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THE PERIPHERY OF THE PERIPHERY: THE WESTERN BALKANS AND THE EURO CRISIS

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SUMMARY

The euro crisis has not killed enlargement but it is relegating the region to the outermost circle in a multi-speed Europe – the periphery of the periphery. With Balkan economies beset by low or negative growth rates and rising unemployment, it has exposed the limits of the EU's growth model and undermined the narrative of convergence between the EU and the Western Balkans. Greece, once one of the region's models, is now a warning about the perils of Europeanisation without deeper transformation. EU membership is still popular in the Western Balkans, but more often than not elites talk Europe's talk but do not walk the walk.

The euro crisis further reinforces the temptation that already existed in the EU to pursue a “wait-and-see” approach to the Western Balkans. But the apparent stability of the status quo could prove deceptive. While the violent conflicts of the 1990s are unlikely to re-emerge, stagnation within the region erodes the EU's influence and encourages competitors. To make enlargement work and reclaim its soft power, the EU must shift its focus from a narrative based on security to one based on the economy. The EU needs to deploy strategically its scarce resources, together with other international actors such as the IMF, to avert an economic meltdown and assist growth.

Despite the euro crisis, the European Union continues to expand into the Western Balkans: in July 2013, Croatia will become its 28th member. But beneath the surface, the EU's relationship with the countries on its doorstep is changing as a result of the crisis and the way it is transforming the EU. Integration is a double-edged sword for the Western Balkans: in good times, the European core exported its prosperity towards its south-eastern periphery; but now, at a time of crisis, it is exporting instability. European policymakers and analysts still casually speak of the EU as the cure for Balkan pathologies – as if the crisis has never happened. But the truth is that a disintegrating EU could also be a curse for them.

The EU is now faced with what Timothy Garton Ash calls a “damned if you do, damned if you don't” situation: if the eurozone sorts out its problems, the price might well be introversion and no appetite for enlargement; if it doesn't, the Balkans will be left out in the cold with little external support for their modernisation and democratic consolidation.¹ Either way, the crisis is relegating the region to the outermost circle in a multi-speed Europe – the periphery of the periphery. A Greek exit from the eurozone would send shockwaves through the Western Balkans, with whom it has developed extensive trade, investment and human links over the past two decades – exactly as Brussels hoped it would.

¹ Remark made at the 10th anniversary conference of South East European Studies at Oxford (SEESOX), St Antony's College, Oxford, 28 May 2012.

The euro crisis further reinforces the temptation that already existed to pursue a “wait-and-see” approach to the Western Balkans – particularly as even Romania and Bulgaria struggle to convince “old Europeans” that they are proper members of the club.² But the stability of the status quo could prove deceptive. While Balkan conflicts are unlikely to re-emerge and turn violent, stagnation within the region erodes the EU’s influence and encourages competitors. Balancing and playing off rival powers in order to reap short-term benefits at the expense of long-term public interest may well become the dominant foreign policy strategy for local elites. The EU should therefore re-assert the role of integration as an engine for economic and social modernisation. The EU needs to deploy its existent resources, as scarce as they may be, to bolster growth, competitiveness and employment in order to beef up its power of attraction, encourage pro-reform actors and avoid squandering the political capital already invested in the Balkans.

To make enlargement work and reclaim its soft power, the EU must shift its focus from a narrative based on security to one based on the economy. Political stabilisation through association was a worthwhile strategy in the past but these days it is simply not sufficient. Thanks to its already advanced integration into the EU, the region’s problems are largely identical to those faced by many member states, not least those in Central and Eastern Europe. Perched on the EU’s periphery, the Western Balkans are exceptionally vulnerable to the economic turbulence originating from within its confines. The main challenge is how to safeguard stability in the face of the outside storm while boosting growth.

Enlargement as usual?

Contrary to popular rumour, the euro crisis has not killed enlargement. Following Croatian accession, Montenegro also opened accession talks on 29 June and hopes to join within a decade. Even Serbia was upgraded to candidate status back in March, in recognition of bold steps taken towards normalising ties with Prishtina. Even though they brought to the presidency Tomislav Nikolić, a right-wing populist with an impeccable paramilitary pedigree, and installed Slobodan Milošević’s ex-spokesman Ivica Dačić as prime minister, the elections demonstrated that the EU is not a divisive issue as in the past. Friends of Europe in the current member states would be happy if their own Eurosceptic parties performed as poorly at the polls as Vojislav Koštunica, the only candidate arguing against Serbia’s accession.

Even laggards such as Bosnia and Kosovo, still under international tutelage, aren’t doing that badly. Having recently marked the twentieth anniversary of the war, Bosnia

might submit a membership application this year. After 16 months of agony following the October 2010 elections, a state-level government was formed in Sarajevo and two critical laws, on state aid and on censuses, were passed last February. The principal hurdle to be cleared, according to a roadmap extended by the EU in June, is implementing the 2009 Sejdić–Finci judgment by the Strasbourg-based European Court of Human Rights and allowing those not belonging to the three main communities – the Bosniaks, Serbs and Croats – to serve in high public offices. Constitutional changes regarding the rules on electing the country’s tripartite presidency are proving hard to negotiate but moving closer to the EU is a valuable prize.

Kosovo also scored a success when it launched a visa liberalisation dialogue with the European Commission on 19 January, having fulfilled the criteria set forth by Brussels. Moreover, on 14 June, the Commission delivered a roadmap specifying reforms on the path to lifting the visas. The so-called footnote or asterisk agreement between Prishtina and Belgrade in February was yet another breakthrough. Not only did it pave Serbia’s way to candidacy and open the gates to Balkan regional bodies to Kosovo, but also it helped the Commission start work on a feasibility study in March, which may lead to an Stabilisation and Association Agreement (SAA) with Kosovo. Such steps will strengthen the EU’s hand while inaugurating a more mature and even relationship with both Kosovo and Bosnia, well beyond crisis management under the Common Security and Defence Policy (CSDP).

These are not trivial bureaucratic moves but genuine achievements backed by political will and entrepreneurship from enlargement-friendly EU member states and, in particular, the European Commission. In March, enlargement commissioner Stefan Füle launched a high-level accession dialogue (HLAD) to help Macedonia meet the benchmarks in key areas such as judicial and public administration reform – a way to mitigate the Greek veto preventing Macedonia from starting accession negotiations despite obtaining a positive avis from the Commission. Two days after François Hollande was inaugurated as French president in May, the Commission initiated a “Positive Agenda” as a vehicle to reignite the stalled accession talks with Turkey. In June, the Council gave the Commission a green light to start working on a visa liberalisation roadmap, a longstanding Turkish demand. In exchange, Ankara initialled a readmission agreement. Such moves, though hardly a panacea, do show that Brussels is doing its best to bypass political roadblocks.

Counter-intuitively, the crisis has also boosted certain facets of EU policy. Germany’s economic weight has propelled it to the centre of decision-making and allowed it to act more assertively on the external front too. Thanks to Chancellor Angela Merkel’s decisive intervention, Belgrade started approaching normalisation talks with Prishtina seriously, rather than as a box-ticking exercise, and delivered concrete results. Most of the five member states that do not recognise

² See Heather Grabbe, Gerald Knaus and Daniel Korski, “Beyond Wait-and-See: The Way Forward for EU Balkan Policy”, European Council on Foreign Relations, May 2010, available at http://ecfr.eu/page/-/ECFR21_BALKAN_BRIEF.pdf (hereafter, Grabbe, Knaus and Korski, “Beyond Wait-and-See”).

Figure 1
Balkan support for and opposition
to EU membership

Support for EU membership (percentage of population)

	2006	2008	2009	2010	2011	2012
Albania	84	83	88	81	81 ^a 97 ^b	
B&H	66	49 ^c	67	69	88 ^d	76 ^e
Croatia	35	29	26	25		66 ^f
Kosovo	87	89	89	88		
Macedonia	76	66	62	60		
Montenegro	64	57	67	73	70	66 ^g
Serbia	61	58	50.3	44	50	51 54 ^h 47 47 ⁱ

Opposition to EU membership (percentage of population)

	2006	2008	2009	2010	2011	2012
Albania	1	2	3	5	11 ^a	
B&H	8	11	6	8		
Croatia	30	26	29	32		33 ^f
Kosovo	1	4	2	6		
Macedonia	7	7	9	9		
Montenegro	7	7	3	4		
Serbia	10	9	12	17	37	33 32 ^h 27 37 ⁱ

Source: Gallup Balkan Monitor (unless indicated otherwise).

Key:		
a	AEI	Agency for European Integration
b	AIIS	Albanian Institute for International Studies
c	BAEI	Bosnian Agency for European Integration
d	CDD	Centre for Democracy and Development, Novi Sad
e	CEDEM	Centre for Democracy and Human Rights
f	CES	Center for European Studies and the Department of Political Science and International Relations, Epoka University
g		
h	FPA	Faktor Plus Agency
i	SNPTS	Serbian New Political Thought Survey

Kosovo have, in turn, been enormously debilitated by the crisis and therefore are much less willing to antagonise Berlin or the pro-independence majority in the European Council on a second-order issue such as Kosovo. As ECFR's Foreign Policy Scorecard 2012 argued, the end result has been a unified position by the EU leading to a much more effective deployment of the conditionality tool.³ Over the past year, the EU has started to talk and act tougher, and chances are that it will continue to do so with Nikolić and Dačić, who was minister of interior in the previous government. These days, some of the toughest messages come from none other than Miroslav Lajčák, the foreign minister of non-recogniser Slovakia.⁴

As the enlargement process continues, polls show that the popularity of the EU in the Western Balkans is declining but still respectable. Even in notoriously sceptical Croatia slightly over two-thirds voted in favour of membership in a referendum in January (although turnout was only 43 percent).⁵ In neighbouring Serbia, support for membership has gone down by some 20 percent to 50 percent in late 2011, a juncture when Serbia was still denied a candidate status.⁶ Even in traditionally pro-EU countries such as Montenegro support has contracted down to 66 percent. A similar drop of nearly 15 percent is observed in Macedonia, though there is a stark contrast between the majority and the Albanian community, which remains overwhelmingly positive.

These poll results show Euro-realism rather than Europhilia. Balkan citizens are not in love with the EU; rather, they see it as something inevitable. They have a point. For all practical intents and purposes, the Balkans are already *part of the EU*, one of the marches in what Jan Zielonka famously described as a "neo-medieval empire".⁷ Since the 2007 accession of Bulgaria and Romania, the region is now encircled by the EU. Croatia's membership shrinks the geographical perimeter even further. Trade and financial liberalisation between the EU and the region is now complete and nearly two-thirds of the Western Balkans' exchange is with the EU (followed by Russia with only 5.5 percent of the overall volume).⁸ Four member states play a particularly prominent role in trade: Germany, Italy, Austria and Greece. The EU's share will increase because Croatia is the third-most significant partner for the remainder of the Western Balkans.

³ European Foreign Policy Scorecard 2012, European Council on Foreign Relations, January 2012, p. 82, available at <http://www.ecfr.eu/scorecard/2012/wider/41>.

⁴ Recently Slovakia started recognising Kosovan passports, even if continuing with a formal policy of non-recognition.

⁵ Throughout the accession period Croats were split into three groups of roughly equal size as regards their attitude to EU membership ("yes", "no", "undecided").

⁶ According to data presented by the IPSOS polling agency and the European Integration Office at Serbia's government.

⁷ Jan Zielonka, *Europe as Empire: the Nature of the Enlarged European Union* (Oxford: Oxford University Press, 2006).

⁸ Due to energy, Russia matters only on the import side. On the export side, the Western Balkan countries' second-most significant partner is the region itself (17.3 percent in 2011).

The EU is by far the most important source of financial flows – be it foreign direct investment (FDI) or remittances. The Balkan banking sector is controlled by institutions from Austria, Italy, France, Slovenia and Greece: Balkan countries are the spokes in a financial system whose hubs are in Vienna, Milan and Athens. Kosovo and Montenegro use the euro while Bosnia and Herzegovina's unit, the convertible mark (KM), operates under a currency board regime, effectively delegating monetary policy to Frankfurt. Macedonia's denar is de facto pegged to the euro too. Only Albania floats its currency, the lek. As of 2009–10, all Balkan citizens except those from Kosovo enjoy visa-free access to the Schengen Area.⁹ Given their advanced integration, and therefore exposure, to the single market, accession is the only way to get access to EU decision-making and resources.

The dark side of Europeanisation

However, although the accession process is continuing despite the crisis, the global economic downturn has exposed the limits of the growth model the EU has helped entrench. Between 2000 and 2008, local economies rode high on a boom fuelled by financial flows from Western and Southern Europe. Domestic consumption went up thanks to credit channelled through EU banks to their Western Balkan subsidiaries, by FDI and remittances sent home by labour migrants. However, the crisis ushered in a period of stagnation with no immediate prospect for a bounceback.¹⁰ Despite the tentative recovery in 2010–11, most Western Balkan economies have taken another plunge in recent months, largely owing to the deteriorating conditions in the eurozone. The World Bank has recently revised downwards its projections for the current year to a mere 1.1 percent.¹¹ That compares to an average of 2.2 percent in 2011 and to 5.9 percent before 2008. At least three countries, Serbia, Montenegro and Bosnia, are on the verge of recession with projected growth of 0.4 to 0.1 percent this year.

Integration into the EU increases vulnerability to external shocks. In 2008–9, more open economies such as Croatia suffered from the sharp contraction of trade and decline in demand for their exports coupled with the disappearance of FDI. Croatia, otherwise seen as a political success, is poised to record negative growth in 2012 again. Its trajectory has been very similar to that of EU members Bulgaria and Romania, south-eastern Europe's champions in attracting foreign investment, which previously benefited from a massive influx of foreign finance, including into the real estate sector. As economists Will Bartlett and Ivana Prica argue, the more integrated you were in the EU, the deeper you dropped.¹²

In other parts of the region, less exposed thanks to a lower share of exports in GDP or more limited influx of FDI, the crisis spread more slowly. But judging from the growth figures, its impact has proven equally deleterious and potentially more durable than in the frontrunners. A key reason is the decline of remittances from Western Europe, essential for maintaining consumption. In 2010 alone, the year when growth resumed after the initial slump, remittances contracted by as much as 15 percent in Albania and 14 percent in Serbia.¹³ They have not picked up yet and there are indicators of reverse migration from formerly fast-growing countries such as Greece, Spain and the UK back to the region. The end result is an additional burden for already strained state budgets. A further drop because of the worsening situation in Greece will surely exacerbate the situation in neighbouring Albania, which accounts for two-thirds of migrants in the country, and also Bulgaria and Romania.

The banking system has been an even more significant channel for contagion. After 2008, the credit crunch led to a dramatic restriction in liquidity by subsidiaries of EU parent banks operating in the Balkans. Previously, credit had expanded robustly at an average rate of 30 percent, but by late 2010 all Western Balkan countries recorded negative values. As elsewhere, the previously booming construction sector in big cities and the coastal areas of Montenegro and Croatia was dealt a severe blow. Finance to businesses and households has become more scarce and pricier. Even in the good times the interest-rate differentials with the eurozone were high, increasing the costs of finance and providing a strong incentive for firms and households to borrow in foreign currency. The devaluation in Serbia pushed up costs for servicing outstanding debt. Non-performing loans have shot up since 2009.

In these circumstances, Western Balkan governments have few options. They cannot spend their way out of the crisis. In fact, by 2010, the exhaustion of available fiscal buffers pushed all Western Balkan countries towards austerity. The fiscal position everywhere, with the exception of Macedonia and Kosovo, is precarious. Montenegro, Serbia and Albania (with 59 percent of GDP) are burdened by high public debt. Sizeable budget deficits are a challenge too, especially in Croatia (-5.6 percent) and Serbia (-4.1 percent), as are relatively large current account deficits. Serbia, Bosnia and Kosovo are on IMF support. Belt-tightening measures under the Standby Agreements periodically flare up social tensions, despite the limited strength of trade unions.

All in all, the Western Balkans are confronted by similar challenges as the EU's southern member states. Fortunately, the small size of the economies in question, along with the IMF and EU anchors, has thus far helped weather trouble.

⁹ On the benefits of the visa-liberalisation process, see Grabbe, Knaus and Korski, "Beyond Wait-and-See".

¹⁰ Except for Kosovo and Albania, all Western Balkan countries went through a deep recession in 2009, with a drop: 7.6 percent on average.

¹¹ World Bank, *South East Europe: Regular Economic Report*, 5 June 2012.

¹² Will Bartlett and Ivana Prica, "The Variable Impact of the Global Economic Crisis in South East Europe", *LSEE Papers Series*, Issue 4, 2012.

¹³ Remittances accounted for between 16 percent (Kosovo) and 7 percent (Montenegro) of GDP in 2010. The contraction was -9 percent and -11 percent in Albania and Serbia in Q1 of 2011 (year on year).

But, as the Economist Intelligence Unit argues, this could well be the lull before a storm.¹⁴ The slowdown results directly from the problems in the eurozone. Interdependence exposes the Balkans to crisis-stricken Southern Europe and other troubled parts of the EU. Greek banks account for as much as 25 percent of the assets, deposits and loans in Macedonia, 23 percent in Albania, and between 15 and 20 percent in Serbia. Together with Italian banks they control little under half of the sector in the Western Balkans.

Local subsidiaries of Greek banks in the area, Bulgaria and Romania included, are, as a rule, better capitalised than mother institutions. They have also benefited from external support under the ECB's long-term refinancing operation (LTRO) and received €630 million in loans from the European Bank for Reconstruction and Development (EBRD) intended specifically to prevent a spill-over to Greek bank units in south-eastern Europe. But these are all measures intended to stave off a future crisis, not boost growth across the region. Consolidating the banking sector within the EU has knock-on effects beyond the borders of the EU. Slovenian institutions such as Nova Ljubljanska banka (NLB) proved undercapitalised,¹⁵ while big Austrian players were required by the Vienna authorities to beef up capital reserves after the country lost its cherished AAA rating in January. According to Erik Berglof, chief economist at the EBRD, the whole of Eastern Europe faces a threat as tighter capital rules limit funding available at giants such as Italy's UniCredit and Austria's Erste Bank to daughter units.¹⁶ Financial prudence in the EU leads to deleveraging and ultimately compounds stagnation in the "periphery of the periphery".

There are a few glimmers of hope. In 2011, for instance, FDI returned to the Western Balkans, but, with the exception of Serbia, they are lagging behind already low pre-crisis levels. In the case of Serbia, large investments such as at the Fiat plant in Kragujevac have relied on generous state subsidies and other government incentives to buy political support and win votes. Lavishly funded public campaigns via the global media to attract strategic investors, such as the one carried out by the Macedonian government, has not produced miracles. Courting Chinese, Qatari, Turkish, Russian or other moneymen from the emerging powers is naturally becoming an ever more popular pursuit in the Balkans, but the response has been not as enthusiastic as expected.

Figure 2
FDI in the Western Balkans
(inflows in millions of euros)

	2009	2010	2011
Croatia	2,415	295	1,048
Macedonia	290	204	277
Montenegro	1,068	576	534
Serbia	1,349	917	1,379
Albania	705	589	435
B&H	255	212	139
Kosovo	287	362	158

*Own calculations based on data issued from central banks. In the case of Montenegro for 2011, the figure is based on data from the Montenegrin Investment Promotion Agency (MIPA).

The Western Balkans have a long way to go in developing a new economic model based on high value-added exports to core Europe. They are far behind the new member states in Central and Eastern Europe in terms of implementing the kind of structural and institutional reforms needed to upgrade local potential, improve human capital, diversify exports and plug into the manufacturing networks centred on Germany and other key Western European economies. Industries such as steel production (Bosnia and Herzegovina, Macedonia and Serbia), aluminium (Bosnia and Montenegro) and tourism (Croatia and Montenegro) suffered in the early stages of the crisis. Exports picked up in 2010–11, but the trend turned negative again in the third quarter of last year. In addition, Croatia's entry into the EU will make it harder for neighbours to export their agricultural products because of the higher sanitary standards yet to be adopted by countries such as Bosnia.

In the meantime, low or negative growth means high unemployment (see Figure 3). In a recent op-ed, Gerald Knaus and Kori Udovički spoke of a "Balkan unemployment crisis", lamenting the weak performance of the export sector across ex-Yugoslavia as compared to the likes of Turkey, Bulgaria or Romania.¹⁷ At the same time, political parties continue to use the state as a means of buying public support through patronage. This has helped to offset some of the tensions attendant to the crisis but any wave of structural reforms is sure to break the precarious balance and stir up social conflicts. According to the Confederation of Autonomous Trade Unions, there have been 28 strikes since the start of 2012 in Serbia alone.

¹⁴ Economist Intelligence Unit, "Eastern Europe economy: Balkan vulnerability", ViewsWire, 14 June 2012.

¹⁵ The Slovene government has already injected €380m (equivalent to 1 percent of GDP) into NLB, the country's top lender. As yields on government bonds shoot up beyond 7 percent, fears are spreading that Slovenia, which adopted the euro in 2007, might be next in line for a bailout. "Why yet another country may require a bail-out", the *Economist*, 18 August 2012, available at <http://www.economist.com/node/21560567>.

¹⁶ Veronika Gulyas and Gergo Racz, "EBRD Berglof: Euro Crisis May Cause Emerging Europe Credit Crunch", *Dow Jones*, 18 May 2012, available at <http://www.euroinvestor.com/news/2012/05/18/ebird-berglof-euro-crisis-may-cause-emerging-europe-credit-crunch/11997203>.

¹⁷ Kori Udovički and Gerald Knaus, "Mass unemployment in the Balkans – a need to act", *EUobserver.com*, 12 April 2012, available at <http://euobserver.com/7/115845>.

Figure 3

Unemployment in the Western Balkans (percentage of workforce, 2011)



Source: National Statistics; UNDP (Kosovo).

Against this backdrop it is hardly surprising that a populist such as Tomislav Nikolić won the presidential race in Serbia after failing twice, in 2004 and 2008. Stagnation and rising levels of joblessness, especially among the young, wipe out support for the kind of reformist policies Brussels likes to talk about. Balkan voters are not turning against Europe per se, but they are less likely to take its promise for a bright future at face value. It would be unfair to blame the EU for this: the region's difficulties in coping with the crisis have a lot to do with policy failures at home. Nevertheless, a more pessimist reading of poll figures will not fail to notice the gradual disenchantment with the EU. We may not be far from the day when politicians start to scapegoat Brussels – as already happens in so many member states. The slow pace of enlargement, with Montenegro as the only credible entrant, only adds to the sense of being left out in the cold.

The erosion of the convergence narrative

In the Balkans, Europeanisation held out a promise of modernisation and convergence with the rich and well-governed countries of “old Europe”. But the unfolding Greek drama deals a serious blow to this convergence narrative. Greece was one of the region's models: a quintessentially Balkan country that had made the grade from rags to riches, from underdevelopment and marginality to prosperity under the star-studded EU flag. The Greek success story even empowered Athens to act as an intermediary between the EU and Balkan membership hopefuls culminating in the European Council's Thessaloniki summit, which in 2003 charted an accession perspective for Yugoslavia's successors and Albania. Now, however, Greece is a warning about the perils of Europeanisation without deeper transformation.

The euro crisis and the EU's diminishing ability to win hearts and minds threaten to both marginalise and fragment the Western Balkans. The region is already moving at different speeds. New member state Croatia is certainly in the fast lane. Montenegro, for all its governance deficits, has also opened accession talks. But in Serbia, Nikolić's win in the presidential election raises tough questions: denying that Srebrenica was an act of genocide, choosing Moscow for his first post-election visit and curbing central bank independence do not augur well. Having gained candidate status, Serbia faces three challenges: a cohabitation between a populist president who is comfortable in the company of Vladimir Putin and a disparate coalition government; normalising ties with Kosovo; and completing a painful economic overhaul under IMF stewardship.

Prospects are even gloomier in the slow lane. In Albania, Bosnia and Herzegovina, and Macedonia, political elites pay lip service to EU accession but are certainly not going out of their way to speed up the process. And Kosovo, which has no contractual relations with Brussels, has not even started its European journey. State capture and deep-seated political and inter-ethnic divisions (and, in the Macedonian case, Greece's veto) present formidable obstacles. It is hard to see the EU's carrot-and-stick methods working on powerful local leaders such as Nikola Gruevski, Sali Berisha or Milorad Dodik whose principal motivation is consolidating power in a less and less competitive political environment.

There is indeed a silent pact between enlargement-fatigued EU member states and rent-seeking elites in the Western Balkans who don't mind slowing the pace of transformation, especially if the price to pay would be to share the destiny of Croatia's disgraced prime minister Ivo Sanader, who is being charged with corruption. For every success of EU policy in the Balkans there is a failure or two. As membership becomes a growingly distant prospect, stagnation trends are reinforced. Despite the variety of experiences from one country to the other, the deterioration in the Western Balkans' performance in terms of democratic consolidation, governance and market reform is well captured by international indices. Only Croatia and Serbia are improving their Freedom House scores (see Figure 4).

Figure 4
Freedom House democracy scores
(1 highest, 7 lowest)

	2008	2009	2010	2011	Trend
Albania	3.82	3.82	3.93	4.04	Negative
B&H	4.11	4.18	4.25	4.32	Negative
Croatia	3.64	3.71	3.71	3.64	Positive
Kosovo	5.21	5.14	5.07	5.18	Negative
Macedonia	3.86	3.86	3.79	3.82	Negative
Montenegro	3.79	3.79	3.79	3.82	Negative
Serbia	3.79	3.79	3.71	3.64	Positive

The Bertelsmann Transformation Index, which measures progress in a number of fields such as democratisation, economic performance and governance reform, paints a similar picture, even for the frontrunners in the EU integration process (see Figure 5).

Figure 5
Bertelsmann Transformation Index
(10 highest, 1 lowest)

	2008	2009	2010	Trend
Albania	7.07	7.17	7.01	Negative
B&H	6.51	6.43	6.41	Negative
Croatia	8.57	8.30	8.25	Negative
Kosovo	n/a	6.48	6.28	Negative
Macedonia	7.52	7.53	7.35	Negative
Montenegro	7.28	7.35	7.28	Negative
Serbia	7.20	7.39	7.51	Positive

The dangers of stagnation

European leaders seem to be content with this status quo in the Western Balkans. Since a return to the bloodshed of the 1990s is unlikely, some in Brussels and in member states may think they can afford to focus on their own formidable economic challenges. They are not, formally speaking, abandoning enlargement – just deferring it. Periodic crises and outbursts of violence, in northern Kosovo or elsewhere, can be tackled as they arise using the “fire brigade” approach. At the end of the day, catching up with the governance standards and welfare levels of Western Europe is the responsibility of national politicians, not of supranational institutions whose primary *raison d’être* is policing the rules of the market. The message Western Balkan politicians hear in Brussels, Berlin or Paris is: sort out your internal mess, demonstrate you are ready, and then come and talk to us.

This sense that it is better to wait and see is strengthened by developments in Bulgaria and Romania, which acceded to the EU in 2007. The hefty dose of austerity measures Bucharest and Sofia have gone through in the name of preserving budgetary stability should endear them to the fiscal hawks in Berlin, Helsinki and The Hague. But the political vendetta waged in Romania by Prime Minister Victor Ponta against President Traian Băsescu shows how fragile its democratic institutions are and how quick politicians are to break fundamental rules. The catch-up index survey published by the Open Society Institute places Bulgaria and Romania in the same basket as non-members Serbia and Montenegro.¹⁸ The two countries have been receptive to Brussels’ precepts but have failed to live up to EU governance standards.¹⁹

However, accepting stagnation in the Western Balkans would be an admission of failure by Europe. The Western Balkans are low-hanging fruit – an area in which EU policy has made a real difference in terms of stability and, at least until 2008, growth. If the EU cannot deliver transformation in the Western Balkans – a region that many see as its backyard – how can it expect other global players to see it as a credible actor in the Middle East, the post-Soviet space or East Asia? Putting enlargement on hold allows other actors to seize on business opportunities, score political points and carve out niches of influence – in part, free riding on the tremendous investment into stability already made by the EU. The United States still plays a decisive part in Kosovo and often has greater leverage over the government there than the EU. But ambitious powers such as Russia, Turkey and China are also beginning to fill the gaps.

¹⁸ Marin Lessenski, “State of the Union: A Big Bang Theory of Europe”, European Policies Initiative, Open Society Institute Sofia, January 2012, available at http://eupi.osi.bg/fce/001/0070/files/CatchUpIndexReport_c.pdf.

¹⁹ Daniel Smilov, “Bulgaria and the Anxieties of Incomplete Membership”, European Council on Foreign Relations, 5 July 2012, available at <http://ecfr.eu/page/-/ReinventingBulgaria.pdf>.

Russia holds more than a few trump cards up its sleeve, especially where energy is concerned. Gazprom acquired a controlling stake in Serbia's NIS in 2008 and is now bidding for the Greek state's majority package in the national gas corporation Depa SA, as well as for DESFA, the "unbundled" transmission system operator.²⁰ These landmark purchases will only deepen the Balkans' already extensive dependence on Russian energy supplies and complicate the EU's diversification policies. Cyprus has approached Russia with a request for a €5 billion loan to prop up its crumbling public finances which have taken a blow from the meltdown in Greece, and Greek banks across the region might also soon go under the hammer.²¹ In June, Sberbank, backed by the Russian government, took over DenizBank, Turkey's eighth-largest bank, which was formerly owned by cash-strapped European lender Dexia. Parts of south-eastern Europe could well turn into the outer circle in Russia's "lily pad empire" through the acquisition of strategic assets.²²

Turkey is similarly exploiting commercial and diplomatic opportunities. Its investment in the region is miniscule but increasing.²³ In 2010, it stepped in as a mediator in Bosnia after EU and US efforts failed. Unlike other external actors in the region, Turkey is itself a Balkan country and has dense human, cultural and trading links to ex-Yugoslavia and Albania.²⁴ Turkish interests are more or less in line with that of the EU: Turkish neighbourhood policy aims to build stability across the country's frontiers. At the same time, some in the Western Balkans see Turkey as a model: a growingly prosperous, confident and influential country that is no longer dependent on the EU. Leaders of countries such as Macedonia – long blocked on its EU accession path by Greece – might be tempted to emulate Turkey's example, however delusional or costly the goal of autonomy may be.

China is also becoming increasingly present across south-eastern Europe. For example, in 2010, the Chinese group COSCO bought a shipping terminal at the port of Piraeus in Greece, and last year China's Export-Import Bank also made a €345 million loan to upgrade Serbia's Kostolac thermal power plant. Governments in south-eastern Europe are now as eager to attract Chinese investment as their counterparts in other corners of Europe.²⁵ In fact, Serbia's reluctance to alienate Beijing was a primary reason why it initially declined to attend the ceremony awarding the

Nobel Peace Prize to Liu Xiaobo, a Chinese dissident, in December 2010.²⁶

For the moment, the EU remains the "indispensable power" in the region – even for Serbia, which casts itself as the centre of gravity and talks about the "four pillars of foreign policy" (the EU, the US, Russia and China). When push came to shove, Belgrade accommodated the EU's demands over border management and customs in Kosovo and the footnote agreement in order to obtain candidate status. But it is when the EU eases the pressure that political opportunism sets in. Playing off the EU against other powers, one member state against the other, or simply going for the highest bidder becomes the most rational course of action by local elites. The idea behind Western Balkan enlargement was to repeat the example of Central and Eastern Europe. However, unless the EU can reinvigorate its approach, the Western Balkan countries might be more likely to follow the neo-Titoist path trodden by the eastern neighbours.

Reinvigorating enlargement

If the likes of Greece, Spain, Portugal and even founding member Italy are now relegated to the EU's "periphery", then the Western Balkans are becoming "the periphery of the periphery" – countries that have an important stake in the current debate about the future contours of Europe but no real voice. The prospects of the Western Balkans are critically dependent on a strong EU that is willing and able to spread prosperity – and therefore on a solution to the euro crisis. The region will not be able to get back on its feet unless the EU reverts to growth, draws in Balkan exports and stabilises the European banking system, while remittances and (hopefully) FDI make a comeback. But although solving the euro crisis is a necessary condition for consolidating and expanding the EU's gains in south-eastern Europe, it is not in itself sufficient. Further steps are needed to reinvigorate enlargement.

Putting enlargement on hold now, as some in Europe are tempted to do, would compound the problems of the Western Balkans and do incalculable damage to the EU's foreign policy ambitions. Sceptics will surely ask whether the bitter experience with Greece warrants importing yet more dysfunctional countries into the EU. But, thanks to the EU's own policies, the Western Balkans are already halfway in, and there is little reason to believe that the EU can simply insulate itself. Optimists suggest the different layers of membership in a multi-speed Europe could actually speed up accession by Western Balkan countries, at least into the outer circle. However, such a scenario implies minimal redistribution of resources, limited access to decision-

²⁰ Depa runs a large debt to Gazprom. See Kerin Hope, "Greek utility battles to pay Gazprom for supplies", *Financial Times*, 12 June 2012, available at <http://www.ft.com/cms/s/0/866ef514-b3dd-11e1-8fea-00144feabdc0.html>.

²¹ Dan Bilefsky, "Cyprus Weighs Russian Loan or a Bailout From Europe", the *New York Times*, 14 June 2012, available at <http://www.nytimes.com/2012/06/15/business/global/cyprus-weighs-european-bailout-or-loan-from-russia.html>.

²² See Ben Judah, Jana Kobzova and Nicu Popescu, "Dealing with a Post-BRIC Russia", European Council on Foreign Relations, November 2011, available at http://www.ecfr.eu/page/-/ECFR44_RUSSIA_REPORT_AW.pdf.

²³ "Turkey in the Balkans: The Good Old Days?", the *Economist*, 5 November 2011, available at <http://www.economist.com/node/21536647>.

²⁴ Dimitar Bechev, Turkey in the Balkans – Taking a Broader View, *Insight Turkey*, Vol. 14, No. 1, January 2012.

²⁵ For figures about Chinese investment in south-eastern Europe (Romania, Bulgaria, Slovenia, Croatia, Serbia, Albania, Montenegro and Macedonia), see the interview with Chinese Vice Minister of Foreign Affairs Fu Ying in *Novinite*, 21 March 2011, available at http://www.novinite.com/view_news.php?id=126501.

²⁶ François Godement and Jonas Parello-Plesner with Alice Richard, "The Scramble for Europe", European Council on Foreign Relations, July 2011, available at http://www.ecfr.eu/page/-/ECFR37_Scramble_For_Europe_AW_v4.pdf.

making, barriers to free movement of labour – in short, second-class membership – and, as a result, no sustained pressure for convergence. Anything less than full EU membership based on the solidarity principle would mean prolonging indefinitely the status quo – that is, economic and political stagnation.

Thus there cannot be a trade-off between forms of accession and the scope of benefits available for the future members from the Western Balkans. However, this does not rule out forms of post-accession conditionality such as the one applied to Bulgaria and Romania under the so-called Cooperation and Verification Mechanism (CVM). To reassure sceptics within the EU and to discipline Balkan elites, the EU has to develop and perfect its tools to push for consolidation of the rule of law, both prior to and after accession. But what is really important, and what has sadly not happened in the case of Bulgaria's and Romania's prolonged entry into the Schengen Area, is to establish a firm link between implementation of clearly defined standards and rewards.

As the crisis has shifted power away from Brussels, the European Commission needs support from national capitals. Pro-enlargement countries should co-ordinate much more closely their lobbying efforts to ensure that the Western Balkans do not slip completely off the EU agenda. In particular, having coped relatively well with the crisis and as proof that enlargement is a project that pays off, the “new member states” in Central and Eastern Europe should make the case for further expansion and keep Berlin and Paris committed to the process. Such an assertive pro-enlargement coalition of governments could also apply pressure, both privately and in public, to Western Balkan politicians regarding democratic backsliding or gaps in the rule of law.

In short, the EU should offer the Western Balkans a deal: improved support for overcoming economic and institutional problems in return for stricter adherence to democratic norms and practices. In particular, it should:

Tackle the difficult cases

Even though the Western Balkan countries are moving at different speeds, none of them should be left out in the cold. The EU should also encourage Bosnia to submit a candidate application and work on a Stabilisation and Association Agreement (SAA) and visa liberalisation with Kosovo. It should also extend High-Level Accession Dialogue (HLAD), which was tried in Macedonia, to include other countries down the line. It would be a helpful device to frontload parts of the *acquis* that are directly beneficial to economic development, bring improvement in the business environment, increase competitiveness and bolster domestic sources of growth. Restoring a sense of momentum would allow the EU to more credibly wield its political conditionality and generate pressure from below on governments to implement reforms. The EU must also keep

frontrunners such as Serbia on track. Full normalisation of relations with Prishtina, short of recognition, should be a precondition for a formal start of accession negotiations.

Avert an economic meltdown

The EU's most pressing priority in the Western Balkans should be stability. Particular attention should be paid to assisting countries in preventing contagion from the Greek banking sector. The European Commission should work alongside the IMF and the EBRD to identify policy measures for the most exposed countries. Co-ordination mechanisms and policy dialogue has to occur also multilaterally, through existing platforms such as the network of central banks in the region. The EU must give the EBRD the strongest possible support for a revamped Vienna Initiative. Back in 2009, the Vienna Initiative helped to avoid a rapid deleveraging of Eastern European subsidiaries of large Western banking institutions. The EU banking sector should not be consolidated to the detriment of markets in the “periphery of the periphery”.

Assist growth

The EU is successful only when it is seen as a driver of growth and development – the most credible instrument for restoring political influence in the Western Balkans and avoiding the emergence of a geopolitical grey zone. The EU's policies should therefore put a premium on measures pushing for growth, gains in competitiveness, expansion of employment and economic opportunities. In particular, the EU should invest more in regional co-operation initiatives that include Turkey (a member of the Sarajevo-based Regional Cooperation Council), which could unlock new growth potential, attract FDI, strengthen competitiveness and improve export performance. In the words of Ivan Vejvoda of the German Marshall Fund, regional co-operation is the Balkans' unsung success story.²⁷ The European Commission could look into deepening CEFTA 2006, the region's trade integration platform, to include trade in services. More action should be taken in tackling non-tariff barriers constraining regional trade such as customs procedures.

Regional efforts should be complemented by structural reforms at home. The EU should extend its 2020 Strategy for growth and development. Candidates and potential candidates should be asked to produce national convergence strategies, including lists and targets in key sectors such as employment policy, education and skills training, energy efficiency, research and development. Again, the Regional Cooperation Council is the right mechanism to co-ordinate national policies and identify cross-border projects.

²⁷ Testimony to the House Committee on Foreign Affairs, 15 November 2011.

This does not mean the EU should pour extra money into the Western Balkans. Rather, it means setting different priorities in the region than in the past. If the Instrument for Pre-Accession Assistance (IPA) was geared to institution building and adoption of the *acquis* in the previous period (2007–13), IPA2 (2013–20) should support the transition to a new growth model based on competitive exports. For instance, the programme should commit funds for large cross-border infrastructure projects, in conjunction with the European Investment Bank (EIB). Such measures should upgrade the regional market and tap into new sources of growth.

Over time the Western Balkans have normalised. Gone are the days of large-scale ethnic violence and military interventions by the West. But sadly what has been also steadily lost is the belief that normalisation means convergence with economic and political standards associated with the liberal vision of the 1990s and 2000s. The EU can still be the solution, rather than the problem, in the Western Balkans – but only if it does not drop enlargement from its political agenda.

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