milosevic was arrested in March 2001 and was extradited in June. Despite its initial success, the stabilisation programme faced difficulties due to political instability within the ruling coalition.[84]

2.4.4. The "State Union of Serbia and Montenegro"

Political and economic relations between Serbia and Montenegro deteriorated progressively in the second half of the 1990s. After 1997, for both political and economic reasons, Montenegro decided to distance itself even more from Serbia by adopting separate laws and implementing its own economic policies, as part of its project of political independence. This was motivated by the need for protection from the disastrous political and economic consequences of Milosevic's policies dictated by the Belgrade government, including currency instability, inflationary pressures, declining official reserves, and rising external balances. At the October 1997 elections, Milo Djukanovic was elected President of Montenegro, defeating the pro-Milosevic candidate Momir Bulatovic. Djukanovic's government introduced a series of measures which established independence from Serbia in most economic fields. Montenegro achieved monetary independence through the creation of its own central bank and the introduction of the German mark, first as a parallel currency and after November 1999 as the official legal tender. Tensions escalated during the last period of the Milosevic regime, when the Serbian leadership turned against Montenegro and imposed an economic blockade: trucks were held at the border and Serbia started importing goods through Thessaloniki rather than the Montenegrin port of Bar. The transfer of federal funds and pension payments to Montenegro was suspended. Political conflict and tensions between the two republics escalated over the next few years, especially during the war in Kosovo.[85] By late 2000 the FR of Yugoslavia represented a unique case: it was still one federal state, but

[84] M. Labus, "Transition in FR Yugoslavia a Year After Radical Political Changes", in *Post-Communist Transition to a Market Economy: Lessons and Challenges*, D.M.Nuti and M. Uvalic (eds) Longo Editore, Ravenna, 2003, pp. 285-92.

[85] P. Simic, "Yugoslavia at the crossroads: Reforms or disintegration?", in Sotiropoulos and Veremis (eds), *op. cit.*, pp. 199-206.

without a full common market, or a customs union, or a monetary union, between its constituent republics.

Under the Constitutional Charter adopted in February 2003, the Federal Republic of Yugoslavia was disbanded and replaced by the "State Union of Serbia and Montenegro" (known simply as "Serbia and Montenegro"). The new confederal union retained powers only over joint defense and foreign affairs, while each member state achieved broad autonomy in other areas including economic and social policy.[86] The arrangement was to last for three years until 2006, at which time Montenegro would be able to hold a referendum on independence. The State Union was run by a six-person Council of Ministers elected by the parliament, whose members were appointed by the two republics. Power was highly devolved to the republics, and the State Union was characterised by a low level of political and economic integration. In effect, the federal state had little more than a symbolic function to disguise the *de facto* separation of the two republics as independent states.

The March 2003 assassination of Prime Minister Zoran Djindjic –who had launched a campaign against organised crime in Serbia– highlighted the difficulties of initiating and implementing reformist policies in Serbia, and underlined the fragility of the democratic transition since the fall of Milosevic. It also highlighted the fact that organised crime had penetrated political structures, public administration, the commercial sector, and the criminal justice system, and continued to be a hindrance to the pursuit of institutional reform.

The stabilisation programme failed to eliminate inflation in Serbia, which remained at over 10 percent in most years. Unemployment also remained high – over 20 percent in Montenegro and over 13 percent in Serbia– and was increasing due to the cuts inherent in the privatisation and restructuring process.[87] Many large state-owned enterprises continued to be supported by subsidies, while the informal sector remained a significant force. In Montenegro, the rate of economic growth was even less than in Serbia: poverty was particularly widespread in the de-industrialised North-East of the country where the main employer, the wood-processing industry, had collapsed due to the combined effects of sanctions, war, and neglect by the central government.

[86] V. Pavlakovic, "Serbia Transformed? Political Dynamics in the Milosevic Era and After", in P.S. Ramet and V. Pavlakovic (eds), *Serbia since 1989: Politics and Society under Milosevic and After*, University of London Press, Seattle and London, 2005, pp. 16-18.

[87] Government of Serbia, *Second Progress Report on the Implementation of the Poverty Reduction Strategy in Serbia,* Government of Serbia, Belgrade, 2007.

However, over the years the Serbian government succeeded in implementing some significant institutional and economic policy reforms, and economic growth peaked at over 9 percent in 2004.[88] The country also benefited from several favourable write-offs of its external debt, starting in 2001 when the Yugoslav government reached an agreement with the Paris Club on the consolidation and write-off of 66 percent of its debt. An agreement was also reached with the London Club of creditors in July 2004 on the cancellation of 62 percent of Serbia's debt and the rescheduling of the rest over the next 20 years. Moreover, in 2004, a large part of Serbia's debt to Russia was written off. These agreements permitted a substantial reduction in Serbia's debt/GDP ratio, from 167 percent in 2000 to 43 percent in 2006.[89]

FDI flows to Serbia started increasing after 2001, which contributed both to compensating for the increasing current account deficit and to the process of privatisation. During the period 1989-2007, cumulative FDI into Serbia reached almost US$12 billion; however, 88 percent of the total amount arrived after 2001. Privatisation receipts in 2003 exceeded US$1.3 billion, with most of the revenue coming from three deals. Serbia earned US$845 million by selling controlling stakes of its largest cigarette-rolling plants to Phillip Morris International and British American Tobacco (BAT). Lukoil, the Russian oil giant, meanwhile bought Beopetrol, the country's largest retailer of oil products, for US$270 million. In 2004 Austria's Raiffeissen Bank established itself as the country's largest bank, while Hypo-Alpe-Adria Bank quadrupled its assets during 2004, joining France's Société Générale on the sector's leaderboard. In 2005 Greece's Alpha Bank bought 89 percent of previously state-owned Yubanka, and Pireus Bank purchased Belgrade-based Atlas Bank. They joined the National Bank of Greece, long present in Serbia. Record FDI inflows to Serbia were recorded in 2006 (US$ 4.3 billion) and the year after (US$3.4 billion). The highest investors in Serbia are Austria, Greece, Norway, Germany and the Netherlands, while Italy and France are close behind. The largest part of FDI in Serbia reflects privatisation deals in specific sectors – cement, tobacco, base metals, and more recently banking and telecommunications – and there has been very little greenfield investment, particularly in the industrial sector. Other companies that have invested in Serbia are US Steel, Microsoft, FIAT, Coca Cola, Gazprom, Siemens and Carlsberg.

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[88] European Bank for Reconstruction and Development, *Transition Report 2009: Transition in Crisis*, EBRD, London, 2009.

[89] *Ibid.*

TABLE 5
Serbia, Economic Indicators

	1998	1999	2001	2003	2006	2007	2008	2009	2010
GDP (% change)	..	-18	5.3	2.5	3.6	5.4	3.8	-3.5	0.9
GDP per capita ($US)	2,039	1,444.1	1,523.6	2,612.9	3,957.6	5,277.4	6,467.2	5,438.1	5,138.9
Unemployment (%)	12.8	13.2	12.2	14.6	21.6	18.8	14.7	17.4	19.6
Consumer price Inflation (%)	30.0	41.0	80.1	15.2	12.7	6.5	12.4	8.1	6.2
Current account balance (as % of GDP)	n/a	n/a	-5.2	-7.3	-10.2	-16,2	-21.6	-7.1	-7.2
External debt (as % of GDP)	n/a	n/a	114.5	77.7	43.1	35.6	34.2	38.2	44.8

Source: IMF *World Economic Outlook*, September 2011; EBRD *Transition Report 2010*.

Meanwhile, in Kosovo, growth was initially rapid due to post-war recovery and the inflow of aid and GDP grew by over 16 percent in 2001. The momentum was not sustained, however: GDP fell in 2002 and 2003, and following a small recovery in 2004, fell again the next year. The collapse in growth was largely due to the decline in international aid inflows and the weak export performance, which was not compensated by growth in domestic consumption or investment. The economy thus came to depend on overseas remittances and on international aid. Over the next years Kosovo remained the poorest part of the Western Balkans with GDP per capita just $790 in 2004. The mainly agricultural and raw material-based economy produces few exportable goods, and there is a massive trade deficit. Unemployment is a staggering 50 percent, while in 2002 over one third of the population was living below the poverty line of 1.42 euro per day.

2.4.5. The "Velvet Divorce": The Independence of Montenegro (and Kosovo?)

The final unravelling of what was left of the former Yugoslavia occurred in May 2006, when a referendum in Montenegro secured a narrow majority in favour of independence. Montenegro declared itself an independent country the following month, the Union of Serbia and Montenegro was officially dissolved, and each country was left to pursue its transition and its path to the European Union as an independent country. The "velvet divorce" would finalise the division of assets, troops and foreign reserves between Serbia and Montenegro. According to the formula for division of assets, 94.5 percent of all property went to Serbia and 5.5 percent to Montenegro, in proportion to their size (7.5 million and 650,000 respectively) and their participation in generating the overall capital and property of the formal state.[90]

TABLE 6
Montenegro, Economic Indicators

	2001	2002	2003	2006	2007	2008	2009	2010
GDP (% change)	1.1	1.9	2.5	8.6	10.7	6.9	-7.1	1.1
GDP per capita ($US)	1,892.5	2,085.9	2,753	4,322.9	5,878.9	7,254.2	6,632.4	6,417.2
Unemployment (%)	20.1	21.2	24.1	22.2	20.1	17.3	15.2	16.1
Consumer price Inflation (%)	23.7	19.3	7.5	3.0	4.2	8.5	3.5	0.5
Current account balance (as % of GDP)	n/a	-10.1	-6.7	-24.1	-39.5	-50.5	-30.2	-26.6
External debt (as % of GDP)	n/a	75.7	40.3	32.6	27.5	31.8	40.1	44.1

Source: IMF *World Economic Outlook*, September 2011; EBRD *Transition Report 2010*.

The territorial integrity of Serbia proper was challenged in February 2008, when Kosovo declared independence. Over the following days, a number of countries (including the United States, Turkey, Albania, Croatia, Montenegro and FYROM) announced their recognition, despite intense protests from Serbia and Russia. The EU had decided, against the background of considerable internal disagreement, that states wishing to recognise Kosovo's independence should do so individually. Most did so, with the exceptions of Cyprus, Greece, Romania, the Slovak Republic and Spain. Despite Serbia's Foreign Minister's declaration to the Security Council that "Kosovo shall remain a part of Serbia forever",[91] by November 2011, 81 UN members had recognised Kosovo as an

[90] Uvalic, 2010, p. 72.
[91] Vuk Jeremic's speech to the UN Security Council. 12 March 2008, Asscociated Press.

independent state, and it had become a member of the IMF and the World Bank as the Republic of Kosovo. In July 2010 the International Court of Justice rejected Serbia's claims that Kosovo's declaration of independence had violated its territorial integrity and was thus illegal. In the face of pressure from the international community, Serbian President Boris Tadic declared that "Serbia will never recognise the unilaterally proclaimed independence of Kosovo", and warned of a perilous precedent which could be replicated in other parts of the world.[92] Kosovo's representatives' warning that any attempt to reverse its independence might spark further conflict raised concern over another potentially dangerous situation in the region. Recognition of Kosovo's independence provoked intense reactions in Serbia: over the next few years the issue of Kosovo fuelled the rise of Serb nationalist rhetoric and also proved to be one of the main obstacles to Serbia's quest for EU admission.

2.5. Former Yugoslav Republic of Macedonia (FYROM)

2.5.1. Independence without Bloodshed

FYROM was the only constituent republic of Yugoslavia which gained its independence peacefully and without bloodshed in September 1991. This declaration was sealed shortly after, with the peaceful departure of the federal Yugoslav army from the country. In light of the ongoing hostilities involving Serbia, Croatia and Bosnia, the viability of yet another independent Yugoslav republic was questioned by the international community. Thus, the independence of the country was not recognised until April 1993, i.e. two years after it declared independence, when it became a member of the United Nations. The only countries which did not recognise the new state's independence were the Federal Republic of Yugoslavia (the official successor state to the Socialist Federal Republic of Yugoslavia), who rejected the very notion of an independent "Macedonian" state and nation, and Greece, who believed that the independence of the new country under the name "Macedonia" implied territorial ambitions over the region of Northern Greece which has the same name.

In addition to the political uncertainties, the new state faced extremely difficult economic conditions as it prepared to launch its transition to a market

[92] http://www.bbc.co.uk/news/world-europe-10734502

economy. The economy, already in a deep recession in 1989-1991 was heading for another "nosedive" as the full implications of the break-up of the single Yugoslav market were felt. FYROM was (with Bosnia) the poorest of the Yugoslav republics, producing a mere 5% of the total federal output of goods and services. Since it had been a net receiver of fund transfers in the now-defunct federation, FYROM immediately faced a liquidity problem, which was exacerbated by non-recognition by the international community and the subsequent lack of international financial support. FYROM was also seriously affected by the economic consequences of the war in the former Yugoslavia and the economic sanctions on Serbia. FYROM's and Serbia's economies were still closely intertwined on many levels, and FYROM depended on Serbia also as a passageway for exports.[93] Trade with Serbia – which was still FYROM's main trading partner both as a market for its goods and as a supplier – was shut down. A further negative blow came in 1994, when Greece, in reaction to the chosen name "Macedonia" closed its borders, thus severing FYROM's access to the sea (port of Thessaloniki) which was a crucial passageway for transport, especially in light of the blockade on Serbia.[94] Thus, from its earliest, most crucial days of independence, the new country found itself totally isolated, without financial support and without access to markets and supplies.[95]

As the country launched its transition the economy was characterised by rising inflation, declining GDP, declining industrial production and rising unemployment. Specifically, the new state did not yet have its own currency and was tied to the Yugoslav dinar and Belgrade's economic and monetary policy, which was focussed on financing the wars in Croatia and then Bosnia. Also, the government was financing the huge federal deficit by printing money. Thus, inflation reached 115 percent in 1991, and shot to 1,620 percent in 1992. GDP contracted by 6.6 percent in 1992, 7.5 percent in 1993, and 1.8 percent in 1994, while unemployment increased from 23.5% in 1992 to 30 percent in 1994. Another problem inherited from the former Yugoslavia was foreign debt: in 1992

[93] E. Karafotakis, "Domestic Market Development in FYROM: The Case of Wholesale Trade", *Agora without Frontiers*, 6, 3, 2001, pp. 201-204.

[94] Three quarters of FYROM's trade, including 90% of its oil requirements, normally moved through the port of Thessaloniki.

[95] It is estimated that the loss incurred by the economy due to the embargo by Greece was US$1.5 billion for 1994-95. M. Wyzan, *First steps to economic interdependence in Macedonia: The struggle for survival in a hostile environment* (Stockholm: Institute of Economics), Working papers, no. 59, 1992, p.5.

FYROM's debt accounted for about 45% of the country's GDP, which the country was unable to service. Also, since in the early years the country had still not been formally recognised by the international community, the inflow of foreign aid was made even more difficult for individual states and international organisations.

2.5.2. Stabilisation and Reform Programme

In April 1992 the new leadership launched the first stabilisation programme, whose main targets were the creation of a new currency, tight monetary and fiscal policy in order to control inflation, and freezing of wages. The programme was practically abandoned within one year, and the period which followed was characterised by a lack of coherent policy towards economic transition.[96] FYROM became a member of the International Monetary Fund in 1993, and thereafter negotiations began for the creation and implementation of a programme for stabilisation and transformation of the economy.

The main points of the IMF Stabilisation and Reform Programme, which was launched in 1994, were the imposition of fiscal discipline and strict monetary policy, measures to control the budget deficit and the acceleration of the privatisation process. The reform programme had positive results. Inflation fell from 338 percent in 1993, to 26 percent in 1994, to 16 percent in 1995 and 2.3 percent in 1996. After contracting consistently for 5 consecutive years, GDP started to rise in 1996. Greece's embargo was lifted in 1995 following the signature of the Interim Agreement, and FYROM's economy was given a major boost with the normalisation of the two countries' relations. However, the programme was not as successful in implementing vital structural reforms of the banking system and in bringing down unemployment levels.

New institutional regulations for the Central Bank of Macedonia (National Bank of the Republic of Macedonia – NBRM) and the banking industry were adopted. The Central Bank was established as an independent monetary authority with the unique aim of maintaining price stability. Due to the fact that FYROM is a small and open economy, after mid-1995 monetary targets were substituted by the exchange rate target. A universal type banking system was

[96] S. Valden, *The Economy of Former Yugoslav Republic of Macedonia* (in Greek), Greek Center for European Studies (Athens: Sakkoula Publishers), 1995, pp. 187-195.

inaugurated after monetary independence; the number of banks rapidly increased (from 4 before monetary independence to 23 by the end of 1999), and 17 savings houses were established. [97]

The country's outlook was transformed from the mid-1990s, when the country seemed to enter smoother waters both in the condition of its economy –as the IMF-supported reforms started bearing fruit– and in the geopolitical context of its relations with its neighbours, as relations with Greece were normalised. Finally, since attracting large-scale investment had become a top priority for FYROM's leadership, the acceleration of the privatisation process and the drafting of the necessary legislation significantly improved the investment climate.[98] Between 1991 and 1996 FYROM had attracted only US$ 59.5 million in FDI. This figure was the lowest, in relation both to population and GDP, of any post-communist country in Central and Eastern Europe, other than Bosnia-Herzegovina and Serbia. The total for FYROM was also well below the comparative figures for 10 of the 15 former Soviet Republics.[99] FDI flows started to increase in 1997, and investment interest peaked in 1998 with investments worth $127.7 million. Great public interest was generated that year by the privatisation of part of the Landa Valalnica steelwork plant in Skopje, which was realised with the help of an investment worth 35.6 million DM by the French-Swiss firm Balkansteel. Following that, one of the largest foreign investments in the country was realised: the 50.5 million DM in the Usje cement-producing plant in Skopje, effectuated by the Swiss firm Holderbank and the Greek firm Titan. Also, there was a joint venture between the firm IGM TIPO from Skopje (which manufactures ceramic products) and the Greek firm Interamerican, where the foreign share of the investment amounted to 20 million DM. By the end of 1998 two more important FDI projects were under way: the injection of Greek capital into Skopska pivara-Skopje (which produces beer and non-alcoholic beverages) and the entry of Slovenian capital in Tutunski kombinat- Skopje (a plant for production of fermented tobacco and cigarettes).[100] Investment dropped the following year,

[97] G. Bishev and B. Nanevski, "The Banking and Financial System of FYROM", *Agora without Frontiers*, 6,3, 2001, pp. 192-196.

[98] I. Kikerkova, "Foreign Direct Investment and its Influence upon the Development of the Macedonian Economy", *Agora without Frontiers*, 6, 3, 2001, pp. 217-220.

[99] National Bank of the Republic of Macedonia, *Foreign Direct Investments Report 1997-2003*, Statistics Department, 2004, p. 5.

[100] Data published by the Agency for Transformation of Enterprises with Social Capital of the Republic of Macedonia, 1996-1999.

however, as a result of the fallout from the war in Kosovo and the high risk factor involved in the area, only to rise again the next year and peak in 2001 with US$ 441.5. However, as a consequence of the 2001 crisis and near-civil war conditions in the country, investment fell sharply the following year.

2.5.3. One Step Forward, Three Steps Back: The Crisis in Kosovo and its Economic Implications

The armed conflict in Kosovo and its fallout had serious economic, social and political implications for FYROM. Radical Albanians in FYROM –some of whom actively participated in the Kosovo Liberation Army (KLA)– were encouraged to step up their own campaigns for autonomy or even independence.[101] The ethnic Slav-Macedonians feared that a combination of the influx of almost 300,000 Albanian refugees from Kosovo and a faster natural increase of the native Albanian population in FYROM would turn the delicate ethnic balance against them.[102] There were also serious concerns that the links between the KLA and elements among FYROM's ethnic Albanian community might provoke Serbia to intervene militarily in FYROM, or even that the ethnic Albanians may secede from FYROM, leaving a weakened rump state that could fall prey to the ambitions of its neighbours.[103]

The conflict in Kosovo opened Pandora's box concerning the question of the Albanian minority living in FYROM. The success of the KLA in Kosovo encouraged ethnic Albanian extremists to confront the government of FYROM in the name of increasing the rights of the Albanian minority and demanding more autonomy. The crisis culminated in 2001 in a violent confrontation which led the country to the verge of civil war. Albanian guerrillas from the National Liberation Army (NLA) began an insurgency against the government, demanding a federal solution for the ethnic problem, which ethnic Slavo-Macedonians feared would be the first step towards the break-up of the country. Ethnic strife

[101] Already in 1991-92 there had been calls for the unification of all lands inhabited by ethnic Albanians (in Kosovo, Western Macedonia, Montenegro and Southern Serbia) into a "Greater Albania" and for the creation of an autonomous province ("Ilirida") in Western Macedonia.

[102] P. Sklias, "Politics and Economics of FYROM: the repercussions of the crisis in Kosovo" (in Greek), *Agora without Frontiers*, 6, 2, 2000, p. 86.

[103] S. Sofos, "The Albanian question: Macedonia at the crossroads", *Journal of Southern Europe and the Balkans*, 3, 2, 2001, pp. 145-147.

spread throughout the country, raising valid fears for a split of the country along ethnic lines. The crisis was eventually settled in August 2001 with the signature of a peace agreement in Ohrid between the two foremost Albanian and Slavo-Macedonian political parties. The agreement guaranteed the civil rights of the Albanian minority, *inter alia* by allowing the use of Albanian as an official language in those areas where the Albanian minority surpassed 20% of the total population, enhancing power-sharing arrangements, and providing more funding for Albanian language education. The main principles of the agreement were incorporated in the new Constitution, which was adopted in 2002.

TABLE 7

FYROM, Economic Indicators

	1992	1996	1999	2001	2004	2007	2008	2009	2010
GDP (% change)	-6.6	1.2	4.3	-4.5	4.6	6.1	5.0	-0.9	1.8
GDP per capita ($US)	1,201.7	2,232.7	1,837.1	1,704.5	2,717.3	3,997.9	4,827.8	4,549.6	4,482.8
Unemployment (%)	23.5	31.9	32.4	30.5	37.1	34.9	33.9	32.1	32.2
Consumer price inflation (%)	1,620.3	2.3	-0.3	5.5	-0.4	2.2	8.3	-0.8	1.5
Current account balance (as % of GDP)	-0.3	-7.5	-2.6	-7.2	-8.2	-6.9	-12.8	-6.7	-2.7
External debt (as % of GDP)	45.2	38.1	32.0	48.7	35.6	23.9	20.6	23.8	24.6

Source: IMF *World Economic Outlook*, September 2011; EBRD *Transition Report 2010.*

The six-month crisis had extremely serious repercussions for the country, highlighting the weakness of the new institutions' capacity to handle crises of such proportions. The crisis also highlighted the fragile ethnic balance in the country, while the ongoing friction between the various ethnic groups revealed yet another potentially volatile area in the Balkan region.[104] Finally, the upheaval had serious repercussions on the country's fragile economy, which had been

[104] See also Y. Florou and P. Sklias, "The Crisis in FYROM: Perceptions, Expectations and Prospects for Development" (in Greek), *Agora without Frontiers*, 9, 3, 2004, pp. 219-228.

showing signs of strain even before the collapse of 2001, due to prolonged military activity in the region, the NATO bombing of Serbia, sanctions against Serbia, and the massive influx of refugees. Thus, the 2001 crisis and its fallout reversed the significant progress which had been achieved in stabilising and transforming the economy since the mid-1990s. All significant macroeconomic indicators deteriorated, privatisation practically halted (since foreign investors were not forthcoming), and the necessary restructuring of the banking sector was brought to a standstill. Industrial production declined dramatically in almost all sectors, while unemployment remained at extremely high levels, revealing a long-term major weakness of the economy.[105]

After years of stagnation, economic stability and growth resumed; in 2004 GDP grew by 4.6 percent, inflation was low at 0.5 percent, and external debt was stable at 35.6 percent of GDP. Despite the resumption of economic growth and stability, FYROM faced an uphill battle in recovering from the long-term effects of the 2001 conflict. Economic growth has been narrowly based on a few key sectors, as has the flow of FDI which has been concentrated on a few large deals related to privatisation in oil refining, telecommunications and banking. Improving the investment climate has become a priority area for the government. Other problems include the continued high levels of unemployment, and the fact that the informal economy accounts for almost 40 percent of household income.

2.6. Some Conclusions Regarding the Western Balkan Transitions

As the above analysis illustrates, the 1990s were a period of extreme instability in the Balkans, as the region suffered from the violent dismemberment of Yugoslavia and subsequent wars, sanctions, ethnic unrest, refugee crises, financial scams, destroyed infrastructure, hyperinflation, and airstrikes. The region seemed to be perpetually on the brink of chaos and unrest, with little interest in political or economic reform.[106] However, the period following the

[105] R. Panagiotou, "FYROM's transition: On the road to Europe?", *Journal of Southern Europe and the Balkans*, 1 (1), April 2008, p. 57.

[106] G. Petrakos and S. Totev, *The development of the Balkan region*, Ashgate, Aldershot, 2000; M. Zarkovic Bookman, *Economic decline and nationalism in the Balkans*, Macmillan, Basingstoke, 1994; F.W. Carter and H.T. Norris (eds), *The changing shape of the Balkans*, UCL Press, London,1996.

cessation of hostilities in Serbia until the emergence of the economic crisis was one of relative growth and stability in the region, with democratic regimes and market-oriented economies taking root. The conflicts of the 1990s seemed to have been replaced by a greater commitment to political and economic reform, regional cooperation and rapprochement with the EU.[107] With varying speed and intensity, the countries of the region had adopted stabilisation and reform programmes under the guidance of the IMF, the main points of which were the imposition of fiscal discipline and strict monetary policy, measures to control the budget deficit, liberalisation of prices and trade, and the acceleration of the privatisation process.[108]

The long and arduous transition process counts both important successes and enduring challenges. Firstly, through the imposition of the reform measures, the region as a whole achieved macroeconomic stabilisation, GDP started to rise after contracting consistently for several years, inflation was brought under control, and FDI levels started to grow after years of non-existent activity (Figures 1 and 2).[109]

Remarkably, average growth in the region equaled or exceeded that in Central-Eastern Europe every year between 2001 and 2008 – prior to the economic crisis, which reversed many of the gains. However, the high growth rates should be seen in the context of the region having a lot of catching up to do; this point is brought out by a comparison of the 2007 level of GDP per capita with selected countries in Central Europe, which highlights the persistent gap between the two regions (Croatia being a notable exception).[110]

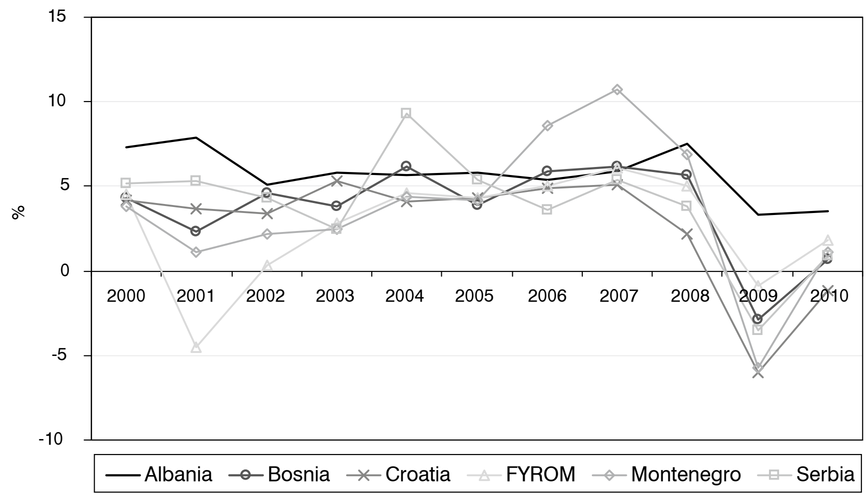
[107] "Political and Economic Development in the Balkans: Is there a Critical Mass of Support for Reform?", Workshop Report, SEESOX, St Antony's College, Oxford, May 2007.

[108] I. Jeffries, *The former Yugoslavia at the turn of the twenty first century: A guide to the economies in transition,* 2002; C. Michalopoulos, "The Western Balkans in World Trade", *Journal of Southeast European and Black Sea Studies*, 2 (2) 2002.

[109] E. Busek and B. Kuehne (eds), *From stabilisation to integration: The Stability Pact for South Eastern Europe*, Bohlau Verlag, Wien and Koln, 2010, pp. 3-5.

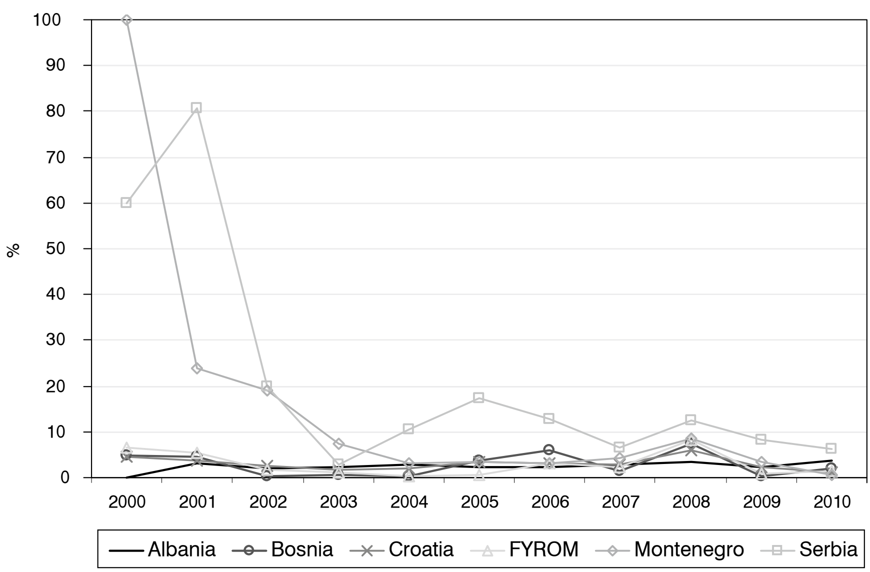
[110] Two measures of GDP are given: one is a simple conversion to dollars at average market exchange rates, while the second gives an estimate in terms of purchasing power parity (PPP).

FIGURE 1
GDP Growth Rates in Southeast Europe



Source: IMF, *World Economic Outlook*, September 2011.

FIGURE 2
Inflation Rates in Southeast Europe



Source: IMF, *World Economic Outlook*, September 2011.

TABLE 8
GDP per capita in 2007, nominal and PPP adjusted ($US)

Country	GDP per capita	GDP per capita (PPP-adjusted)	Country	GDP per capita	GDP per capita (PPP-adjusted)
Albania	3393.4	6,319.8	Czech Republic	17,070.2	24,236.2
BiH	3891.3	7,205.1	Hungary	13,762.2	18,842.1
Croatia	13,382.7	17,888.3	Poland	11,157.3	16,372.5
FYROM	3997.8	8,960.9	Slovakia	13,857.1	20,375.4
Montenegro	5,868.9	10,120.6	Slovenia	23,565.6	27,981.2
Serbia	5,277.4	9,722.4			

Source: IMF, *World Economic Outlook*, September 2011.

As far as foreign direct investment flows are concerned, it is clear that in the early years of the transition period the opportunities for attracting FDI were much more limited for the Balkan countries than for the Central European transition economies.[111] As a consequence FDI in the Balkan region lagged far behind: between 1990 and 1999, cumulative FDI per capita for the Czech Republic was US$967, for Hungary US$1,627, for Estonia US$953 and for Poland US$389, compared to only US$132 for Albania, US$121 for FYROM, US$157 for Serbia, and US$43 for Bosnia.[112] This differentiation was due to the assessment of the Balkan region as being a high-risk area as far as investment was concerned, for all the reasons discussed above: political and social instability following the break-up of Yugoslavia, ethnic conflicts and turmoil, corruption, high criminality rates and lack of transparency, non-commitment to economic, political and structural reforms. However, after 2000, the Western Balkan region became an increasingly attractive destination for foreign investors, and FDI into the region experienced a considerable growth, spurred by significant reforms, renewed stability and newly-developed relations with the European Union.[113] During the period 2003-2008 the annual average of FDI inflows for all six Western Balkan

[111] R. Panagiotou, "Foreign Direct Investment in Southeast Europe", *Countdown Project, European Union enlargement: Regionalism and Balkan integration,* Institute for International Economic Studies, Vienna, 2001.
[112] OECD *Economic Survey*, 1999.
[113] L. Kekic, "Foreign Investment in Eastern Europe: How Important is EU Membership?", in *World Investment Prospects 2003, the Future of FDI: Globalisation or Regionalisation?* Economist Intelligence Unit, London, 2003.

countries was US$7.7 billion, compared to the annual average of US$840 million for the period 1990-2000 (Table 9).[114]

TABLE 9

Foreign Direct Investment Flows in the Western Balkans (million US$)

	1990-2000 (annual average)	2003	2004	2005	2006	2007	2008	2009	2010
Albania	53	178	338	264	325	662	988	979	1,097
Bosnia	35	381	668	613	766	2,077	932	246	63
Croatia	447	2,049	1,227	1,788	3,468	5,023	6,179	2,911	583
FYROM	51	96	157	97	424	699	587	201	293
Montenegro	-	45	63	478	618	921	960	1,527	760
Serbia	254	1,365	966	1,609	4,350	3,462	2,995	1,959	1,329
Total	**840**	**4,114**	**3,419**	**4,849**	**9,951**	**12,844**	**12,641**	**7,823**	**4,125**

Source: World Investment Report, 2005-2011, United Nations Conference on Trade and Development.

The increase in net FDI inflows to SEE came largely from progress in large scale privatisation. For example, one-third of FDI in Croatia in 2000 and two-thirds of the inflow in Albania were generated by sales of a bank and the award of a mobile telephone license respectively. The sale of the state's stake in FYROM's national telecom operator in 2001 generated as much FDI as the preceding ten years. Similarly, the partial privatisation of the oil company INA in Croatia, and lucrative privatisations in the tobacco and oil sectors in Serbia were responsible for a large percentage of total FDI. Over the past years there was an increase in export-oriented foreign investment in the region, as well as in FDI in greenfield investment and existing private companies in the region.[115] As will be discussed below, however, this upward trend in FDI to the region was abruptly interrupted by the global economic crisis. This is also evident in Table 9.

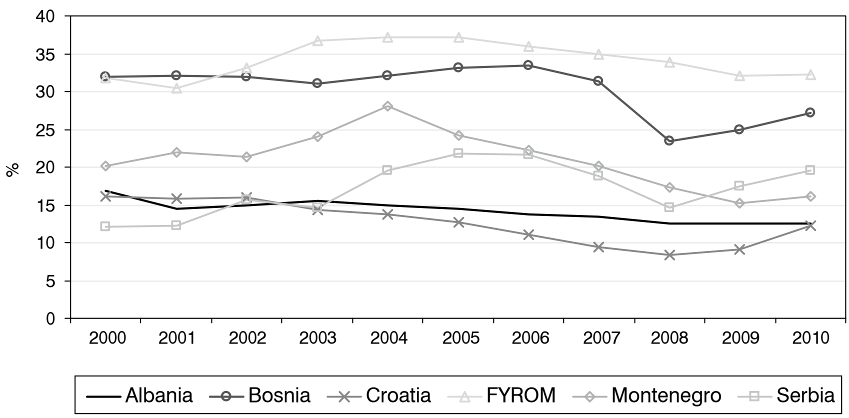
Despite the noteworthy achievements, the transition process in the Western Balkan region continues to be confronted by significant and enduring challeng-

[114] Institute for International Finance, *Capital Flows to Emerging Market Economies*, January 2009.

[115] E. Nowotny, "FDI and trade as pivotal elements for catching up and competitiveness", in K. Liebscher *et al.* (eds) *European Economic Integration and South-East Europe: Challenges and prospects*, Edward Elgar, 2005, p. 201.

es. The major macroeconomic challenges facing the Western Balkan economies remain controlling spending, expanding exports, managing debt and bringing down unemployment levels.[116] As Figure 3 indicates, unemployment was to remain one of the main challenges in the Western Balkan economies, with ongoing public-sector reforms and post-privatisation restructuring adding to the already high unemployment levels.[117]

FIGURE 3
Unemployment Rates in Southeast Europe



Source: IMF, *World Economic Outlook*, September 2011.

As far as the expansion of exports is concerned, it is a fact that during the transition, enterprises in Southeast Europe found it difficult to reach markets abroad. While all businesses in transition countries faced the challenge of making new contacts, acquiring new marketing skills, achieving the quality necessary for western markets and building reliable business relationships, the successor states of the former Yugoslavia had additional problems on that front. The former Yugoslavia had been one economic space, with strong trade and investment linkages among the six republics. These links were broken during the violent dismemberment of the SFRY and the subsequent conflicts of the 1990s, a fact which exacerbated the economic decline of the newly established states

116 "South-Eastern Europe: Global economic challenges and European perspectives", Workshop Report, SEESOX, St Antony's College, Oxford, May 2008.

117 One should caution that official rates of unemployment may be exaggerated. The precise measurement of unemployment in transition economies, where informal and casual labour is common, is problematic.

and created a devastating impact on trade relations in the whole region.[118] After the hostilities had ended expanding trade became a priority for all states in the region, but trade flows –especially within the region– were still below their potential.[119]

In addition to the problems discussed above, in most countries the measures were not so successful in implementing vital structural reforms of the banking and financial system, enterprise restructuring, infrastructure reform and competition policy.[120] Table 10 illustrates the progress achieved in the transition process, based on EBRD transition indicators. As the indicators show, in most countries, the relatively "straightforward" part of transition –reforms such as price, trade and foreign exchange liberalisation, and small-scale privatisation– progressed rapidly. The most difficult challenges involved institutional and structural reforms such as large-scale privatisation, reforms to corporate governance and competition policy, deepening of financial intermediation and infrastructure reform. Significantly, when one compares the 2010 transition indicators to those for 2004, one observes that during this period only marginal progress has been achieved in these areas of reform. Clearly, much more would be needed to bring these countries to the standard necessary for EU membership.

Finally, the reforms were not successful in addressing enduring institutional weaknesses such as slow and cumbersome administrative procedures, shortcomings in the judiciary, fighting corruption and organised crime, and dealing with the "grey economy". Even after several years of reforms, most of the countries of Southeast Europe continued to be characterised as "flawed democracies" or "hybrid regimes".[121]

[118] M. Uvalic, *Yugoslavia: The Economic Costs of Disintegration*, Working Paper EPU 92/17, European University Institute, Florence, 1992.

[119] E. Falcetti, P. Sanfey and S. Tepic, "South-East Europe: Opportunities and potential for investment and growth", in K. Liebscher *et al.* (eds), *op. cit.*, p. 58.

[120] C. Papazoglou, *The Economies of South Eastern Europe: Performance and challenges*, Palgrave Macmillan, London, 2005, pp. 98-109.

[121] European Bank for Reconstruction and Development, *Transition Report 2006*.

TABLE 10

Transition Indicators,* 2010 and 2004

	Enterprises						Markets and trade						Financial institutions				Infrastructure	
	Large privatisation		Small privatisation		Enterprise restructuring		Price liberalisation		Trade		Competition policy		Banking reform		Securities markets		Infrastructure reform	
	2010	2004	2010	2004	2010	2004	2010	2004	2010	2004	2010	2004	2010	2004	2010	2004	2010	2004
Albania	4-	2+	4	4	2+	2	4+	4+	4+	4+	2	2	3	3-	2-	2-	2+	2
Bosnia	3	2+	3	3	2	2	4	4	4	4-	2	1	3	3-	2-	2-	3-	2+
FYROM	3+	3+	4	4	3-	2+	4+	4	4+	4+	2+	2	3	3-	3-	2	3-	2
Serbia	3-	2+	4-	3+	2+	2	4	4	4	3+	2+	1	3	2+	2	2	2+	2
Croatia	3+	3+	4+	4+	3	3	4	4	4+	4+	3	2+	4	4	3	3-	3	3
Montenegro	3+	-	4-	-	2	-	4	-	4	-	2	-	3	-	2-	-	2+	-

Source: EBRD *Transition Report, 2010* and *2004*.

* Transition indicators vary from 1 to 4+, where 1 represents minor change or no change in the position from a centrally planned economy, while 4+ represents meeting of standards of an industrialised market economy.

CHAPTER 3

THE EFFECTS OF THE GLOBAL ECONOMIC CRISIS ON THE WESTERN BALKANS

Few countries were unaffected by the global economic crisis, and even those that were growing economically before the crisis –as was the case of the countries of Southeast Europe– felt the crunch. It was clear from the beginning that the crisis would not by-pass the Balkans, and by late 2008 the region was bracing for the inevitable. As the Nobel Prize-winning economist Joseph Stiglitz said during a visit to Belgrade in 2008, "...the region cannot avoid the global crisis... some countries will be hit directly on the trade level, others because of the fall of the price of raw materials... this crisis began at the centre, in the US, but the periphery will be hit the most, because exports and direct foreign investment will suffer. The region depends on Europe, which will suffer even greater consequences than the US".[122]

The global economic crisis hit the Balkan region just as it was consolidating the progress it had made after emerging from years of war, political instability and painful economic reform programmes. As was discussed above, for most countries in the region, the period 2003-2007 was one of the strongest in more than a decade, with annual real GDP growth averaging about 6%. Although the economies of the Western Balkan states were not hit by the first wave of the global financial crisis in early 2008, the economic slowdown in EU countries – the main recipients of Balkan exports– and the decreased influx of foreign direct investment triggered the first symptoms of the crisis in the region by the last quarter of 2008. By mid 2009 the effects on the financial sector were being felt more strongly, particularly with a slowdown in foreign bank lending activities.[123]

The spreading of the crisis followed the predictable pattern whereby the lack of financing meant slower development, lower demand in the world mar-

[122] *Perspective*: *Magazine of the American Chamber of Commerce in Serbia,* vol. 24, December 2008.

[123] J. Bastian, "'Cry wolf' no more: External anchors and internal dynamics in the Western Balkans", *Journal of Southeast European and Black Sea Studies*, special issue, *Europe's Unfinished Transitions: The Convergence-Divergence Debate Revisited*, 8 (4) 2008.

ket meant shrinking exports, while decreased output meant lower public revenues.[124] In fact, the growth model that had been implemented over the past few years in Southeast Europe, combined with the institutional weaknesses which was evident in most of these countries, had left the region vulnerable to external shocks in several respects. It had not managed exchange rates in a way that preserved a wide margin of competitiveness so as to support export-led growth and build up external reserves to very high levels. Capital controls had been removed quite early, while there had been a rapid expansion of lending to households, often by foreign banks and in foreign currencies. Moreover, high levels of current account deficits fuelled by rapid credit expansion –in a setting where structural policies were still lagging– had exacerbated the exposure of economies to the crisis in global markets.[125]

3.1. Structural and Macroeconomic Impact of the Crisis

3.1.1. Worsening Macroeconomic Indicators

The global economic crisis had a negative impact on the macroeconomic indicators, characterised by falling GDP, rising unemployment rates, declining rates of investment, falling industrial output and growing current account deficits (ranging from 9% in Croatia to 30% in Montenegro). According to the European Bank for Reconstruction and Development *Transition Report 2010* and the IMF *World Economic Outlook* of September 2011, the economies of the region contracted significantly in 2009, resulting in negative GDP growth rates in Bosnia-Herzegovina (-2.9 percent), Croatia (-5.8 percent), FYROM (-0.9 percent), Montenegro (-7.1 percent) and Serbia (-3.5 percent) (Figure 1). Albania also faced a slowdown in growth (3.3 percent, down from 7.5 percent in 2008), but was the least impacted by the crisis due to the low volume of Albanian exports and comparatively low level of integration into the international economy. The strong growth levels of the previous years had been based on robust domestic demand fuelled by excessive credit growth in household consumption and mortgage services. The sharp slowdown indicated *inter alia* that consumer

[124] "South East Europe: The impact of the global financial crisis", Workshop Report, SEESOX, St Antony's College, Oxford, June 2009.
[125] *European Report*, August 28, 2009.

demand was radically adjusting downward, with credit availability frozen and debt repayments becoming more commonplace.[126]

Unemployment, which was already very high, continued to rise as the significant fall in exports resulted in the closure of many companies. The official unemployment figures for 2009 stood at 9.1 percent for Croatia, 12.6 percent for Albania, 15.2 percent for Montenegro, 17.4 percent for Serbia, 32.1 percent for FYROM and over 25 percent for Bosnia-Herzegovina (Figure 3). Significantly, in most countries over half of the unemployed were under 30 years old.

As the region's traditional export markets contracted, it was increasingly difficult to keep the state budgets in balance.[127] The characteristically high current account deficits all over the region significantly increased the countries' economic vulnerability, necessitating a fiscal tightening which together with the poor external economic outlook hit Serbia, Croatia, FYROM and Bosnia-Herzegovina particularly hard. The current account deficits as a percentage of GDP in 2009 ranged from 30.1 percent in Montenegro to 5.2 percent in Croatia.

3.1.2. Decline in Remittances

Migrant workers' transfers in the Balkans constitute a major economic force. According to the IMF's Balance of Payments yearbook, in 2006 Albania, Bosnia-Herzegovina, Montenegro and Serbia were among the top twenty countries in the world in terms of remittance inflows as a percentage of GDP. In 2008, remittances as a share of GDP had reached 17.2 percent in Bosnia, 16.5 percent in Kosovo, 14 percent in Serbia and 12 percent in Albania.[128] The economic crisis, however, which led to significant layoffs elsewhere in Europe, adversely affected the migrant workers' continued ability to transfer important amounts to their home countries. Many of these labourers were employed in sectors hit by the recession in their host countries, particularly in car manufacturing, construction and household work. A decline in remittances from relatives working abroad affected families in the countries of origin and their income expectations and

[126] J. Bastian, "Falling Behind Again? Southeast Europe and the Global Crisis", *ELIAMEP Thesis*, March 2009.
[127] D.M. Nuti, "The Impact of the Global Crisis on Transition Economies", UNU WIDER Conference, *Reflections on Transition: Twenty Years after the Fall of the Berlin Wall*, Helsinki 18-19 September 2009.
[128] World Bank, *Migration and Remittances Factbook,* 2009.

also impacted on countries' foreign currency holdings, medium-term budgetary planning and the financing of high current account deficits.

3.1.3. Spillover from Neighbouring Countries in Crisis

As small, open economies –more than one fifth of economic output and employment is based on exports– the Western Balkan countries were especially vulnerable to the effects of the world crisis, especially the fall in global growth and trade. Significantly, since the EU member states constitute the most important trade and investment partners for these countries, the deteriorating conditions in the EU –leading *inter alia* to drastically falling consumer demand– had a particularly detrimental effect on exports to traditional markets and cross border trade relations. For example, due to reduced foreign demand, FYROM's metallurgical industries were operating on 50% of their capacities for a great part of 2009, leading to a large fall in production as well as massive layoffs. Croatia, whose tourism industry is a major source of income and is mostly powered by citizens of EU countries, also lost important revenue as the economic downturn led to a dramatic fall in tourism.

Due to its dependence on steel and metal exports, the region was also hit hard by the global slump in manufacturing and commodity prices in the world market. The price of metals fell by almost two-thirds between 2008 and 2009, contributing further to the slowdown in the region's economies. Thus, Serbia, who relies massively on exports of food and raw materials such as copper and iron (which make up 40% of total exports) suffered not only from the fall in demand of these products but also because of the dramatic fall in the price of copper in 2008. US Steel, one of Serbia's leading exporters, was one of many companies to close a large plant in 2009. Similarly, in FYROM, Silmak –a significant producer of ferro-nickel– cut production and lay off workers due to the drastic fall in ferro-nickel's price on the world markets. Finally, the Western Balkan economies were greatly affected by the dispute between Russia and Ukraine in mid-2008 over gas prices, which reduced energy supply to the region and forced the region's heavy industry to cut production and even halt assembly lines.

3.1.4. Declining Foreign Direct Investment

As discussed above, revenues from foreign investments had played a very important role in the economic growth achieved in the region during the period 2003-2007: they contributed *inter alia* to infrastructure projects, the privatisation process, balancing the budget and the financing of foreign debt payments. Consequently, the sharp decline in foreign direct investment after 2008 –caused mainly by the economic downturn in the investing countries– had a seriously detrimental effect on the national economies in the region.[129] The United Nations Conference on Trade and Development (UNCTAD) *World Investment Report* of 2010 reported a 38 percent decrease in FDI flows to the region between 2008 and 2009, with total flows declining from US$12.6 billion to US$ 7.8 (Table 9). Bosnia and Croatia were particularly hit: Bosnia experienced a 73 percent decline in FDI, from US$932 million to US$246 million, while FDI in Croatia fell from US$6.2 billion to US$2.9 billion.[130]

An important example of lost FDI was the case of FIAT in Serbia: in September 2008, FIAT had signed a 1 billion euro joint investment agreement in Belgrade, which was hailed as a landmark project and was expected to create nearly 5,000 jobs. By February 2009, FIAT had announced that a sizeable proportion of this investment would be postponed, citing concerns about the state of the international automotive industry. Another example is that of Bangalore property developer The Embassy Group, which, despite having scheduled an investment of more than 450 million euros in the country, announced that it was being put on hold. The Czech energy company CEZ and the Norwegian power utility Statkraft both withdrew from major projects in the Republika Srpska in Bosnia-Herzegovina. There were many other similar examples of major investment projects that had been approved before the full impact of the crisis was felt, and then red-lighted and shelved. The decrease in revenues from foreign investments also caused serious difficulties in servicing these countries external debt, which as a percentage of GDP in 2009 stood at 60 percent for Albania, 36 percent for Bosnia-Herzegovina, 23.8 percent for FYROM, 38.2 percent for Serbia, 40.1 percent for Montenegro, and 34.5 percent for Croatia.

[129] L. Kekic, “The Global Economic Crisis and FDI Flows to Emerging Markets”, Economist Intelligence Unit, London, 19 October, 2009.

[130] *World Investment Report 2010,* United Nations Conference on Trade and Development (UNCTAD).

The situation deteriorated even further in 2010.[131] According to UNCTAD's World Investment Report 2011, Croatia received only US$583 million of FDI in 2010, compared to US$2.9 billion in 2009 (which was already down from US$6.2 billion in 2008). For the first time, Croatia fell behind both Albania and Montenegro in the levels of foreign direct investment it received, marking a departure from its position as one of the most popular recipients of foreign funding in previous years. Reductions in investment from EU countries played a crucial role in the sharp contraction of FDI in Croatia, as these countries had traditionally been the dominant source of FDI in the country. Specifically, Austria and the Netherlands –historically two of the largest investors in Croatia– had both divested in 2010, recording negative inflows of US$150 million and US$500 million. FDI in Bosnia also fell dramatically in 2010, to US$63 million, compared to US$501 million in 2009. Only FYROM and Albania achieved a slight increase in FDI between 2009 and 2010: FDI in FYROM grew to US$293 million (from US$248 million in 2009), while FDI in Albania reached US$1.1 billion (up from US$979 million in 2009). The increase in FDI in Albania can be attributed to some privatisations within the strategic sectors and increased investments in the energy, finance and telecommunications industries.

3.1.5. Financial Sector Implications

In the Balkan region foreign banks and non-bank financial institutions (insurance companies) had over the past decade accounted for more than half of the corporate lending market and two thirds of the home-loan business.[132] The countries are very dependent on foreign currency lending, which has mainly been provided by foreign (parent) banks to their subsidiaries. With the credit freeze domestic banks and local companies found it increasingly difficult to refinance their foreign debt holdings, leading to decreasing capital flows. Ironically, the banking institutions of Southeast Europe had not themselves accumulated the kinds of toxic assets seen in the West; however, many of the parent companies of the now almost internationalised industry were heavily exposed.

[131] *World Investment Report 2011,* United Nations Conference on Trade and Development (UNCTAD).

[132] J. Bastian, "Banking on Southeast Europe: Financial sector reform amidst regional volatility", *Journal of Southeast European and Black Sea Studies*, 3 (1) 2003.

As western financial institutions downsized their operations or put their investments on hold, the economies of Southeast Europe were being frozen out of credit markets and were being sidetracked in their effort to attract foreign currency loans.[133] The crisis also affected the stock markets in the region: the Zagreb Stock Exchange index experienced an annual decrease of 67 percent in 2009, while the Belgrade Stock Exchange index lost 75 percent. Due to a substantial fall in the share prices in the region most privatisation processes in both countries were suspended.[134]

The crisis has led to a significant increase in the activities of a number of international financial institutions in the region, most notably the IMF.[135] The number of IMF programmes in operation in the region had declined from 12 during the period 1994-97 to 3 in 2007; by 2008, only Albania still had a lending programme, which ended by the end of the year. But the crisis had exposed most countries to destabilising financial gaps on the external accounts. With the supply of capital drying up rapidly, this raised the possibility of countries not being able to meet their external obligations, which could lead to major depreciations of their currency and/or default. As of May 2009, Serbia signed a multiyear programme with the IMF which provided it with 3 billion euros. The Bosnian authorities signed a letter of intent in spring 2009 and a three-year agreement of around 1.5 billion was signed in July 2009. The stand-by arrangement included a commitment by the authorities to public sector reform and continued implementation of politically difficult cuts to benefits and public sector wages. Other institutions active in the region – the EBRD, EIB and World Bank – also stepped in with their support. [136] The three institutions provided over $US33 billion in support for banks and the transition economies (including the Western Balkans) in 2009 and 2010.

[133] Emerging Europe Monitor*, South East Europe*, 16 (10) October 2009.

[134] M. Uvalic, "The Impact of the Global Financial Crisis for Eastern Europe", *Eighth International Conference on Challenges of Europe*, Conference Proceedings, University of Split, Faculty of Economics, Bol, May 2009.

[135] International Monetary Fund, "Global Economic Crisis: To Help Countries face Crisis, IMF Revamps its lending", *IMF Survey online*, March 24, 2009.

[136] C. Cviic and P. Sanfey (2010): *In Search of the Balkan Recovery: The Political and Economic Reemergence of South-Eastern Europe,* London: Hurst and Company, p. 195.

3.1.6. Contagion from the Greek Crisis

Serious concerns have been raised about the impact of the ongoing economic crisis in Greece on the political and economic situation in the neighbouring Balkan countries. Significantly, the 2010 EBRD *Transition Report* highlights the main short-term challenge for the region as being the survival of "possible contagion effects from economic weaknesses in the eurozone, especially in neighbouring Greece".[137] Possible channels of contagion include trade, remittances and banking, while another knock-on effect would be FDI flows into the region: Greece had previously been a conduit for foreign investors going into Southeast Europe, but had ceased being an entry point as its domestic crisis worsened. In any case, it is clear that due to the interdependence between all the countries of the region, the Greek crisis has produced a vicious circle whereby the decline of the economies of Southeast Europe (which has been exacerbated by the situation in Greece) feeds back into Greece through *inter alia* a fall in demand for imports from Greece and a fall in the return on Greek investments. For Bosnia-Herzegovina and Croatia, the trade, investment and financial links with Greece are negligible, and the risk of any spillover effects for these two countries is very low. Trade relations with Greece are most important for Albania, Montenegro and FYROM, whose exports to Greece account for 12-16 percent of the total. There was a sharp decline in exports to Greece in 2009 and the first quarter of 2010, as the economic crisis in Greece caused a further reduction in demand for goods from these countries.

Albania, Serbia and FYROM are the most vulnerable to negative spillover through reduced FDI flows, as Greece ranks first in investments in all these countries (in 2008, Greek FDI accounted for 27 percent of total investments in Albania, and 15% each for FYROM and Serbia). A considerable decline in Greek FDI flows to the region was evident already in 2008: for example, Greek investment in Serbia for the two-year period 2008-2009 amounted to some 46 million euros, well below the 2007 total of 336 million euros. In terms of the potential impact on remittances, Albania would be the most affected. Some 600,000 Albanians live and work in Greece: in 2009 workers' remittances amounted to about 12 percent of Albania's GDP, of which at least US$900 million (8 percent of GDP) came from Greece, contributing to domestic economic growth and

[137] IMF, *World Economic Survey*, September 2011; EBRD *Transition Report 2010*.

providing livelihood for many families.[138] Thus, a crucial spillover effect from the crisis in Greece relates to the inevitable decline in remittances, as it becomes increasingly difficult for migrant workers to stay employed in Greece and many are forced to return to their home countries. A decline in remittances also has a negative effect on the countries' foreign currency holdings, medium-term budgetary planning and the financing of their current account deficit.

The most likely channel for significant contagion is through the Greek bank subsidiaries operating in the region. Greek banks have been particularly active and have invested heavily in the Balkans: by 2007 seven major Greek banks had established a network of around 20 subsidiaries in the region with around 1,900 branches, employing approximately 23,500 people. The National Bank of Greece, EFG Eurobank, Piraeus and Alpha Bank are major players in the region, accounting for between 10-15 percent of banking assets in Albania, Serbia, FYROM and Montenegro. Greek interests are particularly strong in Serbia, where three out of 10 banks are Greek. Subsidiaries are to a significant extent funded with loans from Athens rather than local deposits. Even if Greek banks do not withdraw from the region, they will try to grow the local deposit base faster than loans, and they are likely to refrain from making fresh loans for a while. Thus, there is a risk that Greek banks will limit their credit activity and reduce their exposure in the region as a result of funding and liquidity pressures on the Greek parent banks. Significantly, Greek banks that benefited from a 28 billion euro government bailout package in 2009 were encouraged –via a verbal agreement between the Greek Finance Ministry, the Bank of Greece and the participating institutions– to use the money to support lending at home, not at their subsidiaries in the Balkans. Thus, subsidiary branches of Alpha Bank, National Bank of Greece or Eurobank in Bulgaria, Serbia, Albania, FYROM and Romania did not get a share of the bailout package.

3.2. Conclusions and Future Outlook

The latest figures published by the World Economic Outlook (IMF, September 2011) allow for some cautious optimism, as they predict a further upturn of GDP growth for the region in 2012, compounding the marginal growth reported for 2011 (Table 11).

[138] World Bank, *Migration and Remittances Factbook*, 2009.

TABLE 11

Western Balkans, Economic Indicators 2011, 2012 (projections)

	Albania		BiH		Croatia		FYROM		Montenegro		Serbia	
	2011	2012	2011	2012	2011	2012	2011	2012	2011	2012	2011	2012
GDP (% change)	2.5	3.5	2.2	3.0	0.7	1.8	3.0	3.7	2.0	3.4	2.0	3.1
Unemployment (%)	11.5	11.0	27.6	27.0	12.7	12.2	32.2	32.2			20.6	20.6
Consumer price inflation (%)	3.9	3.5	4.0	2.5	3.2	2.4	4.4	2.0	3.1	2.0	11.2	4.3
External debt (as % of GDP)	59.4	59.2	39.5	38.4	47.5	50.1	26.3	28.2	43.0	42.2	44.1	44.5
Current account balance (as % of GDP)	-10.9	-9.8	-6.2	-5.5	-1.8	-2.6	-5.5	-6.6	-24.5	-22.1	-7.6	-8.9

Source: IMF, *World Economic Outlook*, September 2011.

Specifically, for 2012 the WEO forecasts GDP growth of 3.5 percent for Albania, 3.0 percent for Bosnia, 1.8 percent for Croatia, 3.7 percent for FYROM, 3.4 percent for Montenegro and 3.1 percent for Serbia. Nonetheless, there is no doubt that the recovery of the Western Balkan economies is inextricably linked to that of the global, the European and the Greek economies. The region needs a strong recovery of demand which would stimulate its export-oriented economies and start the reversal of the negative trends discussed above, which relate to declining exports, decreasing FDI, and dwindling credit. As long as demand remains weak, the familiar route to recovery is blocked. The stakes are very high, and the stability of the region itself is at risk: apart from economic stagnation the Balkan states could be faced with the arrested process of structural reforms and hindered integration in the EU, with very serious implications for their future.[139]

It is a fact that the prospect of EU membership has proven to be a key anchor for reform for the new states in the run-up to their accession in 2004 and 2007, and is likely to play the same role for the Western Balkans countries. The experi-

[139] M. Arandarenko, "Social Interests and the Global Crisis", Friedrich Ebert Stiftung Conference, *20 Years Towards the Market Economy*, Belgrade 28-9 September, 2009.

ence of the new EU members shows that progress towards EU membership is a clear signal of commitment to reform and investor-friendly policies. Similarly, over the past years the Western Balkan countries' progress in political and economic reforms has become inextricably linked to the evolution of their relations with the EU. These relations –which will be discussed in the following section– will play a crucial role in further reforms.

PART II

RELATIONS BETWEEN THE EU AND THE WESTERN BALKANS

Contrary to the other centrally planned economies that established contractual relations with the EU by signing association agreements relatively quickly after the fall of the Berlin Wall and became EU member states in 2004, the countries of the Western Balkans were not able to cultivate relations with the EU until after 2000. This was the direct outcome of the extreme conditions that prevailed in the region, which were discussed in the previous section: the violent disintegration of Yugoslavia, the inward-oriented policies of the newly created states, the embargoes, as well as the leaderships' lack of commitment to change. These events perpetuated a negative image of the Balkan region, which was seen as "an island of instability in the heart of Europe, exporting migrants and importing peacekeepers".[140] This legacy left profound economic, political and social consequences on all the Western Balkan countries, but also greatly delayed the prospects of their integration into EU structures. From the EU's perspective, this turbulence and instability was met with uncertainty about how to create and foster a sustainable policy towards the region.

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[140] European Stability Initiative, *Western Balkans 2004: Assistance, cohesion and the new boundaries of Europe – A call for policy reform*, http://www.esiweb.org/westernbalkans/

CHAPTER 4

EVOLUTION OF EU POLICY: FROM DAMAGE CONTROL TO ACTIVE ENGAGEMENT

4.1. The Terra Incognita Approach (1991-1995)

As was discussed above, on June 26, 1991, after some forty-six years without a war in Europe, violent conflict erupted in the territory of the SFR of Yugoslavia. The war started in Slovenia, but soon involved Croatia, reaching the peak of violence and destruction in Bosnia-Herzegovina. It took more than four years of atrocities before a peace agreement was finally negotiated –with US mediation– in Dayton in November 1995. From the very beginning of the unravelling of Yugoslavia until the peak of the war in Bosnia, the EU's main concern was "damage control", to keep the problem at a distance. Moreover, due to diverging interests of its member states, the EU proved unable to create a united front, to form a coherent policy and to respond appropriately to the evolution of events. European countries were divided on the approach to take and fell back on traditional and historical reflexes: Germany and Austria supported Slovenia and Croatia in their drive for independence against Serb domination, while Greece, France and Russia supported Serbia's desire to preserve the territorial unity of Yugoslavia. Due to these divergences and the inability to define a clear EU position towards the war-affected region, the EU's intervention and assistance policies were shaped mainly in response to emerging crises, usually on an *ad hoc* basis. In this context, the EU imposed an embargo on the import of arms by Yugoslavia in July 1991, and in November 1991 it suspended the Trade and Economic Cooperation Agreement concluded with SFR Yugoslavia in 1980. It also removed the country from the General Scheme of Preferences and PHARE, the new programme of financial assistance offered to post-communist transition economies.[141] Finally, Germany's "alleingang" and its determination to unilater-

[141] M. Uvalic, "Southeast European Economies: From International Assistance towards Self-sustainable Growth", in W. van Meurs (ed.), *Prospects and Risks beyond EU Enlargement:*

ally recognise the independence of Slovenia and Croatia in December 1991 –a move other EU states considered rash and premature– undermined any possibility of a single European policy towards the disintegration of Yugoslavia.

Throughout the periods of conflict in the region –in Croatia, Bosnia and Kosovo– the EU countries were involved in the war-torn Balkan countries primarily through their military presence (via NATO), provision of humanitarian assistance, and the EU/EC civilian monitoring mission, which remained in the region throughout the 1990s. The EU was thus willing to engage in post-crisis reconstruction but was not willing –or able– to engage in crisis management; it had to settle for a "reactive" –as opposed to "proactive"– response to the conflict unfolding in the Western Balkan region. What was supposed to be "the Hour of Europe", the opportunity for the European Union to play a constructive role in the establishment of peace and order in the region, proved to be a failure.[142]

The EU managed to establish basic relations with the countries not involved in the ethnic conflicts, namely Albania and FYROM, providing assistance through the PHARE programme and trade concessions in the form of trade and cooperation agreements.[143] In sum, the period 1991-1995 the EU's relations with the Western Balkans were concentrated more on post-conflict stabilisation in the region, while concepts such as integration and enlargement were not even considered.[144]

Southeastern Europe, Weak States and Strong International Support, Bertelsmann Foundation Risk Reporting, Leske and Budrich, Opladen, 2003, pp. 93-115.

[142] For a comprehensive analysis of the EU's response to the Yugoslav crisis, see S. Lucarelli, *Europe and the Breakup of Yugoslavia: A Political Failure in Search of a Scholarly Explanation*, Kluwer Law International, The Hague, 2000; M. Zucconi, "The European Union in the Former Yugoslavia", in A.H. Chayes and A. Chayes (eds), *Preventing Conflict in the Post-Communist World: Mobilising International and Regional Organisations,* Brookings Institution, Washington, DC, 1996; Sonia Lucarelli, "The European Response to the Yugoslav Crisis: Story of a Two-level Constraint", *Working Paper RSC 95/37*, European University Institute, Florence, 1995; E. Remacle, "La CSCE et la Communauté Européene face au conflit yougoslave: Deux entreprises pour une crise", *Le Trimestre du Monde*, I: 219-233, 1992; R. Sobel "US and European Attitudes towards Intervention in the Former Yugoslavia", in R.H. Ullman (ed.), *The World and Yugoslavia's Wars*, Council on Foreign Relations, New York, 1996.

[143] D.M. Nuti, "European Community Response to the Transition: Aid, Trade, Access, Enlargement", *Economics of Transition*, 4 (2), 1996, pp. 503-11.

[144] M. Uvalic, "European Economic Integration: What Role for the Balkans?" in S. Bianchini and M. Uvalic (eds), *The Balkans and the Challenge of European Integration – Regional and European Perspectives*, Longo Editore, Ravenna, 1997, pp. 19-34.

4.2. The Regional Approach (1995-1999)

The conclusion of the war in Bosnia and the prospect of creating a stable environment and promoting sustainable peace in Southeast Europe provided the stimulus for the EU to initiate its "regional approach". During this period the EU started to see the Western Balkan countries more as a part of Europe, rather than a distant –albeit potentially threatening– security-challenged region.[145] The EU's immediate task was focused on "how to help transform the proverbially chaotic, bloody and unpredictable Balkans of the past into a stable, peaceful and dependable Southeastern Europe of the future".[146]

In this context, on 26 February 1996 the EU initiated the "Regional Approach", which aimed at political and economic cooperation among all the Balkan countries. The Regional Approach thus established a framework for relations with the five countries of the Western Balkan region –Albania, Bosnia-Herzegovina, Croatia, the Former Yugoslav Republic of Macedonia, and the Federal Republic of Yugoslavia (which later became Serbia and Montenegro)– as well as Bulgaria and Romania. The objectives of the regional approach were to support the implementation of the Dayton/Paris and Erdut peace agreements and to create an area of political stability and economic prosperity by establishing and maintaining democracy and the rule of law, ensuring respect for minorities and human rights, and reviving economic activity in the area.[147] It also sought to promote stability, establish good-neighbour relations regarding the free movement of goods, services and people and general improvement of bilateral relations.

All the EU initiatives launched during this time had a significant regional dimension. A clear example is the Royaumont Process for Stability and Good Governance initiated at a conference on 13 December, 1995, which aimed at promoting civil society development and multilateral dialogue between journalists, academics, trade unionists, NGOs and parliamentarians.[148] Initiatives such

[145] A. Mayhew, *Recreating Europe: The European Union's Policy Towards Central and Eastern Europe*, Cambridge University Press, Cambridge, 1998.

[146] International Commission on the Balkans, "The Balkans in Europe's future", 2005, www.balkan-commission.org/activities/report/pdf.

[147] W. Bartlett, "European Economic Assistance to the post-socialist Balkan States", in Bianchini and Uvalic (eds), *op. cit.*, p. 73.

[148] The Royaumont Process was launched with a declaration of 27 countries, to promote stability and good neighbourhood in Southeast Europe. See www.royaumont.lrf.gr

as the Southeast European Cooperative Initiative (SECI) and the Southeast European Cooperation Process (SEECP) were established so as to promote regional cooperation respecting territorial integrity, broad range of issues including security, economic cooperation, humanitarian, cultural and social cooperation and coop in fields of justice and home affairs.

However, the "regional approach" failed to produce significant positive results, either in terms of political stabilisation or substantial economic development. The EU itself acknowledged that the Western Balkan countries did not react positively to the incentives provided by the EU Regional Approach. There were several reasons for this. Firstly, not only were the EU instruments backing them vague and inadequate, but also the internal conditions in most Western Balkan countries were not ripe to enable any meaningful regional cooperation. There was no willingness, in particular on the part of the two key countries –Croatia and FR Yugoslavia– to apply any form of regional cooperation at the time.[149] Secondly, since each Western Balkan country had achieved a different level of economic reform as well as a different degree of integration with the EU, there was a real concern among the more advanced countries that their participation in regional cooperation initiatives would cause a delay in their EU integration process. Finally, the EU regional approach of 1995-1999 did not achieve its objectives because it lacked a long-term strategy and a perspective of EU membership for the Western Balkan countries, at a time when most of them prioritized integration into the EU over cooperation between themselves.[150]

4.3. The Enlargement Approach (1999 onwards)

By 1999 it had become apparent that the EU's existing policies for the region were insufficient, and that simply promoting regional cooperation and economic reconstruction would be an inadequate long-term strategy. The concept of integrating the Western Balkan countries into the EU –as opposed to simply applying damage control– started gaining ground, along with the belief that expansion of the EU towards the Balkans would be beneficial for Europe as

[149] M. Uvalic, "Regional Cooperation in South-Eastern Europe", *Journal of Southeast Europe and Black Sea Studies,* vol. 1, no. 1, 2001, pp. 56-63.

[150] D. Lopandic, *Regional Initiatives in South Eastern Europe*, European Movement in Serbia, Belgrade, 2001.

a whole. As the International Commission on the Balkans put it, "for so long dismissed as Europe's powder keg, if the Balkans were successfully absorbed into the EU it would finally banish the possibility of a revival of the type of conflict that so plagued the continent's 19th and 20th century history, and diffusing the powder keg would be a landmark achievement for Europe".[151] Leaving the Balkans out of the EU could seriously harm the European project itself, since "there cannot be a stable Europe if the Balkans are on fire". The consensus was that the EU would be better off putting its efforts and money on helping develop democracy and economic stability in these troubled countries, rather than deploying military, policing and peacekeeping missions.

The need to promote a new, more comprehensive approach for the region was given a new urgency following the crisis in Kosovo and the NATO bombing of Yugoslavia. In this context, in May 1999 the European Commission presented the rationale for moving to a more ambitious vision for the region's development. This was based on:

- A recognition that the main motivator for reform in these countries –including the establishment of a dependable rule of law, democratic and stable institutions and a free economy– was a relationship with the EU, which would be based on the credible prospect of membership once the appropriate conditions had been met. This prospect was offered explicitly at the Feira European Council in June 2000.
- The need for a regional approach, which would encourage the countries to establish bilateral relationships between themselves and would promote the development of greater economic and political stability in the region.
- An understanding that a flexible approach was essential. This would allow each country to move ahead at its own pace, with assistance programmes and contractual relations flexible enough to accommodate a range of country-specific situations.

Taking these ideas a step further, in June 1999 EU Foreign Ministers met in Cologne and launched the "Stability Pact for Southeast Europe".[152] In the founding document, more than 40 partner countries and organisations undertook to strengthen the countries of Southeast Europe in their efforts to foster peace, democracy, respect for human rights and economic prosperity in order

[151] International Commission on the Balkans, *The Balkans in Europe's Future*, http://www.balkan-commission.org, 2005.

[152] See Stability Pact at http://www.stabilitypact.org.

to achieve stability in the whole region.[153] A new and crucial element of the Stability Pact was the perspective of membership in Euro-Atlantic structures for the countries of the region. The prospect of membership in the EU and NATO was seen as the most effective way to stabilise the region in the long term. At the core of this strategy was the project of "Europeanisation" of the region which would anchor the countries of the Western Balkans firmly into the values and institutional structures of the European community.

All the above concepts created the foundation for what was to become the European Union's first coherent, consistent and constructive policy for the countries of Southeast Europe, namely the Stabilisation and Association Process (SAP), which was officially launched at the Zagreb Summit of November 2000. The Stabilisation and Association Process for the Western Balkan countries outlined a clear set of objectives and conditions.[154] On the one side, the countries of the region undertook to abide by the EU's conditionality and use the Stabilisation and Association Process as a means to prepare themselves for the demands of potential accession to the EU. On the other side, the EU offered a prospect of accession on the basis of the Treaty on European Union and the 1993 "Copenhagen criteria" and an assistance programme to support this goal. In essence, the SAP provided a structured framework through which the EU could help the countries of Southeast Europe achieve their ultimate goal of dependable rule of law, democratic and stable institutions and open market economies. Ultimately, attachment to the EU was meant to ensure that the path of reforms would become irreversible, and to make conflict, extreme nationalism, ethnic strife and war in the region "inconceivable".[155]

[153] D. Papadimitriou, *Negotiating the New Europe: The European Union and Eastern Europe*, Ashgate Publishing Company, Aldershot, 2002, p. 188.

[154] Commission of the European Communities, *Commission Communication to the Council and the European Parliament on the Stabilisation and Association Process for countries of South-Eastern Europe*, Brussels, 26 May 1999.

[155] "The Western Balkans on the Road to the EU: Consolidating stability and raising prosperity", *Communication from the Commission of the European Communities*, Brussels, 27 January 2006.

CHAPTER 5

THE STABILISATION AND ASSOCIATION PROCESS

The Stabilisation and Association Process focussed on six key targets areas: development of existing economic and trade relations with and within the region; development and partial redirection of existing economic and financial assistance; increased assistance for democratisation, civil society, education and institution-building; cooperation in the area of justice and home affairs; development of political dialogue, including at regional level; and the development and signature of Stabilisation and Association Agreements.[156] The Stabilisation and Association Process encouraged the integration of the economies of the region with the EU's through a free trade area with the EU and the associated disciplines (competition and state aid rules, intellectual property, etc.) and benefits (e.g. rights of establishment). The Stabilisation and Association Process is founded on three main components: the Stabilisation and Association Agreements, economic and financial assistance, and autonomous trade measures.

5.1. The Stabilisation and Association Agreements

The Stabilisation and Association Agreements represent the cornerstone of the Stabilisation and Association Process. The conclusion of such an agreement represents the signatories' commitment to complete a formal association with the EU over a flexible transition period.[157] The Stabilisation and Association Agreements were conceived as tools which provide, much as the Europe Agreements did for candidate countries in Central Europe, the formal mechanisms and agreed benchmarks which allow the EU to work with each country

[156] Commission of the European Communities, *Report from the Commission: The Stabilisation and Association Process for Southeast Europe*, First Annual Report, Brussels 4 April 2002.
[157] Cviic and Sanfey, *op. cit.*, pp. 115-117.

to bring them closer to the standards which apply in the EU. Although every agreement is tailored to the circumstances of each individual country, they all have the common purpose of achieving the sort of formal association described above. The destination for all countries is expected to be the same: the full realisation of association after a transitional period through implementation of the same core obligations. A set of joint bodies was established, at ministerial level (Stabilisation and Association Council), at high official level (Stabilisation and Association Committee) and at technical level (Subcommittees). These mechanisms would allow the EU to prioritise reforms, shape them according to EU models and monitor their implementation.

Although the particularities of each country are taken into consideration in every agreement, all the agreements include the crucial categories addressing each country's political situation, economic situation, and application of European standards. Specifically, as far as the political situation is concerned, the agreements confirm each country's commitment to promote: a) democracy and the rule of law (i.e. existence of functioning state institutions and public administration, reformed judicial system and staunch commitment to fighting corruption; b) human rights and the protection of minorities (i.e. improving the respect of human rights by law enforcement bodies, ensuring full compliance with the European Convention on Human Rights, the Convention for the Prevention of Torture and Inhuman and Degrading Treatment or Punishment and other relevant international conventions, and promoting freedom of expression and media); and c) regional and international cooperation (complying with the Stabilisation and Association process requirements and Thessaloniki commitments in terms of regional cooperation, and ensuring implementation of all regional free trade agreements).

Concerning the economic dimension, the Stabilisation and Association Agreements seek to establish that each signatory country makes progress concerning: a) free market economy and structural reforms (achieving and sustaining macroeconomic stability, pursuing economic reforms aimed *inter alia* at reducing the role of the state in the economy, clarifying and enforcing property rights, improving the business environment by adopting and implementing an improved legal framework on company law, and improved employment policy); and b) management of public finances (improving public finance management by implementing fiscal decentralisation, strengthening internal control and audit capacity in the Ministry of Finance, broadening controls applied to the public administration as a whole, and exerting greater control and supervision of expenditure of extra-budgetary funds).

Finally, concerning the application of European Standards, the Agreements aim to ensure that each country moves forward in the areas of: a) internal market (progressing in the adoption of European technical norms and standards concerning the movement of goods, improving supervision of the financial services sector, achieving significant results in the fight against fraud, smuggling and trafficking, strengthening the services involved in the implementation of trade agreements, adopting legislation against the restriction of competition, promoting competition policy by fostering liberalisation and ensuring a pro-competitive approach to privatisation); b) sectoral policies (adopting the restructuring and conversion programme for various industries in line with the competition related EC *acquis* to create efficient and competitive firms, improving access of SMEs to financial and non-financial services, adopting laws on environment, waste management, water management, protection of natural resources and air quality in line with EU standards); and c) cooperation in Justice and Home Affairs (implementing measures and agreements adopted on border management strategy, strengthening competences of border police, establishing an independent and transparent appeal and review panel for asylum seekers, establishing a common strategy to fight illegal immigration and the trafficking of human beings, completing the ratification of the 2002 UN Convention on Organised Crime and its related protocols on small arms, trafficking in human beings and smuggling of migrants, and ensuring implementation).

It is clear that the quintessence of the Stabilisation and Association Agreements between the Western Balkan countries and the EU is to stimulate and encourage these countries to adopt real reforms towards the immediate objectives of the agreements and beyond. Effective implementation of the Stabilisation and Association Agreements is a stepping stone –but also a prerequisite– for any further assessment by the EU of the country's prospects of accession. After the SAA has been signed, it must be ratified by all 27 EU member states and the European Parliament in order to come into force. By November 2011, Stabilisation and Association Agreements had been signed, ratified and entered into force with FYROM (2004),[158] Croatia (2005),[159] Albania (2009)[160] and Montene-

[158] Stabilisation and Association Agreement between the European Communities and the Former Yugoslav Republic of Macedonia, *Official Journal of the European Union*, L 84, 20 March 2004.
[159] Stabilisation and Association Agreement between the European Communities and the Republic of Croatia, *Official Journal of the European Union*, L 026/48, 28 January 2005.
[160] Stabilisation and Association Agreement between the European Communities and the Republic of Albania, *Official Journal of the European Union*, L 107/166, 28 April 2009.

gro (2010).[161] Serbia signed a SAA in 2008, which is currently in the process of ratification (it has thus far been ratified by 19 EU members and the European Parliament). Bosnia-Herzegovina signed a SAA in 2008,[162] which was ratified in February 2011; however, it has not yet entered into force because of Bosnia's failure to meet its obligations, including the adoption of the necessary amendments to its Constitution.

5.2. EU Financial Assistance

Since 1991 the EU has committed significant financial assistance to the Western Balkan countries through a number of specialised programmes, such as PHARE, ISPA, SAPARD, and CARDS. The PHARE programme provided support for institution-building measures and associated investment in candidate countries. PHARE also funded measures promoting economic and social cohesion and cross-border cooperation. The ISPA programme dealt with larger-scale environmental and transport infrastructure projects, while the SAPARD programme supported agricultural and rural development in candidate countries.

In 2000 all aid to the region was streamlined through the CARDS (Community Assistance for Reconstruction, Development and Stabilisation) programme, which was to be the financial backbone supporting the objectives and mechanisms of the Stabilisation and Association Process.[163] EU assistance to the Western Balkans was adapted as the region's needs and political situation evolved over time. Thus, whereas the EU's focus was initially on humanitarian and emergency assistance, it later shifted to the rebuilding of infrastructure and fostering reconciliation and the repatriation of refugees. As each country progressed into the Stabilisation and Association Process, assistance focussed increasingly on support for developing government institutions and legislation, and approximation with European norms and eventual harmonisation with the EU *acquis*. Aid was increasingly directed at reinforcing democracy and the rule

[161] Stabilisation and Association Agreement between the European Communities and the Republic of Montenegro, *Official Journal of the European Union*, L 108/1, 29 April 2010.

[162] Council Regulation (EC) No. 594/2008 of 16 June 2008, *Official Journal of the European Union*, L 169/1, 30 June 2008.

[163] Council Regulation (EC) No 2666/2000 of 5 December 2000 on assistance for Albania, Bosnia-Herzegovina, Croatia, the Federal Republic of Yugoslavia and the Former Yugoslav Republic of Macedonia.

of law, human rights, civil society and the media and the operation of a free market economy. Assistance was also used to help generate sustainable economic recovery and promote social development and structural reform. Another major objective of the CARDS programme was the promotion of regional cooperation between the Western Balkan countries as well as between the region and EU member states. Overall EU financial assistance to the Western Balkan countries (including CARDS and macro-financial assistance) amounted to over 5 billion Euros for the period 2000-2006.

The Instrument for Pre-Accession Assistance (IPA) replaced CARDS in 2007.[164] The IPA was designed to offer assistance to the countries aspiring to join the EU for the period 2007-2013 on the basis of the lessons learnt from previous external assistance and pre-accession instruments. The total amount allocated for this first period was 5.1 billion Euros (Table 12). The beneficiary countries have been divided into two categories, depending on their status as either candidate countries under the accession process (FYROM, Croatia and Montenegro) and potential candidate countries under the Stabilisation and Association Process (Albania, Serbia, Bosnia-Herzegovina and Kosovo). The IPA was intended to help these countries to introduce the necessary political, economic and institutional reforms in line with EU standards. The main areas of assistance focus on the support for political reform, in particular institution building, strengthening the rule of law, human rights, protection of minorities and the development of civil society, economic and social development, and regional and cross-border cooperation.

In December 2009 the European Commission and the partner international institutions (the European Investment Bank, the European Bank for Reconstruction and Development, and the Council of Europe Development Bank) set up the Western Balkans Investment Framework (WBIF). Through the WBIF –whose aim was to improve coordination of investment in the Western Balkans– international donors and financial institutions approved support for 73 projects worth over 6 billion euros in 2010. The WBIF created a one-stop-shop for beneficiary countries, replacing many bilateral and multilateral aid programmes. The WBIF benefits the countries of the Western Balkans by combining different types of grant finance with loans from international institutions for projects aimed at local development as well as regional integration.

[164] Commission Regulation (EC) No 718/2007 of 12 June 2007 implementing Council Regulation (EC) No 1085/2006 establishing an instrument for pre-accession assistance (IPA) [*Official Journal* L170 of 29.6.2007].

TABLE 12
Instrument for Pre-accession Assistance, 2007-2013 (mn Euros)

	2007	2008	2009	2010	2011	2012	2013	Total 2007-2013
Albania	61	70	81	93	95	97	98	595
BiH	63	74	89	106	108	110	118	668
Croatia	141	146	152	154	157	160	163	1,073
FYROM	58	71	81	92	99	106	117	624
Montenegro	32	32	33	34	35	35	35	236
Serbia	189	191	194	199	203	207	215	1,398
Kosovo	68	125	67	67	69	70	74	540
Total	**612**	**709**	**697**	**745**	**766**	**785**	**820**	**5,134**

Source: http://ec.europa.eu/enlargement/index_en.htm

In July 2011 the European Commission finalised its plans for financial support for ongoing reforms in the Western Balkans. The plans, called Multi-Annual Indicative Planning Documents (MIPDs) outlined a revised strategy for funding under the EU's Instrument for Pre-Accession assistance. The funding will focus on areas such as reform of the judiciary and public administration, enhancing regional cooperation in the fight against organised crime and corruption, building a vibrant civil society, fostering reforms and regional cooperation in education, as well as underpinning sustainable recovery from the economic crisis through investment in strategic infrastructure projects.

5.3. Autonomous Trade Measures

During the European Council of Lisbon in March 2000, asymmetrical liberalisation of trade was judged necessary for the economic development and political stabilisation of the countries involved in the SAP. In this context, exceptional trade measures were introduced which allowed duty free access to the EU market for practically all products originating from the Western Balkan region.[165] These

[165] Council Decision (EC) No 2007/2000 of 18 September 2000 introducing exceptional trade measures for countries and territories participating in or linked to the European Union's Stabilisation and Association Process [*Official Journal* L240 of 23.9.2000].

autonomous trade measures, together with other trade arrangements, aimed to provide a favourable framework for the development of trade between the EU and the region, thus stimulating foreign direct investment in the region and economic development in general.[166] These trade preferences have proved successful, contributing to the average annual increase of 8 percent in the Western Balkans' exports to the EU (2000-2004). In 2005, they were renewed until the end of 2010.

The EU is the main trading partner (both imports and exports) of all the Western Balkan countries (Table 13). For most countries, at least half of the exports go to the EU (of which Italy, Greece, Austria and Germany are the most important trading partners) while the figure is particularly high for Albania (almost 75 percent). Several initiatives have been undertaken to enhance cross-border trading opportunities for enterprises in the region.[167] A series of bilateral free trade agreements within the region have been signed, and many are under implementation. Access to the EU markets have been enhanced in recent years, but further measures are required to overcome technical barriers to trade.

TABLE 13

Western Balkan Countries Trade with the European Union

	EU share of total imports (%)	EU share of total exports (%)
2006	66.5	68.9
2007	65.5	67.2
2008	65.9	66.4
2009	63.6	63.3
2010	63.7	64.5

Source: Eurostat (DG Trade Statistics).

The Zagreb Summit also placed considerable emphasis on the crucial need for regional cooperation as part of the EU's "contract" with the Stabilisation and

[166] R. Priebe, "The Western Balkans' European Perspective", in K. Liebscher *et al.*, (eds), *op. cit.*, p. 40.

[167] I. Druzic, *A Journey through Transition Time, with Special Reference to Croatia*, Political Culture Publishing and Research Institute, Zagreb, 2006, pp. 155-58.

Association Process countries. Thus, the Stabilisation and Association Agreements include a clear commitment to regional cooperation, while CARDS also had an important regional component. Moreover, enhanced regional cooperation was to be one of the major objectives set out in the Thessaloniki Agenda of 2003. As far as regional cooperation is concerned, the EU's policy objective was essentially threefold: to encourage the countries of the region to behave towards each other and work with each other in a manner comparable to the relationships that now exist between EU member states, to create a free trade area between the countries in the region, and to gradually re-integrate the Western Balkans region into the infrastructure networks of wider Europe. Thus, regional cooperation between the Western Balkan countries was conceived as a vital, non-negotiable component of the promotion of political stability and economic prosperity in the area. It was hoped that increasing interaction and interdependence between these countries –to the point of making war between them inconceivable in the future– is the only way to overcome the region's destructive legacy of the past.

5.4. The Thessaloniki Agenda and Beyond

The prospect of European integration was consolidated for these countries at the EU-Western Balkans Summit in Thessaloniki in June 2003. The Thessaloniki Agenda put forward two objectives: on the one hand it aimed to consolidate stability and security in the region through the reconciliation of the populations and regional cooperation. On the other, it aimed to bring these countries closer to the EU with a view to their accession. All the EU member states declared their "unequivocal support to the European perspective of the Western Balkan countries" and assured them that they share a "common European destination". The leaders of the EU and the Balkans approved the document *The Thessaloniki Agenda for Western Balkans: Moving towards European Integration*, which gave a very clear and unequivocal political signal that "the future of the Balkans is within the Union".[168]

Following the Thessaloniki Agenda various new instruments to support these objectives were introduced, the most far-reaching of which were the European

[168] General Affairs and External Relations Council, *Western Balkans, Council Conclusions*, 16 June 2003.

Partnerships.[169] The European Partnerships were created to help the governments of the Western Balkan countries to concentrate reform efforts and available resources where they were most needed, and also to influence the allocation of future financial assistance from the EU. European partnerships were signed in January 2006 with Albania, Bosnia-Herzegovina, FYROM, Serbia and Montenegro, while Croatia, for whom membership negotiations had already begun, benefited from an accession partnership, which took into account its special status. Each European partnership provides a specific framework for supporting the partners' attempts to meet the accession criteria (Copenhagen criteria) with a view to eventual EU membership. Implementation of the Partnerships is monitored within the framework of the Stabilisation and Association Process and its mechanisms, in particular the annual Progress Reports presented by the Commission. The partnerships are regularly revised according to the progress made by each country and any new priorities identified, and also provide a framework for financial assistance aimed at pursuing these objectives and priorities.[170]

The integration process also contains an element of conditionality, which is applied with respect to financial assistance. EU assistance under the Stabilisation and Association Process to the Western Balkan countries is conditional on progress made in satisfying the Copenhagen criteria, the progress in meeting specific priorities of the European Partnerships, as well as recipients' undertaking to carry out democratic, economic and institutional reforms. In case of a failure to respect such conditions, the Council is assigned to take any such measures it considers "appropriate", which may mean delaying, stopping or reducing financial assistance.[171]

Ever since the European Union turned its full attention towards Southeast Europe in the mid-1990s following the end of the war in Bosnia, it has played a hugely important role as the main driver of regional cooperation, stability, and political and economic reform in the region. The Stabilisation and Association Process launched a far-reaching process of Europeanisation in the Western Balkans. As was the case with the Central and East European countries, similar

[169] See Council Regulation (EC) No 533/2004 of 22 March 2004 on the establishment of European partnerships in the framework of the Stabilisation and Association Process.

[170] M. Uvalic, "EU Policies towards Southeast Europe: From Stabilisation towards Integration", in M. Petricioli (ed.), *Mediterranean Europe,* PIE Peter Lang, Brussels, 2008, pp. 291-296.

[171] Council Regulation (EC) No. 2666/2000.

policies of alignment, technical assistance and conditionality are part of the EU's relations with the Western Balkans. Adoption of the *acquis*, i.e. adoption and implementation of EU standards, is the lynchpin of the accession process.[172]

The threat that the dispute over Serbia's opposition to Kosovo's declaration of independence could escalate into a full-blown conflict, threatening once again the peace and stability of the region, has forced the EU to give more urgency to its accession strategy for the Western Balkans. In December 2007 the European Council affirmed its commitment, reiterated in February 2008, to full and effective support for the European perspective of the Western Balkans. Another sign of this new focus on the Western Balkans was the new initiative by the European Commission in March 2008. In a clear attempt to revive the optimistic and forward-looking spirit of the 2003 Thessaloniki programme for the region's progress towards the EU, the initiative called for the mobilization of all available instruments to support this goal.

[172] D. Jano, *The Europeanisation of Western Balkans: A fuzzy set qualitative comparative analysis of the new potential EU member states*, VDM Verlag Dr Mueller, 2010, pp. 44-45.

CHAPTER 6

CURRENT STATUS OF RELATIONS BETWEEN THE EU AND THE WESTERN BALKAN STATES

This section discusses the status of bilateral relations between the European Union and individual Western Balkans states, as well as the prospects of these countries joining the EU. Each country's progress will also be evaluated concerning the three key areas of the Copenhagen criteria, namely political criteria, economic criteria and the obligations of membership (chapters of the *acquis*/administrative criteria). The progress in fulfillment of the Copenhagen criteria will be assessed *inter alia* by analysing the most recent Progress Report (released in October 2011) for each country. The countries have been categorized into two groups, according to their level of integration with the EU, namely candidate countries (Croatia, FYROM, and Montenegro – who have applied and have been granted official candidate status), and potential candidate countries (Albania, Serbia, Bosnia-Herzegovina and Kosovo).

In the autumn of each year the Commission adopts its "Enlargement package", a set of documents explaining its policy on EU enlargement and reporting on progress achieved in each country. Most importantly, this package includes the Annual Strategy Document which sets out the objectives and prospects for the coming year as well as a summary of the progress made over the last twelve months by each candidate and potential candidate country. In addition to the strategy paper, the package contains the Progress Reports in which the Commission services present their monitoring and assessment of what each candidate and potential candidate has achieved over the last year. The Progress Reports are used as benchmarks to evaluate each candidate's progress in all areas of the Copenhagen Criteria. Following Serbia's application for EU membership, the Commission also presented in the 2011 package its Opinion on the readiness of the country to start accession negotiations. Following the closure of accession negotiations with Croatia, the Commission presented a formal opinion confirming Croatia's readiness to sign an Accession Treaty with the EU.

6.1. The Accession Process and EU Membership Criteria

For the transition economies that emerged in Central and Eastern Europe in the early 1990s, the EU did not apply the classical method of accession which had been used in the previous enlargement rounds of 1973, 1981, 1986 and 1995. This was due to the fact that unlike previous enlargements –in which the EU was absorbing countries of similar socio-political and economic structures– in the case of Central and Eastern Europe the EU would have to absorb countries that were undergoing a radical transformation of their political and economic systems after a long period of communist rule. The EU therefore devised a very specific and stringent set of criteria that formed the framework of political and economic conditions for EU membership, that came to be known as the "Copenhagen Criteria".[173] The Copenhagen Criteria were established by the European Council in 1993 and were used to frame the accession process for the Central and Eastern Europe countries that joined in 2004 and 2007. The Copenhagen membership criteria require that before accession the candidate country must have achieved:

1. Stability of institutions guaranteeing democracy, the rule of law, human rights, and respect for and protection of minorities (**political criteria**);
2. The existence of a functioning market economy, including the capacity to cope with competitive pressures and market forces within the Union (**economic criteria**);
3. The ability to take on the obligations of membership, including adherence to the aims of the political, economic and monetary union (the *"acquis communautaire*", or **administrative/technical criteria**).

Finally, the EU itself must have the capacity to absorb new members without endangering the momentum of European integration.

Following the 2004 enlargement, during which an unprecedented ten new members acceded (including eight from the former communist bloc) and the 2007 enlargement, which brought Romania and Bulgaria into the EU, the enlargement process has become increasingly complicated. The current enlargement round, aiming to bring the countries of the Western Balkans into the European Union, is far more complex and difficult than any previous enlargement.

[173] Conclusions of the Presidency, European Council in Copenhagen, 21-22 June, 1993, DOC/93/3, 22/06/1993.

It was anticipated from the very beginning that the Western Balkan countries would require a longer implementation period of complying to the Copenhagen criteria than the other CEE countries: in addition to the challenges of overcoming the legacy of communism, the Western Balkan countries would have to overcome the heavy legacy of the region, including wars, ethnic conflicts and divisions, political instability, factors that *inter alia* contributed to the very wide development gap between the existing EU members and the candidates from the Western Balkans.

As far as the "technicalities" of the enlargement process are concerned, the long and arduous path to EU accession entails the following steps:

1. Formal application for membership submitted to the European Council;
2. The applicant completes a questionnaire, which includes hundreds of detailed questions about the country's institutions, political system, legal system, economy, etc.;
3. On the basis of the answers to this questionnaire, the Commission submits an *"avis"*, or Opinion, on the application, according to which the Council will eventually grant the country candidate status;
4. The actual accession negotiations begin after the Council confirms that the country has met the necessary conditions (based on the Copenhagen criteria). The negotiators have to deal with nearly 80,000 pages of EU legislation, which cover the adoption of the EU's *acquis*, which is divided into policy areas known as "chapters";[174]
5. After the talks are concluded, the Commission, the Council of Ministers, the European Parliament and all the EU member states approve the final results of the negotiations, which then form part of an Accession Treaty;
6. The Treaty must be approved by the European Parliament (absolute majority required);
7. The Treaty must ratified by the appropriate procedures by all the EU member states (either through parliament or by referendum) and the acceding states.

[174] For the 2004 enlargement 31 chapters were identified, whereas for the current negotiations a preliminary list of 35 chapters has been identified. Some chapters are non-controversial and relatively easy to finalise (such as science and research, education and training) while others are extremely difficult (such as free movement of goods, persons and services, the environment, agriculture, justice and home affairs) as they touch upon core vested interests of current members.

6.2. Group 1: Candidate Countries (Croatia, FYROM, and Montenegro)

6.2.1. Croatia

6.2.1.1. Overview and Recent Developments

Croatia celebrated twenty years of independence with a birthday offering from the EU: on the eve of the historic anniversary on June 24, 2011, the EU agreed to embrace the country as its 28th member. At the EU summit European leaders adopted a declaration commending Croatia for its "intensive efforts, which have allowed negotiations to reach their final stage".[175] After six years of negotiation talks, EU leaders called for "all necessary decisions for the conclusion of the accession negotiations with Croatia by the end of June 2011". After a long process, Croatia is poised to become the 28th EU member state by July 2013. Croatia will be the second former Yugoslav republic to join the EU –after Slovenia in 2004– but the first that suffered the full force of the brutal wars that ravaged the Balkans in the 1990s. These positive developments have raised hopes that Croatia's imminent accession will give momentum to the accession process for the other Western Balkan countries. This hope was expressed by Commission President Barroso who stated that "the forthcoming accession of Croatia should act as a catalyst for the whole region to move steadily towards the European Union".

The EU had established diplomatic relations with Croatia in 1992, one year after the country's declaration of independence.[176] In 1997 the Council laid down the political and economic conditions for developing bilateral ties with Croatia.[177] In May 2000, the Commission adopted a positive feasibility report to commence negotiations for a Stabilisation and Association Agreement (SAA), which was eventually signed in October 2001.[178] On 21 February, 2003, Croatia became

[175] *Associated Press*, 24 June 2011.

[176] L. Mintas Hodak, "Activities of the Government of the Republic of Croatia in the Process of European Integration", Center for European Integration Studies, Rheinische Friedrich-Wilhelm's Universitet, Bonn, Discussion Paper C43, 1999.

[177] W. Bartlett, *Croatia between Europe and the Balkans*, Routledge, London and New York, 2003, p. 33.

[178] *Stabilisation and Association Agreement between the European Communities and their Member States, on the one part, and the Republic of Croatia, on the other part*, *Official Journal* L26 of 28.1.2005.

the first Western Balkan country to officially submit an application for EU membership. In April 2004 the Commission issued a positive opinion on Croatia's application, and awarded Croatia candidate status.[179] Accession negotiations were officially scheduled to start in March 2005, provided that Zagreb continued to cooperate fully with the ICTY. The day before the talks were to start, the EU postponed commencement of the negotiations, because the ICTY prosecution assessed the Croatian efforts to capture the fugitive general Ante Gotovina –indicted by the ICTY for war crimes– as neither timely nor sufficient. Although the Croatian government had proclaimed its willingness to cooperate with the ICTY tribunal, in practice it was reluctant to do so, fearing a political backlash from the right-wing opposition and from within the coalition itself.[180] Official negotiations were opened in October 2005, as the ICTY evaluated Croatia's commitment to cooperation as satisfactory. Gotovina was eventually arrested in December 2005, thus removing an important obstacle to Croatia's accession.[181] In December 2008 Slovenia's blockade of Croatia's accession due to a border dispute stalled the negotiation process for 10 months. In September 2009, Slovenia announced that it would remove restraints on Croatia's negotiations with the EU without prejudice to the international mediation on the border dispute.

When Croatia started its accession negotiations, the country's leadership had been hoping and aiming for a 2007 accession date – such an achievement would have broken Slovakia's record of two and a half years of negotiations to complete the process.[182] When the 2008 Progress Report was published, Enlargement Commissioner Olie Rehn stated that the country should complete accession negotiations by the end of 2009, with membership following by 2011 at the latest. In 2009, when it was reported that Iceland might be fast-tracked into the EU, Ollie Rehn declared that "the EU prefers two countries joining at the same time, rather than individually. If Iceland applies shortly and the negotiations are rapid, Croatia and Iceland could join the EU in parallel".

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[179] *National Programme for the Integration of the Republic of Croatia into the EU*, Government of the Republic of Croatia, Zagreb, 2005.

[180] When the government agreed to hand over two indicted generals to the ICTY, four cabinet members resigned, eliminating the coalition's slender majority.

[181] D. Jovic, "Croatia and the European Union: A long delayed journey", *Journal of Southern Europe and the Balkans*, 8 (1), April 2006, pp. 85-103

[182] Ministry of Foreign Affairs and European Integration of the Republic of Croatia, "Negotiations for the Accession of the Republic of Croatia to the EU", http://www.eu-pregovori.hr, accessed June 29, 2011.

Despite not accomplishing its original –overambitious– accession goal, Croatia is close to the finish line. On 24 June, 2011, the European Council called for the closing of negotiations by the end of June, and the signature of the Treaty of Accession by the end of 2011. In fact, the Accession Treaty was completed by 14 September 2011, paving the way for the signature of the document in December. The accession of Croatia is strongly supported by the current EU members: the ratification process by the Parliaments of all 27 EU member states is expected to take two years, if no controversy arises.[183] Therefore, entry into force and accession of Croatia into the EU is expected by July 2013. At the request of some EU nations which believe Bulgaria and Romania were given entry before being fully ready, a monitoring system will be put in place to ensure that Croatia follows through on reforms in the judicial system between the end of negotiations and its accession.

6.2.1.2. Economic Relations with EU

Throughout it pre-accession phase, Croatia has benefited from three EU financial assistance instruments: PHARE for institution-building and economic and social cohesion; ISPA for environment and transport infrastructure, and SAPARD for agricultural and rural development. At the end of 2001, the Commission adopted a country strategy for Croatia covering the period from 2002-2006, which provided the framework for EU assistance via the CARDS programme. Since 2007, Croatia has been receiving EU financial aid under the Instrument for Pre-Accession Assistance. For the period 2007-2012 the amount allocated was 907.3 million euros. IPA assistance to Croatia is implemented under decentralised management according to the five IPA components available to candidate countries (transition assistance and institution building, cross-border cooperation, regional development, human resources development, and rural development).

Croatia's trade with the EU has substantially increased since the opening of the EU market under the Autonomous Trade Measures regime in 2000 and the trade provisions of the Stabilisation and Association Agreement. In 2010 Croatia's trade with the EU accounted for 65.5 percent of total trade. Export revenues are primarily composed of industrial goods (71 percent, including principally machinery), transport equipment (8 percent), chemical products (9.4 percent)

[183] Commission Opinion on the application for accession to the European Union by the Republic of Croatia, COM(2011) 667 final, Brussels, 12.10.2011.

textiles and clothing (9 percent). The Croatian imports from the EU in 2010 were mainly industrial goods (78.7 percent, including mostly machinery and transport equipment), chemical products (12.4 percent) and textiles and clothing (5 percent).

6.2.1.3. Progress on Copenhagen Criteria

According to its 2011 Progress Report, Croatia fulfills the political criteria necessary for membership.[184] It is a functioning democracy, with sound institutions, solid public administration, and respect for the rule of law. Overall, civil and political rights are generally well respected. There has been substantial progress in rights of minorities, refugees continue to return to Croatia, and Croatia is continuing to participate actively in regional cooperation.[185] Relations with neighbouring countries have improved, although outstanding issues remain, in particular regarding the settlement of border disputes, property issues and the return of refugees. Croatia had shown its commitment to improving regional harmony by signing the Sarajevo Process on 31 January 2005, whereby BiH, Croatia, Montenegro and Serbia agreed to cooperate within this framework to find solutions for refugees and other persons displaced during the Yugoslav wars of 1991-95. The Report highlighted the need for further judicial reform, and for steps to fight corruption and enforce greater transparency. Traditional organised crime activities –drug and human trafficking– continue along the borders with BiH and Serbia, triggering public mistrust in the government and its abilities. Further efforts are recommended to continue building a modern, reliable and de-politicised public service.

In the economic sector, Croatia was evaluated as having a functioning market economy, which should be able to cope with competitive pressures and market forces within the Union, provided that it continues to implement its comprehensive reform programme in order to reduce structural weaknesses. Croatia's economy has recently shown signs of a mild expansion following three years of recession which had resulted in higher unemployment, public deficits and debt. Although the current account deficit has fallen sharply, external debt has continued to increase and remains a key vulnerability of the economy. Mon-

[184] Commission Staff Working Paper, *Croatia 2011 Progress Report*, SEC(2011) 1200 final, Brussels, 12.10.2011.

[185] The Croatian authorities have registered over 132,600 returnees belonging to the Serb minority, corresponding to approximately half of those who fled the country between 1992 and 1995.

etary policy has maintained exchange rate and financial stability, while fiscal policy has, to some extent, contained the negative budgetary consequences of the recession. Further efforts are needed as regards structural reforms, including reforms of the labour market, improvements in the business environment, advancing privatisation and enterprise restructuring.

Croatia's preparations for meeting EU requirements have brought further progress in all key areas, including in those chapters where the level of alignment with EU rules was already high. However, additional efforts are needed in certain areas such as strengthening further the administrative capacity necessary for the proper implementation of the EU legislation and standards, as well as the absorption of EU funds.

6.2.2. The Former Yugoslav Republic of Macedonia (FYROM)

6.2.2.1. Overview and Recent Developments

FYROM's relations with the EU officially began in 1996, when it became eligible for funding under the PHARE programme. FYROM was the first country in the region to sign a Stabilisation and Association Agreement with the EU on 9 April, 2001.[186] In March 2004 FYROM submitted its application to join the EU, shortly before the Stabilisation and Association Agreement came into force in April. Following a positive opinion by the Commission on FYROM's application, the country was granted candidate status in December 2005. Six years later, however, accession talks have still not started; this is due almost exclusively to the still-unresolved dispute with Greece regarding the name issue. Athens has repeatedly argued that Skopje's constitutional name of the "Republic of Macedonia" implies territorial ambitions over Greece's northern province, also called Macedonia. Greece, being an EU member state of long standing, has veto power against new accessions, and has repeatedly stated that it will block FYROM's accession –as it did in the case of the country's admission to NATO in April 2008– unless the name issue is resolved beforehand. At the June 2008 EU Summit the Commission decided that finding a solution to the name issue would be a precondition for accession.

[186] *Stabilisation and Association Agreement between the European Communities and their Member States, on the one part, and the Former Yugoslav Republic of Macedonia, on the other part, Official Journal* L84 of 20.3.2004.

In October 2009, following a positive Progress Report and a renewed commitment between Greece and FYROM to settle the name dispute before the December 7th General Affairs Council meeting, the Commission recommended starting accession talks. However, as talks had not progressed by the time the Council meeting took place, the Council of Ministers postponed granting FYROM a specific start date for accession negotiations. Over the next two years the EU repeatedly called for "pragmatism", "long term vision" and resistance to "antiquisation", in order for a solution to be found so that the accession process could progress. However, despite EU pressure and the flurry of international initiatives –including repeated interventions from the UN special envoy Matthew Nimetz– the situation remained deadlocked. A July 2010 poll indicated that 66 percent of FYROM's citizens preferred preserving the country's constitutional name to joining the EU and NATO.[187]

Following the October 2010 Progress Report's recommendation for opening accession talks with FYROM, FYROM's Foreign Minister Antonio Milososki sent a letter to his Greek counterpart, Dimitri Droutsas, pleading for Greece to lift its objections to FYROM's EU bid. In light of the upcoming meeting of the Council of the European Union Milososki asked the Greek Foreign Minister for "support for the adoption of a decision for starting accession negotiations of the EU with the Republic of Macedonia".[188] Milososki pointed out that his country had qualified to start accession negotiations for two consecutive years and had been a candidate country without opening accession talks for five full years, a situation that is unsustainable. FYROM did not receive the support it requested as Greece remained fixed in its positions.

Starting in January 2011 the country became entrapped in a political stalemate, as the opposition Social Democratic Union of Macedonia –led by former Prime Minister and former President Branko Crvenkovski– boycotted the parliament over disagreement on the electoral code. The political standoff held back progress in key internal reforms and cast a shadow over the long-running bilateral talks with Greece on the name issue. Moreover, concerns were raised over growing inter-ethnic tensions in the country, corruption, and as well as deep problems in the country's political culture, including recent attacks on freedom of the media and civil society representatives. Over the next few months the EU called on FYROM's leaders to overcome the political stalemate and step up

[187] *Associated Press*, 12 July 2010.

[188] *Sofia News Agency*, 3 December 2010.

their pro-European efforts. Parliament was dissolved in April 2011, and Nikola Gruevski's ruling VMRO-DPMNE coalition won the elections that were held in June. At this time, tensions between Greece and FYROM also escalated further when a 13-meter statue of Alexander the Great was erected in Skopje that month, a move that enraged Greece. EU Commissioner for Enlargement Stefan Fuele declared that FYROM "does not have the luxury to disrespect its neighbour", and that the country "can lose its candidate status if it continues to make moves that Greece perceives as provocations".[189]

Despite the fact that the European Commission endorsed the launch of accession talks in the 2011 Progress Report, for a third consecutive year FYROM received no specific date for the start of the negotiations. Stefan Fuele declared that "the continuing name dispute has reduced FYROM's reform motivation and progress, which is why the name dispute needs to be resolved".[190] FYROM's Prime Minister expressed the leadership's frustration with the fact that "for three years we have been blocked by a virtual problem that has no connection with EU standards". FYROM's leadership was particularly aggravated that the Progress Report avoided using the term "Macedonian" in reference to the country. FYROM's President Gjorge Ivanov wrote a letter to Commission President Jose Manuel Barroso expressing his dissatisfaction with the "absence and failure to use the adjective 'Macedonian' in the EC report".[191]

6.2.2.2. Economic Relations with the EU

Between 1992 and 2000 the total amount of EU assistance FYROM received was 475 million euros. In 2001 the CARDS programme came into force, while after 2007 FYROM has also received aid under the Instrument for Pre-Accession Assistance. For the period 2007-2012, the amount allocated to FYROM was 505.3 million euros, allocated for infrastructure projects, strengthening of the judiciary, integrated border management, democracy and fundamental rights, and adaptation of the *acquis communautaire*.

The country's openness to trade is high. The main export commodities are textiles and steel. The EU is the main trading partner, accounting for 60 percent of total imports and 47 percent of total exports. The second most important trade destination is the neighbouring Western Balkan countries with about 34

[189] *The New York Times*, 21 June 2011.
[190] *Associated Press*, 12 October 2011.
[191] *Sofia News Agency*, 12 October 2011.

percent of exports and 11 percent of imports. In 2007, the EU accounted for about 75 percent of FDI inflows.

6.2.2.3. Progress on Copenhagen Criteria

According to the 2011 Progress Report, FYROM has made significant progress as far as the political criteria are concerned.[192] The parliamentary elections in June were generally in line with international standards, and the governing coalition was swiftly established. Some progress has been achieved in the fields of the judiciary and public administration, notably as regards the legal framework. Nonetheless, considerable and sustained efforts would be necessary in order to ensure effective implementation, in particular regarding judicial and public administration reform, fighting corruption, enhancing freedom of expression of the media, and ensuring the respect and protection of minorities. Dialogue between the government and the opposition needs to be strengthened in order to ensure the smooth functioning of institutions and to allow the parliament to play its full role.

FYROM's economy started to recover in the second half of 2010, as a result of increased external demand and investment in construction. The country made further progress towards implementing market-oriented reforms and becoming a functioning market economy, leading to a further reduction of the role of the state in the economy, as well as facilitating company registration and further simplifying the regulatory framework. Fiscal policy maintained its stability orientation, and the country has completed a follow-up programme with the IMF. FYROM has significantly opened its economy, reduced barriers to market entry, has liberalised prices and made significant progress with privatisation. However, despite measures to improve the business and investment environment, market entry and exit procedures are still long, partly due to insufficient clarity of property rights and weaknesses in the administration and the judiciary. Moreover, weaknesses in the rule of law continue to impede the proper functioning of the market economy. Public administration efficiency is still low and some regulatory and supervisory agencies continue to lack the necessary independence and resource allocation to fulfil their functions effectively. The quality of fiscal governance has remained low, while progress with reducing very high structural unemployment has remained very limited. Deficiencies in

[192] Commission Staff Working Paper, *FYROM 2011 Progress Report*, SEC(2011) 1203 final, Brussels, 12.10.2011.

the rule of law and a large informal sector continue to have a negative bearing on the business environment.

Further progress was made in aligning legislation, policies and administrative capacity with the EU, in particular as regards the single market such as company law, financial services and energy. Good progress was also made on food safety and economic and monetary union. Less progress has been achieved in other areas such as taxation, public procurement as well as social policy and employment. Sustained efforts are needed to strengthen administrative capacity for the implementation and enforcement of legislation.

6.2.3. Montenegro

6.2.3.1. Overview and Recent Developments

Montenegro started its path towards EU accession in October 2005 –while it was still a part of the federal union of Serbia-Montenegro– when negotiations for a Stabilisation and Association Agreement started. Within the framework of the approved “double track” approach, three negotiating teams were to hold talks with EU delegations: one at the level of Serbia-Montenegro, headed by the state union’s Foreign Minister, and two at the level of the republics, led by Serbia’s deputy Prime Minister and Montenegro’s minister of European Integration. Following a referendum in May 2006, the Montenegrin Parliament declared independence on 3 June 2006 and the state of Serbia-Montenegro was dissolved. Although the EU had consistently declared that it would only pursue accession negotiations with the united state of Serbia-Montenegro, it had no choice but to accept the independence of Montenegro. Shortly thereafter, the European Council declared its willingness to develop further relations with Montenegro as a sovereign, independent state. In October 2007 the Stabilisation and Association Agreement between Montenegro and the EU was signed (it entered into force in May 2010) and a European Partnership was adopted in January 2007. In November 2009 the Council decided to lift visa requirements for the citizens of Montenegro (along with the citizens of Serbia and FYROM) with effect from December 2009.

On 15 December, 2008 Montenegro submitted its application for EU membership, and one year later presented the completed questionnaire to the Commission. On 17 December 2010 the Commission recommended that the Council should grant Montenegro candidate status. This decision made Montenegro the first country in the Western Balkans in the last five years to be granted candidate status. However, a specific date for commencing negotiations was not chosen: the Montenegrin leadership was told that the country must make progress in seven key priorities –rule of law, judicial and public administration reform, combating organised crime and corruption, media freedom and minority rights– before talks could begin. The following year witnessed an acceleration in the momentum of EU and Montenegro relations, illustrated in a March resolution in the European Parliament as well as public statements by European leaders urging the launch of accession talks. In June 2011 Enlargement Commissioner Stefan Fuele praised Montenegro's progress in fulfilling the criteria for EU membership, and assured the Montenegrin leadership that there is "no enlargement fatigue". Indeed, on 12 October 2011, through its annual Progress Report the European Commission recommended opening negotiation talks with Montenegro, bringing the country one step closer to EU membership.

6.2.3.2. Economic Relations with the EU

Since 2007 Montenegro has been receiving EU financial aid under the Instrument for Pre-Accession Assistance: the amount allocated for the period 2007-1012 was 202.8 million euros. Montenegro has also profited from EU autonomous trade measures since 2000, and in January 2008 access of Montenegrin products to the EU was expanded further. In 2009, notwithstanding the negative impact of the international crisis, integration with the EU remained high. The main source of export revenues are tourism and metal industry. The EU is the main trading partner of the country, while FDI from EU countries accounted for 80% of total inflows in 2009.

6.2.3.3. Progress on Copenhagen Criteria

According to the 2011 Progress Report, Montenegro has made good progress in meeting the political criteria for membership in the EU, in particular addressing the seven key priorities identified in the Commission's Opinion, released in November 2010.[193] The legislative and institutional framework has been significantly improved, strengthening the work of the parliament, the electoral framework, the professionalism and de-politisation of public administration, the independence and accountability of the judiciary, anti-corruption policy, media

[193] Commission Staff Working Paper, *Montenegro 2011 Progress Report*, SEC(2011) 1204 final, Brussels, 12.10.2011.

freedom and cooperation with the civil society. Montenegro's track record in combating corruption and organized crime follows a positive trend, while steps have been made to improve the implementation of anti-discrimination policies and to guarantee the legal status of displaced persons and ensure respect of their rights. Moreover, Montenegro continues to play a constructive role in the region and to broadly respect the conditions of the Stabilisation and Association Process.

However, both policy and legislation implementation remains a challenge. There is a need for more judicial reform and an improvement in the quality of legislation, *inter alia* to expand freedom of expression in the media and guarantee the protection of vulnerable groups –minorities, children and women– who continue to face discrimination in practice. Continuing efforts are needed to ensure the positive trend in combating corruption, which remains widespread in many areas, especially in the construction, privatisation and public procurements sector, and organised crime, especially money-laundering and smuggling.

Concerning the economic criteria, Montenegro made further progress in establishing a functioning market economy. The Montenegrin economy started to recover in 2010 and reinforced its macroeconomic stability, stabilizing the bank sector and maintaining a relatively prudent fiscal stance, as well as pursuing fiscal adjustments and restructuring of strategic sectors. Montenegro remained consistent in its economic policy and made further progress in some structural reforms, thus improving the quality of public finances. Integration and openness of the economy with the EU, the Western Balkans and EFTA countries increased.

Yet, persisting structural problems of the Montenegrin economy and the fragile international financial environment continue to put the recovery of the country's economy in risk. Business continues to be confronted with tight and expensive credit conditions. Unemployment remains high, and the privatization process has been influenced by the negative global environment. Further steps are needed to adopt and implement the necessary reforms in order to minimize structural weaknesses. Adaptability and skills of the labour force are to be strengthened, and the transport and energy infrastructure enhanced. Fiscal consolidation has to be kept of track and measures to be taken for the accumulation of tax arrears. Environmental sustainability and economic growth have to be combined productively. Lingering weaknesses in the rule of law negatively affect the investment and business environment.

Concerning the adoption of EU legislation, Montenegro continues to smoothly implement the Stabilisation and Association Agreement. Important laws have been adopted and the dialogue with EU institutions and the civil society has been enhanced in further aligning the country's legislation to the *acquis*. Significant compliance and progress has been achieved in science and research, audiovisual policies, public procurement and company law. Yet, Montenegro has to face significant challenges both in adopting and implementing the necessary legislation in order to ensure the alignment with the *acquis* in key areas such as social policy and employment, regional policy, environment, competition, and financial control, as well as free movement of goods, protection of intellectual property, agricultural policy, food safety justice, freedom and security.

6.3. Group 2: Potential Candidates (Albania, Serbia, Bosnia-Herzegovina, Kosovo)

6.3.1. Albania

6.3.1.1. Overview and Recent Developments

After decades of political and economic isolation, Albania's first contractual relations with the European Communities were established in 1992 with the signature of an Agreement on Trade, Commercial, and Economic Cooperation. The 1992 Cooperation Agreement was founded largely to encourage trade and continued democratisation in Albania. Such contractual links were intended to "progress towards the objective of an association agreement in due course, when objectives are met".[194] The Cooperation Agreement paralleled the Europe Agreements being pursued with the more advanced Central and East European transition economies starting in 1991, with one key difference: no guarantee of eventual EU membership.[195] However, the 1997 collapse of the pyramid schemes and Albania's subsequent descent into chaos not only reversed the significant progress the country had achieved in the early years of the transition process, but also led to the freezing of relations with the EU. In the aftermath of

[194] European Economic *Community, Agreement between the European Economic Community and the Republic of Albania, on Trade, Commercial and Economic Cooperation*, 1992, *Official Journal* L343, 25/11/1992.

[195] A. Johnson, "Albania's Relations with the EU: On the Road to Europe?", *Journal of Southern Europe and the Balkans*, 3 (2), 2001, p. 175.

the crisis the EU provided Albania with economic assistance and relief aid; however, institutional relations remained frozen until 1999, when the Stability Pact and the Stabilisation and Association Process were launched, which included Albania in the process of closer integration with the EU.

Following the Zagreb Summit of 2000 an EU-Albania High Level Steering Group was set up, which aimed at supporting the reforms necessary for Albania to start negotiating a Stabilisation and Association Agreement. Due to serious apprehension over the lack of democratic procedures and political instability, as well as an enduring concern over corruption and organised crime in Albania, the launch of official negotiations for a Stabilisation and Association Agreement was delayed until 31 January, 2003. Unlike FYROM and Croatia, whose SAA was signed within one year of the beginning of negotiations, Albania's SAA negotiations took 3 years due to the slow pace of the country's reforms. The key areas of concern were the fight against organised crime and corruption, rule of law, respect of human rights and minorities, electoral reform and trafficking in drugs and people. The SAA was eventually signed in June 2006; after it was ratified by the European Parliament and all 27 EU members it entered into force in April 2009.[196]

Although the EU had discouraged Albania from making its bid for candidacy before the country's parliamentary elections of June 2009, Albania submitted its official application for EU membership on 28 April, 2009. In this context, the June 2009 elections were seen as a litmus test for the country's political maturity and readiness to move forward towards closer integration with the EU. However, according to international observers, the electoral process did not meet international standards, and there were serious shortcomings and irregularities. The opposition parties contested the results, claiming they were rigged to ensure Berisha's re-election, and demanded a recount. The Prime Minister, who controlled 75 of parliament's 140 seats, rejected calls for a recount, leading to the opposition's boycott of the parliament, which was to paralyse the country for over two years. In May 2010 opposition members and their supporters staged a hunger strike in the center of Tirana to press for a recount of the April 2009 vote. The strike ended after 19 days, after political leaders agreed to EU-sponsored talks to end the political crisis. In July 2010 the opposition parties partly suspended their boycott of the parliament and took up

[196] Stabilisation and Association Agreement between the European Communities and the Republic of Albania, *Official Journal of the European Union*, L 107/166, 28 April 2009.

their parliamentary seats, following mediation by the leaders of the European Parliament's main political groups. However, a consensus was still not reached between the governing party and the opposition, and tensions remained very high. EU Enlargement Commissioner Stefan Fuele declared that the EU was concerned about "the dysfunctional parliament and the possible systemic effects across the institutions".[197] He also warned the Albanian leadership that "the EU perspective of Albania is at stake", emphasising the negative impact the stalemate and the paralysis of Albanian policy-making had on Albania's accession prospects.

Despite the political deadlock, the mandatory questionnaire was completed by the responsible Albanian authorities and submitted on 14 April, 2010. In November the Commission presented its Opinion on Albania's application: in light of the continuing political crisis that prevented Parliament from functioning and from passing new laws, the Commission refused to recommend the Council granting Albania candidate status. The Opinion included a set of 12 key priorities to be fulfilled in order for Albania's application to progress further. However, the EU did approve visa-free travel to the Schengen Area for Albanian citizens in December 2010.

In September 2011, Albania's main opposition party decided to end its boycott of the parliament. Edi Rama, the leader of the Socialist Party, told the party's lawmakers that to end the boycott was the only way to unblock the country's path towards the EU, declaring that "the socialist opposition will be present in the Albanian parliament to take up its national responsibilities with regards to Albania's integration into the European Union".[198] However, this move came too late to have a positive impact on the Commission's evaluation and assessment of Albania's progress: the October 2011 Progress Report cited Albania's "political stalemate" as the main reason Albania was not awarded candidate status.

6.3.1.2. Economic Relations with the EU

Albania became eligible for funding under the PHARE programme in 1992. Through the CARDS and other macro-financial assistance programmes, aid to Albania amounted to 320 million euros for the period 2000-2006.[199] The total

[197] *Associated Press*, 31 May 2010.
[198] Associated Press, 5 September 2011.
[199] European Community CARDS Programme, *Albania: Country Strategy Paper 2002-2006*, External Relations Directorate General, Brussels, 30 November 2001.

amount designated to Albania for the period 2007-2012 through the Instrument for Pre-accession Assistance was 497.4 million euros, to help the country to introduce the necessary political, economic and institutional reforms in line with EU standards. [200] The main areas of assistance were focussed on the support for political reform, in particular institution building, strengthening the rule of law, human rights, protection of minorities and the development of civil society, economic and social development, and regional and cross-border cooperation. Finally, Albania is also eligible for funding from the European Investment Bank –in the form of grants and loans– principally under the pre-accession mandate.

Albania has profited from Autonomous Trade Preferences with the EU since 2000. Following the entry into force of the Interim Agreement in December 2006, Albania's trade with the EU expanded further through the extension of duty-free access to EU markets for Albanian products and additional preferences granted. The EU is Albania's main trading partner and in 2010 trade with the EU accounted for 74.5 percent of Albania's total trade. Inward processing, particularly textiles and garments and footwear represent the main volume of Albania's exports to the EU. The EU accounts for almost 80 percent of all FDI flows into Albania.

6.3.1.3. Progress on Copenhagen Criteria

In the 2011 Progress Report the European Commission concluded that, although progress was achieved during the last year in some of the key priorities identified in the 2010 Opinion on the country's application, conditions for granting Albania candidate status and opening of accession talks have not yet been met.[201] As far as the fulfilement of the political criteria is concerned, Albania's progress has been very weak. The effectiveness and stability of democratic institutions has not been sufficiently achieved, parliamentary institutions and procedures do not function properly, while political dialogue is confrontational and unconstructive. Most important, Albania's progress towards EU membership is imperiled by the deeply flawed electoral process. With the exception of the first democratic elections in March 1992, almost all elections in Albania have thereafter been highly controversial and bitterly disputed, characterised

[200] Commission Regulation (EC) No 718/2007 of 12 June 2007 implementing Council Regulation (EC) No 1085/2006 establishing an instrument for pre-accession assistance (IPA) [*Official Journal* L170 of 29.6.2007].

[201] Commission Staff Working Paper, *Albania 2011 Progress Report*, SEC(2011) 1205 final, Brussels, 12.10.2011.

by a plethora of technical irregularities, allegations of corruption and electoral bribery, lack of transparency, and high volatility.[202] A predictable pattern has emerged concerning the Albanian electoral process, whereby following each election, almost all the losing parties or coalitions refuse to recognise the results and proceed to boycott the parliament. The ensuing political paralysis and stalemate inhibits each new government's ability to implement necessary policies as well as the parliament's ability to legislate. This was the case after the elections in 1996, 1997, 2000, 2001, 2009, and most recently in the local elections of 8 May 2011.

Other problems facing the Albanian political system include the lack of transparency, the slow pace of institutional reform, corruption, bribery and clientelism. Also, the lack of democratic culture means that politicians have a limited understanding of the concept of national interest, leading to intense political and personal rivalries within and between the main political parties. EU representatives have often condemned the lack of constructive political dialogue and the confrontational political culture, where individual interests often prevail over national ones. Judicial reform remains incomplete, and there are substantial shortcomings regarding the independence, transparency and accountability of the judicial system. Political tensions remain high, as indicated in the anti-corruption demonstrations in Tirana on 21 January 2011: four people were shot dead as protestors demanding the resignation of Prime Minister Berisha clashed with riot police, marking the worst outbreak of political violence in a decade. All these events diverted political attention away from much needed EU policy reforms.

Concerning fulfilement of the economic criteria, Albania exhibits many features of a functioning market economy, and important progress has been made on achieving macroeconomic stabilisation and liberalisation of prices and trade according to IMF objectives. Market entry has been facilitated, the banking system has rapidly expanded due to privatisation and foreign investment, state aid to enterprises has been reduced, and the share of trade and investment integration with the EU remains high. Progress has also been achieved in removing administrative barriers to investment, and Albania's SME agency is now operational. Its capacity to cope with competitive pressures and market forces within the Union in the medium term is on track, provided Albania steps up structural reforms, including reinforcing the legal system and strengthening physical and human capital.

[202] Bogdani and Loughlin, *op. cit.*, p. 41.

The political stalemate hampered the capacity of the government to implement necessary structural reforms. According to the Progress Report, insufficient progress has been achieved in areas such as business legislation –causing insecurity in the business environment– ownership transfer, recognition of property rights, as well as the fight against corruption and organised crime. Further investments in infrastructure are needed, as reliability of the power supply and the financial viability of the electricity sector are uncertain. Finally, cronyism remains a strong feature of the Albanian economic system: national wealth and economic activity is possessed and controlled by a privileged minority –mainly through political power and affiliation– while the majority of the population has access to a tiny proportion of this wealth and lives in sustained poverty.

Albania has made some progress in improving its ability to assume the obligations of membership by approximating its legislation and standards to the EU, in particular in the areas of free movement of goods, enterprise and industrial policy, justice, freedom and security, and financial control. However, increased efforts are needed as progress has been limited in other areas such as free movement of workers, public procurement, intellectual property law, air transport, information society and media as well as energy and environment. Overall, the administrative capacity for implementation and enforcement of legislation needs to be strengthened.

6.3.2. Serbia

6.3.2.1. Overview and Recent Developments

In February 2001 –shortly after the elections that led Vojislav Kostunica to the Presidency and heralded the end of the Milosevic regime– an EU team visited Belgrade, to hold talks over potential areas of cooperation between the EU and Yugoslavia. These included economic and legal reforms, regional cooperation, aid and association. A 200 million euro emergency winter aid package was endorsed, providing fuel, electricity imports, medicine, food and help for schools, and humanitarian assistance for the country's huge refugee population. The European Commission and the World Bank, in consultation with the Yugoslav leadership, also prepared reports on the country's longer term needs, a structural reform plan, as well as a feasibility study for a Stabilisation and Association Agreement. It was clear from the beginning that in addition to the fulfillment of the Copenhagen criteria –which applied to all the Western Balkan countries– Serbia's road to EU accession had two other specific issues that needed to be resolved in order for the process to move forward: cooperation with the ICTY (arresting and extraditing suspected war criminals) and the question of the status of Kosovo.

In October 2005 the EU officially opened negotiations for a Stabilisation and Association Agreement with the state of Serbia-Montenegro, within the framework of the “double track” approach discussed above. However, in May 2006 talks for the achievement of a Stabilisation and Association Agreement were suspended because Belgrade failed to deliver fugitive general Ratko Mladic to the UN war crimes tribunal.[203] That same month, 55.5 percent of Montenegro’s population voted for independence by referendum; the split dissolved the last vestiges of the former Yugoslavia. The “Velvet Divorce” and Montenegro’s independence were recognised by the EU the following month: thus, the “double track” approach was abandoned, and relations would thereafter be pursued between the EU and the two states individually.

In November 2006, EU Commissioner for Enlargement Ollie Rehn reiterated that the EU was willing to restart talks on the SAA as soon as Serbia fulfilled its obligations with respect to the Hague Tribunal and proved its willingness and ability to arrest and extradite war criminals. Talks were resumed in June 2007, following the arrest of Zdravko Tolimir,[204] which was seen as proof of the Serbian leadership’s commitment to achieve full cooperation with the ICTY. In February 2008 the Council adopted the new European Partnership for Serbia which set out priorities for Serbia’s European perspective. At this point, however, Serbia’s EU bid was almost de-railed by the situation in Kosovo, which had declared independence on 17 February. Thus, whereas the SAA was concluded that month, the Belgrade leadership refused to sign it due to the EU’s stand over Kosovo. Over the next months Serbia’s relations with the EU deteriorated as several EU member states recognized the independence of the break-away province. Prime Minister Kostunica denounced the deployment of an EU mission to Kosovo,[205] as well as the newly-appointed EU representative in Kosovo,

[203] The European Commission had given Belgrade an April 30 deadline to deliver Mladic –who was believed to be hiding in Serbia under the protection of hard-line military supporters– as a precondition for resuming talks with the EU on May 1.

[204] Tolimir was the no. 3 on the list of most wanted war crime suspects still at large, after Mladic and Karadzic.

[205] The EU planned to deploy a 1800-strong mission in Kosovo to replace the UN administration.

saying his presence there was illegal and an affront to the United Nations.[206] Top Serb officials claimed that the establishment of an EU mission represented an attempt to circumvent UN resolution 1244 of 1999 which formally recognized Serbia's sovereignty and territorial integrity while simultaneously placing Kosovo under a UN interim administration backed by NATO-led forces.

As tensions escalated, the Serb leadership reverted to increasingly nationalist rhetoric. Kostunica declared that the country would join the EU only with Kosovo as its province, adding that "the West is determined to humiliate us... Serbia will never accept a western-backed fake state of Kosovo, because in a fake state everything is a lie".[207] Kostunica also claimed that "the United States has trampled on international law that is the basis of the peace and stability in the world", and branded ethnic Albanian leaders as terrorists and drug traffickers.[208] Kostunica proposed that Serbia should drop its proclaimed goal of joining the EU and should instead turn to its Slavic ally Russia, which also staunchly opposed Kosovo's independence.

Tensions also grew within Serbia's coalition government: in March 2008 the government collapsed under the pressure of the battle between pro-western liberals and nationalists over whether joining the EU meant giving up Serbia's claim to Kosovo. Parliamentary elections were called for May 2008 by Kostunica, who declared that members of his government could no longer function alongside President Tadic's pro-Western Democrats because of their insistence on pursuing EU membership even though 18 of the bloc's 27 members recognized Kosovo's declaration of independence. Kostunica insisted that the EU nations must rescind their recognition of Kosovo and recognise Serbia's claim to the territory before Serbia resumed pre-membership talks. On the other hand, President Tadic and members of his Pro-Europe DS party reaffirmed that EU membership remained Serbia's foreign policy priority and the country hoped to achieve candidate status by the end of 2008. Tadic opposed tying Serbia's EU integration bid to the issue of Kosovo's future status, and insisted that EU membership was the best way to oppose the independence of Kosovo, as Serbia had a better chance of fighting for its territorial rights if it was not isolated. Tadic's Democrats won in the 11 May, 2008 elections, delivering a crucial boost to Serbia's quest for EU integration.

[206] *Associated Press*, 1 March, 2008.
[207] *Associated Press*, 29 February, 2008.
[208] *Ibid*.

In July 2008 the Serb government arrested and handed over former president of Republika Srpska Radovan Karadzic, who faced eleven counts of genocide, war crimes, crimes against humanity and other atrocities in the Bosnian war of 1991-1995. Spurred by the Karadzic extradition, rapprochement with the EU was accelerated: the Stabilisation and Association Agreement – that had been signed but frozen since April 2008 – was finally ratified by Serbia in September 2008. Ratification from the EU side, however, was blocked by Holland because of ICTY obligations, pending the arrest and extradition of Radko Mladic. Visa liberalisation for Serb citizens traveling in the EU was established in December 2009. On 22 December, 2009 Serbia formally applied for EU membership, and submitted the answers to the questionnaire in January 2011.

After sixteen years in hiding, Radko Mladic, former commander of the Republican Srpska army, was arrested in May 2011 and extradited to the Hague.[209] Two months later, in July 2011, the only major remaining war crimes suspect, the former Croatian Serb leader Goran Hadzic, was arrested by Serb police forces.[210] With Hadzic's arrest, the last remaining fugitive of the 161 suspects identified by the ICTY was delivered to justice; Serbia had thus fulfilled all its obligations towards the ICTY, drastically increasing its standing vis-à-vis the EU and lifting another obstacle to its accession process. In July 2011 Holland declared its intention to lift its blockade of the ratification of Serbia's SAA. However, the recent escalation of ethnic tensions with Kosovo dashed Belgrade's hopes of receiving a date this year for opening accession negotiations. The violent clashes between the local Serbs and the KFOR forces at the Serbia-Kosovo border crossings in the summer of 2011 led to a collapse of an EU-sponsored dialogue between Kosovo and Serbia, triggering sharp criticism from EU member states.

On 12 October 2011 the EU Commission issued a positive recommendation on candidate status for Serbia in its annual Progress Report. By upgrading Serbia's status the Commission acknowledged the good progress in implementing democratic reforms and rewarded Belgrade for arresting the two remaining war criminals, Radko Mladic and Goran Hadzic, earlier this year. Belgrade did not, however, receive a date for opening accession talks; the Commission opted for a similar model to the one used in the case of Albania and Montenegro last year,

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[209] Mladic was charged with eleven counts including genocide, war crimes, crimes against humanity and other atrocities in the Bosnian war.

[210] Hadzic has been accused of fourteen counts of war crimes and crimes against humanity; many of his war orders were carried out by the infamous paramilitary leader Zeljko Raznatovic Arkan.

whereby the launch of accession talks would be made conditional on several issues, in particular Belgrade's ability to improve relations with Kosovo.

6.3.2.2. Economic Relations with the EU

Since 1991, Serbia has received over 3 billion euros in financial assistance from a variety of EU funds; most of these funds were granted after the fall of the Milosevic regime. In 2001 a macro-financial assistance arrangement (MFA) from the EU was introduced, amounting to 375 million euros. A grant of 30 million euros was released to Serbia in 2002, along with a new MFA package of 130 million euros. The Instrument for Pre-Accession assistance allocated about 1.2 billion euros to Serbia for the period 2007-2012.

On July 6, 2010, EU Commissioner for Economic and Monetary Policy, Olli Rehn, and Serbian Deputy Prime Minister for European Integration, Bozidar Djelic, signed an agreement on macro financial assistance (MFA) to Serbia in the amount of 200 million euros. This agreement was conditional upon Serbia maintaining a disbursing programme with the IMF as the key facility to help the government in addressing the country's external financing needs. The MFA funds would become available upon a satisfactory fulfillment by the Serbian authorities of a set of conditionality requirements which mainly related to public finance management reforms, aiming at establishing a more transparent, coherent and accountable PFM system.

Serbia has profited from autonomous trade measures with the EU since 2000. The EU is the main trading partner of Serbia and EU-Serbian trade has been rapidly growing over the past decade. Trade integration with the EU is high: in 2009 the EU accounted for 54 percent of total Serb exports and 56 percent of total imports. Serbia mainly exported agricultural products, tires, iron, steel and machinery while its main imports were vehicles, diesel fuels and medicaments.

6.3.2.3. Progress on Copenhagen Criteria

According to the Commission's 2011 Opinion, Serbia has made significant progress towards meeting the political criteria for accession, particularly regarding the implementation of democracy and the rule of law, public administration, guarantee of freedom of religion and expression and protection of minorities.[211]

[211] Commission Opinion on Serbia's application for membership of the European Union, Communication from the Commission to the European Parliament and the Council, COM(2011) 668 final, SEC(2011) 1208 final, Brussels, 12.10.2011.

Serbia has a comprehensive constitutional, legislative and institutional framework which overall corresponds to European and international standards. Parliament has become far more effective in its legislative activity under the current legislature. Serbia was commended for having successfully fulfilled the requirements/cooperation with the ICTY and for taking an increasingly active role in fostering reconciliation in the region. At the same time, the EU stressed that Serbia will also need to achieve further significant progress in improving relations with Kosovo and implementing pragmatic and sustainable solutions. Moreover, significant work remains in the areas of fight against corruption, police reform, judicial and administration reform.

As far as the economic criteria are concerned, Serbia has taken important steps towards establishing a functioning market economy and has achieved a certain level of macroeconomic stability in spite of the global economic and financial crisis. However, further efforts would be necessary for restructuring the economy and improving the business environment, in particular by strengthening the rule of law and removing red tape, enhancing competition and the role of the private sector as well as tackling rigidities in the labour market. In order to enable it to cope with competitive pressure and market forces within the Union, Serbia would need to pursue structural reforms to upgrade the productive capacity of the economy and create a climate conducive to increased foreign investment.

Serbia would be in a position to take on the obligations of membership in the medium term, in nearly all fields of the *acquis*, provided that the alignment process continues and that further efforts are made to ensure the implementation and enforcement of legislation. Particular attention needs to be paid to the areas of agriculture and rural development, judiciary, freedom and security and financial control.

6.3.3. Bosnia-Herzegovina

6.3.3.1. Overview and Recent Developments

BiH's formal relations with the EU began in 1999, four years after the end of the war, when the country was included in the Stabilisation and Association Process for the Western Balkans. The 2000 Feira European Council confirmed the EU membership perspective of BiH, declaring that all SAP countries are "potential candidates" for membership. At this point, there was a shift in the EU's focus, from implementing the tenets of the Dayton agreement to helping

BiH prepare for Europe. In March 2000 the European Commission established a specific 18-point "EU Road Map", which highlighted specific economic and political criteria to be met before the country could sign a Stabilisation and Association Agreement. EU conditionality in BiH focused especially on building functioning institutions, implementing economic reforms, achieving the return of displaced persons, addressing the issue of human rights and rule of law, and ensuring cooperation with the ICTY.

In November 2005, the Commission's assessment was that the country had made adequate progress relating to the established priorities, and recommended the opening of negotiations for a Stabilisation and Association Agreement. However, the SAA negotiation process was extremely slow, arduous and volatile, owing to lack of agreement between BiH's political leaders. Thus, the SAA was only achieved after a three-year stalemate over key police reforms was finally resolved in the parliament in April 2008. The Stabilisation and Association Agreement was eventually signed in June 2008. Following the signature of the SAA, the EU's main focus was on the strengthening of the rule of law and public administration structures, economic and social development and democratic stabilisation. In parallel, the Commission launched a visa liberalisation dialogue with BiH on 26 May 2008, and a new European partnership was adopted by the Council on 18 February 2008.

As of October 2011, BiH was the only Western Balkan country that had not yet applied to join the EU: the accession process remains frozen: although the Stabilisation and Association Agreement has been ratified by all EU member states (France was the last country to ratify it in February 2011), it has not gone into force because Bosnia has failed to meet its obligations, including the adoption of the necessary amendments to its Constitution. Bosnian Foreign Minister Sven Alkalaj confirmed that Bosnia's current path to the EU of his country was "stopped in its tracks... Instead of moving towards the opening of our EU membership talks, the gap is getting deeper". The political leaders' apparent lack of will for a common future has led to concerns that the situation is turning into an insurmountable impasse. It is indicative that although the EU has firmly stated that the future of the Western Balkans lies within the Union, its representatives warn that the situation in BiH is threatening to create a "black hole" at the very heart of the region.

6.3.3.2. Economic Relations with the EU

Between 1991 and 2000, the EC had set aside more than 2.5 billion euros to deal with conflict and post-conflict issues in Bosnia and Herzegovina. More than 2 billion euros of EC assistance (mainly through the ECHO, PHARE and OBNOVA programmes) focused on refugee programmes and reconstruction. In addition, the EC has provided macro-financial assistance to Bosnia and Herzegovina. Since 2001, the main source of EU assistance for BiH has been the CARDS and IPA programmes, with the focus shifting from post-war assistance to institutional capacity-building and economic development. In the period 2001-2006, the Community supported BiH with over 500 million euros, focusing on key areas such as public administration reform (including customs and taxation), justice and home affairs-related issues (including police reform, integrated border management, judicial reform) and improving the investment climate (including trade, education, environment and infrastructure). In 2008 BiH signed the agreement for pre-accession assistance (IPA), which was set at 550 million euros until 2012.

BiH has profited from EU Autonomous Trade Measures since 2000. Following the entry into force of the Interim Agreement on 1 July 2008, access of products from BiH to the EU expanded further. The main source of export revenues are manufactured goods (including textiles, machinery and transport equipment), base metals, wood and wood products, mineral products, chemicals and raw materials, while its imports include in particular machinery, mineral products, foodstuffs and chemicals. The EU remains the country's largest trading partner (particularly Italy, Germany, Slovenia and Austria) with shares of 54.5 percent of total exports and 45.9 percent of total imports in 2010. The EU also accounts for about 50 percent of total FDI inflows to BiH.

6.3.3.3. Progress on Copenhagen Criteria

It appears that –with few exceptions– BiH has made only limited progress in addressing the political and economic criteria dictated by the accession process.[212] Concerning the fulfillment of the political criteria, the main problem is the complex institutional architecture of BiH. The fragmented policy-making process between the federal state and the two entities causes serious difficul-

[212] Commission Staff Working Paper, *Bosnia and Herzegovina 2011 Progress Report*, SEC(2011) 1206 final, Brussels, 12.10.2011.

ties for the State office to influence and coordinate the whole decision-making and reform process. One of the main challenges is building state capacity and transferring authority from the entities to the central state. Various attempts to reform the Dayton-era constitution and improve the functioning of BiH's institutions have failed due to widespread disagreement between the political parties. An agreement was reached on future constitutional reform in November 2008, but no concrete progress followed this. The two entities have not yet made their constitutions compliant with the 2006 ruling of the Constitutional Court of BiH. The country's administrative structures are still not capable of responding effectively to the requirements of EU integration.

The civil service remains highly politicised, there is no uniform application of the law and no effective investigation, prosecution and conviction of high-level corruption. Little progress has been made on the promotion and enforcement of human rights: freedom of expression and free press are not fully implemented, while BiH continues to be primarily a country of origin but also a transit and destination country for trafficking in women. Also, no steps have been taken towards the implementation of anti-discrimination policy and the protection of minorities' rights.

Another potentially dangerous situation is the re-emergence of nationalist political rhetoric over the past few years, while the local elections in October 2008 reconfirmed the deep ethnic divisions that still exist in the country. In March 2009, outgoing EU/High Representative for Bosnia and Herzegovina Miroslav Lajčák warned that the situation was in danger of deteriorating further. Nationalist rhetoric was also prominent during the general elections of October 2010 for the Presidency and lower chamber of the Parliamentary Assembly of BiH. Ethnicity dominates the political arena and frequent challenges to the Dayton Agreement are made – mainly by Republika Srpska, a breakaway province which continues to claim its right to self-determination. Talks on the future of BiH in October 2009 saw a hardening of positions among the country's Serb, Croat and Muslim leaders. In particular, the leader of Republika Srpska, Milorad Dodik, has been pushing for a referendum, putting in doubt the future of a multi-ethnic Bosnia. In a speech on 18 February 2010, EU High Representative for Foreign Affairs and Security Policy Catherine Ashton said that BiH could only join the EU as one country with one voice, and that the EU will never accept a break-up of the state. Eventually, facing pressure from the European Union, in May 2011 Dodik backed off plans to hold a referendum that would have challenged the authority of statewide institutions in the country.

Bosnia-Herzegovina has had no functioning government since the October 2010 elections. If and when a government is formed, Bosnia-Herzegovina needs a state government that is both functional and in compliance with the 2009 European Court of Human Rights (ECHR) anti-discrimination ruling, which called on Bosnia-Herzegovina to end its unlawful racial or ethnic-based exclusion of Jews and Roma from the highest elected offices. This means undertaking real constitutional reform.

Concerning the economic criteria for accession, BiH has made very little progress in establishing the infrastructure of a functioning market economy. Commitment to structural reforms and sound public finances has remained uneven across the country. Progress towards creating one single economic space within the country –a key European Partnership priority– has been unsatisfactory. Market liberalisation remains insufficient, most utility providers still do not apply market prices, and state influence on competitiveness remains high. There has been negligible progress in the areas of free movement of persons, coordination of social security, provision of services, customs, and social policies. The private sector's share in GDP is estimated at 60 percent, but the privatization process has stalled. The weak rule of law –with prevalent corruption and unreliable contract enforcement– continues to hamper the business environment. A Standing Committee for financial Stability, comprising the Central Bank, the Banking Agencies and the Ministries of Finance, was established in the context of the IMF programme and had its first meeting in May 2010.

Some progress has been made in aligning the country's legislation, policies and capacity with European standards in areas such as free movement of goods, intellectual property, state aid, research, culture, transport and in a number of justice, freedom and security-related matters. Progress remains insufficient in other areas, such as the free movement of goods, persons and services, customs and taxation, competition, public procurement, employment and social policies, education, industry, agriculture and fisheries, environment and climate change, energy and statistics. A comprehensive energy strategy needs to be adopted and a country-wide functioning national transmission company established. Sustained efforts in sensitive areas such as the fight against corruption and organized crime are also a priority.

6.3.4. Kosovo

6.3.4.1. Overview and Recent Developments

As was discussed above, Kosovo enjoyed autonomy within Serbia until 1989, when this status was revoked following mounting ethnic tensions. It was ruled directly from Belgrade until 1999, when the NATO attacks forced Serbia to withdraw. A UN Security Council resolution on Kosovo (1244/99) adopted at the end of that campaign reaffirmed "the commitment of all member states to the sovereignty and territorial integrity of the Federal Republic of Yugoslavia" (of which Kosovo was part at the time). The resolution also called for "autonomy and meaningful self-administration for Kosovo". In the twelve years since, Kosovo has been a self-governing, international protectorate; however, the UN Security Council had never agreed on Kosovo's final status. Following Kosovo's declaration of independence in February 2008, the UN Security Council remained divided on the question: of the five members with veto power, USA, UK, and France recognised the declaration of independence, the People's Republic of China expressed concern, while Russia considered it illegal. In July 2010 the International Court of Justice concluded that Kosovo's declaration of independence did not violate general international law or Security Council resolution 1244/99. Serbia –who does not recognise Kosovo's independence– continues to fund parallel government institutions in Kosovo's north, mainly municipal councils, schools and hospitals. The 60,000 Serbs in the region also pledge allegiance to Belgrade. To date, 81 countries in the UN have recognised Kosovo's independence.

The main obstacle to Kosovo' embarking on the path to EU membership remains the fact that five EU member states do not recognise its independence. The unanimous consent of the EU27 is required to even begin talks on EU membership with a candidate country, let alone admit it to the Union. This process cannot begin as long as these five members –Cyprus, Greece, Romania, Spain and Slovakia– do not accept Kosovo's existence as a sovereign state.

Over the past years, the EU's role as aid provider, trade partner, and administrator has grown exponentially. Commission funding for Kosovo, between 2009 and 2011, was 800 million euros. Over half of FDI in Kosovo comes from the EU, while EU imports account for 52 percent of Kosovo's GDP. The EU provides training for Kosovo's police, judiciary and customs service via its EULEX mission. With the EU already omnipresent, the challenge for international mediators and policy makers is to transform Kosovo from a *de facto* EU protectorate into a credible EU candidate.

6.3.4.2. Progress on the Copenhagen Criteria

According to the 2011 Progress Report, Kosovo has made some progress as regards the political criteria in a number of areas. Although the general elections were marred by serious shortcomings and allegations of fraud, a government was formed and started to address the number of challenges Kosovo is facing, including the Belgrade/Pristina dialogue. There is a clear need for judicial and electoral reform, public administration restructuring, as well as a commitment to fight widespread organised crime and corruption. Concerning the economic criteria, Kosovo has made no progress towards establishing a functioning market economy. Considerable reforms and investments are needed to enable it to cope over the long term with the competitive pressure and market forces within the Union. The economy has grown, however there are concerns regarding the long term sustainability of the budget. Weak economic policy planning and implementation caused the derailment of the IMF Stand-by-Agreement reached in 2010. Firms continue to be confronted with overall weak policy planning and public administration, weak rule of law, the lack of reliable electricity supply, inadequate infrastructure and an unskilled labour force. Unemployment remains very high.

Progress has been mixed in aligning Kosovo's legislation with European standards. The legislative framework has been strengthened in particular as regards trade issues and public procurement, and Kosovo organised a census in line with international and European standards –although the North of the country did not participate. In areas such as movement of persons, services and rights of establishment, money laundering and personal data protection, little progress has been achieved. Kosovo's European prospects were dealt a serious blow following the publication in December 2010 of a report by Dick Marty, a Swiss Senator and prosecutor. Drawn up for the Council of Europe, the Marty report claims that Hashim Thaci –ex-leader of the KLA and acting Prime Minister of Kosovo– led a mafia network responsible for smuggling weapons, drugs as well as the kidnappings of Serbs and others in Kosovo, some of whom were murdered in Albania for their organs during the period 1998-99. Although Thaci denied this, the EU mission launched a probe into the allegations, which tainted Kosovo's image regarding widespread organised crime and corruption.

CHAPTER 7

THE WESTERN BALKANS' EU PERSPECTIVE: AN APPRAISAL

There is no question that the Western Balkan countries have come a long way on their political and economic transition paths, especially when one considers the heavy legacy of the region. Once an area of perpetual instability and conflict, ethnic turmoil and economic backwardness, the countries of the region have made integration into the EU structures, the pinnacle of their transition process. All states have made progress in their quest for EU membership over the past years, albeit in varying degrees: thus, on the one side of the spectrum is Croatia, whose accession journey has essentially been completed, and on the other is Bosnia, who does not have a functioning Stabilisation and Association Agreement yet and who has not even applied for admission into the EU. The European Union's enlargement process entered a new phase in 2011 with the signature of the Accession Treaty with Croatia, and with the Commission's recommendation to start accession talks with Montenegro and give Serbia candidate status. However, tremendous challenges remain: during the long journey that lies ahead the EU prospects of the Western Balkan countries will be affected both by endogenous and exogenous factors.

7.1. Endogenous Challenges Affecting Enlargement

These endogenous challenges are the factors that are inherent to the systems of the region and are directly linked to the countries' legacy and inheritance, as well as policy choices during the transition phase. The candidate countries themselves are responsible for tackling these challenges in order to fulfill the EU accession criteria.

In this context, the fight against corruption and organised crime is undoubtedly one of the most serious challenges facing the Western Balkans. The road towards integration into the EU will definitely be longer if fragile and unreformed institutional structures, a weak rule of law, and largely corruption-based economies and organised crime flourish. Corruption not only harms economic growth and development, it distorts markets and fair competition, undermines the rule of law, damages government legitimacy, erodes the private sector and contributes to greater income inequality.[213] All candidate and potential candidate countries have been urged by the EU to show concrete, tangible results in fighting high-level corruption and organised crime.

Table 14 presents the Corruption Perception Index for the Western Balkans, as calculated by Transparency International. The Table shows that Croatia and FYROM were the best placed in 2010, while Bosnia was ranked the lowest of all the Western Balkan countries. Compared to 2004, all countries except Bosnia have improved their standing over the past few years. It is also interesting to compare the Corruption Perception Index of the Western Balkan countries to those of other EU countries, members that joined in 2004 or newest members, Romania and Bulgaria, who joined in 2007.

TABLE 14
Corruption Perception Index

Country	Rank		Country	Rank	
W. Balkans	2010	2004	*Other EU*	2010	2004
Albania	87	108	Slovenia	27	31
Bosnia-Herzegovina	91	82	Poland	41	67
Croatia	62	67	Slovakia	59	57
FYROM	62	97	Romania	69	87
Montenegro	69	-	Bulgaria	73	54
Serbia	78	97	Greece	78	49

Source: 2010 Transparency International Corruption Perception Index (www.transparency.org)

Although fighting corruption and organised crime is a prerequisite for EU accession, it could take decades to eradicate totally organised crime networks and establish the rule of law in the Western Balkan region –the principle reasons being the weak state of the rule of law and the lack of independent judiciary.

[213] B. Sergi and Q. Qerimi, *The political economy of Southeast Europe from 1990 to the present*, Continuum, New York and London, 2008, pp. 112-120.

Thus, other key challenges are the broader political problems linked to governance and transparency, including the need to strengthen the rule of law, to accelerate public administration reform, and to ensure freedom of expression in the media. Progress in these areas would also be conducive to a more positive business environment.

Other endogenous challenges to accession of the Western Balkan countries into the EU include unresolved political questions that generate ethnic, social and political tensions. The most crucial issues in this category are the unresolved political status of Kosovo, the impasse between FYROM and Greece relating to the question of FYROM's name, the political stalemate in Bosnia and Herzegovina and the recurring parliamentary crises in Albania. Each one of these "impasses" represents a deadlock on the road to the EU, and as such must be resolved in order for the accession process to continue. Moreover, in addition to being obstacles to accession, these stalemates could also become potential source of conflict and instability in the region.

On the economic level, the key challenges include achieving sustainable economic recovery, reforms to corporate governance and competition policy, deepening of financial intermediation, infrastructure reform and progressing with structural reforms. Structural reforms –such as large-scale privatisation– are needed to boost competitiveness and improve the investment climate, thus attracting FDI, fostering job creation and ensuring the sustainability of growth. Despite significant progress over the past years, there remains a tremendous gap between the economies of the Western Balkan countries and those of the EU. All the Western Balkan countries preparing for EU membership were below 40 percent of the E.U.27's GDP per capita level in 2007 (with the exception of Croatia at 60 percent, while Albania is the lowest at 25 percent). Apart from Croatia, the Western Balkan countries are the poorest ever to have applied for EU membership, and all have uncompetitive economies burdened with high unemployment. Unemployment in Kosovo, Bosnia-Herzegovina and FYROM remains the highest in Europe.

7.2. Exogenous Factors Affecting Enlargement

The most crucial exogenous factor which affects the EU prospects of the Western Balkan countries is the impact of the global economic crisis, and particularly the crisis in Greece. As was discussed earlier in this study, all the countries in the region have been seriously affected by the global economic crisis: in light of the deteriorating economic situation and its negative social impact, important structural changes –that are a *sine qua non* for accession– are being postponed, stalled, or even reversed. Thus, the setback in economic progress and the slowdown in growth will also affect their EU accession prospects, since the countries will find it increasingly difficult to implement the necessary structural reforms that are still pending in order for accession talks to begin.

A few of these countries –namely Albania, FYROM, Serbia and to a lesser degree Montenegro– have the added disadvantage of being particularly affected and vulnerable to spillover from the crisis in Greece, due to the very high level of interdependence between their economies. Greece is a crucial trade and investment partner for these countries, has a major involvement in the local banking sector and is also the host country for hundreds of thousands of migrant workers: this implies that the crisis in Greece impacts the region profoundly on many levels and will make meeting the economic criteria for accession even more difficult.

The Greek crisis may affect the Western Balkans' accession prospects on another level as well. Since 2003 Greece had made enlargement towards the Balkans a cornerstone of its foreign policy and had promoted it actively. Its "Agenda 2014" aimed at achieving accession of all Western Balkan countries to the EU by 2014, as part of a plan to promote peace, security and democracy in the region. However, Greece no longer has the clout, the prestige or the capacity to play the role of the "champion" of Balkan enlargement, or to be a bridge between Brussels and the Balkans, leaving the potential candidate countries without an enthusiastic ally in Brussels. Moreover, the Greek crisis, combined with high-profile cases of mis-handling of EU funds in Bulgaria and Romania, have fuelled the negative perceptions of the Balkans as a region that is characterised by high levels of corruption and criminality, low levels of transparency and unreliable accounting techniques. This, in turn, has prompted even more stringent criteria to the EU evaluation process.

The second exogenous factor affecting the region's EU prospects is the repercussion of EU "enlargement fatigue", which is directly linked to the factors discussed above. The "enlargement fatigue" –which set in after the unprecedented rounds of enlargement during the period 2004-2007– has been exacerbated by the economic crisis, due to which many EU member states prefer to give priority to their own problems. Faced with an unprecedented economic slowdown, falling industrial output, rising unemployment, and especially the sovereign debt crisis within the Eurozone, the EU is currently focussed on domestic political and economic issues, with further enlargement moving down as a priority on the agenda. It is indicative that only 47% of the population of the EU surveyed in May 2009 supported the idea of further enlargement; crucially, only 33% of Germans and 31% of French were in favour.

The fear of many EU member states of a massive influx of migrant workers from the Balkan region –due to the wide income gap between the two regions– has also contributed to a serious dampening of enthusiasm for enlargement. Already this concern was evident following visa liberalisation for the Western Balkan countries: although liberalisation was to apply only for short-term tourist stays, it soon led to an increase in illegal immigration and asylum seekers. [214] The EU had to clarify that being allowed to travel in the EU without a visa did not mean an unlimited stay, jobs or social benefits. Moreover, a rise in transborder crime was evident within months of visa-free travel, with criminal groups taking advantage of the situation and trafficking people across borders. By May 2011 there emerged a real possibility that there would be an emergency restoration of the visa regime.

Crucially, support for EU integration has declined on the Balkan side as well. Analysts have warned that the increasingly complicated and drawn-out enlargement process shows the contrast between the EU's plan to accept the Western Balkans and its actual implementation. This is where "enlargement fatigue" within the EU meets "evaluation fatigue" in the Balkans, through the erosion of popular support for EU accession. A survey conducted by Gallup Balkan Monitor in November 2010 disclosed a largely pessimistic population with little trust of domestic institutions and falling enthusiasm for the EU, especially when compared to the previous year.[215] Although the majority of citizens of the region see the EU as the only option, enthusiasm for joining the EU was generally on the decline, mostly due to what the population perceived as "a lack of concrete commitment" on behalf of the EU. This lack of enthusiasm could also translate into lack of commitment to the necessary reforms regarding the political, economic and *acquis* criteria in the Western Balkans.

While it is clear that the Western Balkan countries cannot control or reverse the exogenous factors that have a negative effect on their accession process,

[214] Visa requirements were lifted in December 2009 for Serbia, Montenegro and FYROM, and November 2010 for Albania and Bosnia.
[215] "Perceptions of the EU in the Western Balkans", *Gallup Balkan Monitor*, November 2010.

they can –and must– address the endogenous challenges which impact their EU prospects. In this context, they must accelerate the momentum for political, economic and social reform, and must renew their commitment to profound restructuring and change. As the President of the EU Commission declared at the Joint Parliamentary Meeting in Brussels, "the enlargement process is not just about ticking boxes, it is about a transformational agenda which impacts the entire structure of a country. Each of these countries holds its European future in its hands. And the pace of its accession process depends on its progress on key reforms. They have to deliver on their commitments. This calls for strong ownership and strong leadership. This calls for mutual respect and a willingness to work together".[216]

As far as the EU is concerned, accession of the region's six countries continues to be its official Balkan policy. EU officials have repeatedly stated that they remain committed to the integration of the Western Balkans into the bloc, dismissing fears of "enlargement fatigue" in the wake of the Greek financial crisis. According to EU enlargement Commissioner Stefan Fuele, "the Western Balkan region is the top priority for the external policy of the European Union".[217] In practice, however, and under growing pressure as a result of the financial crisis, Europeans seem to be increasingly divided about what to do with the Balkans, and have adopted a wait-and-see policy. Some policymakers increasingly view the prospect of enlargement into the Balkans with alarm, with potentially destabilising political, social and economic repercussions. Other policymakers, however, see postponing the accession of the Western Balkans indefinitely as an even greater risk that could undermine the fragile progress that has been made in the region. The promise of EU integration has not only been the catalyst for reforms, but also the political glue that has held the Balkans together this past decade. Divided between the fear of a hasty enlargement and the fear of a slow one, the EU may begin losing influence across the Balkans, as the region's leaders and population start to doubt the sincerity of the EU's commitment –and the need to pursue EU-mandated reforms. The European Union must maintain its "soft power" in the region, and build on its position of creating incentives for reform and progress, rather than risk sowing disillusionment and the possibility of regression.[218] These are difficult times for Western Balkan politics. The

[216] *Reuters*, 14 April 2011.
[217] *Reuters*, 2 June 2010.
[218] J. Teokarevic, "It's Time for Thessaloniki 2", Belgrade Center for European Integration,

economic crisis in Greece and other EU member states will affect the already weak economies of the region and deepen the mood of uncertainty. Moreover, despite the danger of delaying enlargement indefinitely, it is difficult to interest EU leaders in the Balkans at the moment. The signature of Croatia's Accession Treaty, the decision to start negotiation talks with Montenegro and the imminent granting of candidate status to Serbia are a step in the right direction. Commission President Barroso recently declared that "we see the countries of the region as members of the European family of nations, we see them all as part of Europe. Their roots, their present and their future are in Europe".[219] The Western Balkans are indeed the European Union's final frontier, but there is a long way to go before these words become reality.

Belgrade, 2000.

[219] *Associated Press*, 5 May, 2011.

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