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ECONOMIC TRANSITION IN THE
WESTERN BALKANS: AN ASSESSMENT

REPORT

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I. INTRODUCTION: A TROUBLED REGION OF CENTRAL IMPORTANCE TO THE TRANSATLANTIC COMMUNITY

1. Over the past 15 years, the countries of the Western Balkans have undergone a very difficult and, in several cases, only partial transition from socialist toward market economies and from overtly authoritarian toward more plural governance systems. They have done so under exceedingly difficult conditions characterised by political, ethnic and sectarian tensions and war, redrawn borders, the emergence of new states and new institutions, and persistent problems of poor governance and corruption, political instability, and opportunist interventions by outside powers. Several of these states today might be characterised as illiberal democracies effectively captured by a small groups of people who control their country's media, public institutions and large swathes of the economy. The region is clearly burdened by a conflict heritage, ongoing regional instability and a persistent sense of insecurity arising out of that heritage which helps perpetuate this illiberal democratic order (Stojanovic).

2. The European Union and NATO, their member countries, as well as a host of other international actors have played roles in supporting peace and stability in the region, including backing for post-conflict development, economic transition and extending the promise, not yet fully consummated, of integration into Euro-Atlantic structures. The record on this front has indeed been uneven, with Croatia and Slovenia having already acceded to both the European Union and NATO, Albania and now Montenegro joining NATO, while Serbia, Bosnia and Herzegovina and the former Yugoslav Republic of Macedonia¹ and Kosovo are outside both of these institutions although they are, with several exceptions and to varying degrees, either candidate countries or seeking to develop closer ties with them. Yet political problems continue to beset the region and have complicated its relations with both the EU and NATO.

3. The Western Balkans remains an area of special concern for NATO, which first engaged militarily in the region during the early stages of the war in Bosnia and Herzegovina in 1992 and later during the Kosovo conflict. Today, NATO retains a military presence in the Western Balkans through the Kosovo Force (KFOR) and Operation Althea in Bosnia and Herzegovina. It maintains headquarters in Sarajevo and Skopje to support defence reform efforts in Bosnia and Herzegovina and the former Yugoslav Republic of Macedonia respectively. It also has a Military Liaison Office in Belgrade to work on the practical aspects of the implementation of the Transit Agreement between NATO and Serbia and to support Serbian participation in Partnership for Peace (PfP) programmes. These efforts foster dialogue and cooperation with other non-member countries in the Euro-Atlantic area including the region's other partners.

4. Currently Serbia is the only SEE6 (Bosnia and Herzegovina, Montenegro, Croatia, the former Yugoslav Republic of Macedonia, Slovenia and Serbia) country that has not expressed an interest in acceding to NATO. Serbia's opposition to this notion is partly rooted in its own experience in the Balkan wars in which Serbian forces and infrastructure were targeted during NATO's 1999 air campaign which sought to put an end to the conflict between the Milosevic regime and Kosovo Albanians. NATO had also targeted Bosnian Serb forces in the 1995 Operation Deliberate Force, a UN-sanctioned effort to undermine the military capability of the Bosnian Serb Army which had attacked UN-designated safe areas. The idea of joining NATO is not at all popular in Serbia and indeed the Serbian public's view of NATO has worsened even though the government has a good cooperative relationship with it. The NATO bombing has loomed large in the Serbian memory and continues to condition that county's views of the Alliance. Likewise, in Republika Srpska in Bosnia and Herzegovina there is strong opposition to acceding to NATO. There are signs, for example, that the government of the Republika Srpska based in Banja Luka is blocking reforms and measures such as the registration of military property to keep the Bosnian state from moving

¹ Turkey recognises the Republic of Macedonia with its constitutional name.

closer to accession. The registration of military property is an essential prerequisite for a NATO-offered Membership Action Plan (MAP) (NATO PA). For its part, NATO is not pushing any country to consider accession, but it maintains an open-door policy for those countries which are interested in joining the Alliance and which have undertaken the many reforms needed to make their candidacy viable. There is a false narrative spread by elements of the media that NATO is pressuring countries to join the Alliance but this utterly misleading.

5. Although NATO has been a key player in the region's security-military landscape over the last twenty years, the European Union has also carried out important peacekeeping and police missions in the region. It has, however, been the primary external actor supporting economic and governance reforms. The EU, along with international financial organisations such as the European Bank for Reconstruction and Development (EBRD), the World Bank and the International Monetary Fund (IMF), has sought to foster a degree of policy, governance and economic convergence between the Western Balkans and the member countries of the Europe Union. During the first decade following the end of the Balkan wars, the SEE6 underwent considerable GDP growth, on average close to or exceeding 5% (Bonomi). Of course, much of this was related to the naturally expansionary nature of post-war recovery as well as an influx of prodigious international support for the region. But reforms and liberalisation were also a factor as these countries finally began to undertake the difficult steps toward economic transition.

6. Of the successor countries to Yugoslavia, Croatia and Slovenia were the most successful in rapidly closing the gap with European Union member countries. But it is important to note that these two states were relatively well off to begin with. That they were the first countries in the region to become EU members was both a recognition of their rapid transition and effective reform platforms, and the additional investment and growth these reforms ultimately encouraged. Membership, of course, afforded these states even greater privileges including market access and full participation in EU programmes available only to members. In other words, their successful reforms triggered a virtuous circle that has helped them converge more quickly toward European economic standards. Unfortunately, even with the prospects of eventual membership on the table, the pace of reform stalled throughout much of the region following the 2008 financial crisis, and so too has the pace of economic growth. The Western Balkans seem to have fallen into a middle-income trap, in which it now seems unable to achieve a rate of growth that will move it quickly toward European averages. Several of the region's countries currently rank near or at the bottom of the European Policies Initiative's Catch Up Index².

7. Indeed, the boom years in the SEE6 countries ended in 2009 as a financial crisis that had begun in the United States started to undercut growth throughout Europe while precipitating a near collapse of the European monetary order. That crisis weakened growth in the Eurozone, which underwent a 4.4-point drop in its real GDP growth rate in 2009 compared to 2008 (Eurostat). With this important market in the midst of a serious crisis, the prospects for sustaining growth in the Western Balkans rapidly diminished, even though it had been initially sheltered from the shock. Recession and falling employment in the EU zone eventually spilled over to the Balkans through the channels of declining demand, lower exports, diminished investment and deteriorating remittance payments of labourers from the region who were working in European Union markets.

8. This crisis not only set back economic growth and development, but it also had important political and social implications. Throughout the region and indeed beyond it as well, economic crisis seems to have opened the door for populist and nationalist movements, some of which have challenged difficult reforms and, in some cases, the very notion of advancing toward EU membership. Ultra-nationalism and populism have been persistent problems in the region and

² The Catch Up Index is a tool created by the European Policies Initiative that registers the level of convergence or divergence of 35 European countries along four categories: *Economy, Quality of Life, Democracy and Governance*.

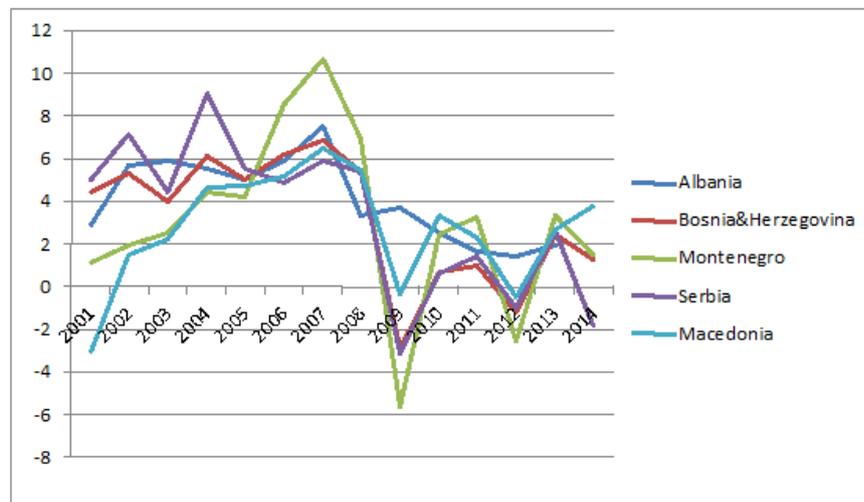
were obviously factors in the war that tore the region asunder in the 1990s. Today some of these groups have remade themselves, have adopted more pro-EU positions and have learned to use the language of EU integration. In some cases, however, the language used in the international arena is not the same as the political discourse employed domestically.

9. Adding to the general sense of confusion has been a growing perception that European enthusiasm for enlargement has waned considerably. Some observers suggest that the Union has also grown more hesitant to promote democratic values in the region. They argue that the Eurozone crisis, its political fallout and Europe's new-found hesitancy on enlargement have impeded the transition process and undermined the hopeful narrative of convergence between the EU and the Western Balkans that had initially helped sustain reform efforts. There are also important economic lessons at play. Economists have largely understood the Euro crisis as reflecting a failure to achieve genuine convergence within the EU itself. It demonstrated that in a currency union of countries with extraordinarily divergent rates of productivity, the optimum exchange for one country could prove highly inappropriate for another. Events surrounding this crisis undoubtedly had an impact on enlargement discussions as they created doubts about convergence and fostered new worries that hasty enlargement would only sharpen the contradictions and fissures within the Union itself.

10. Between 2001 and 2008, the EU had become the Western Balkans' largest trading partner and a critical source of financial support and investment. The region's growth was essentially based on domestic consumption financed, in part, through European capital inflows as well as on aid programmes. The key drivers of growth in the Western Balkans, however, differed substantially from the Central and Eastern European economies that had earlier acceded to the EU. According to one EU study reviewing growth patterns until 2009 in the region:

*Productive investment was not a key driver of growth in the Western Balkans, unlike in the central and eastern European countries that have now become EU Member States. In all countries except Serbia, construction accounts for more than half of gross fixed capital formation (GFCF). Construction is an essential form of almost any investment activity, but higher machinery and equipment acquisitions, in particular with more sophisticated technologies, are also an essential ingredient in order to move towards higher productivity. In recent years, the share of construction has increased in Croatia and Serbia and remained unchanged in the former Yugoslav Republic of Macedonia. In Montenegro investment in hotels and restaurants has been very high as a result of the booming tourism industry, and has proved more resilient to the contraction of external demand than the rest of the real estate sector, which has contracted (European Commission, *The Western Balkans in Transition*).*

11. These patterns of growth are a cause for concern as it has not ratcheted up long-term productivity to the degree necessary for more substantial growth in the Western Balkans. This could explain why much of the region has only made slow progress converging with Europe in economic terms. The EU remains a critical trade and investment partner for the Western Balkans, and it plays a far more important economic role there than does either the United States or Russia, although the broader public does not always understand this. A greater effort is now needed to help the region move toward a development model that will make convergence more likely. The key here will be sustained domestic economic and political reform.

Figure1. Real GDP growth (2001-2014)

Source: Voices of Liberty, 2015

12. As the EU has begun to recover from recession, so too has GNP growth in the Western Balkans. The outlook for 2017 is that growth will continue and will, in some countries, accelerate. The EBRD projects a weighted average growth of 3% in 2017 for the region, compared to a 2.2% average in 2015 (EBRD, December 2016). But convergence remains an enduring challenge and growth rates will have to be even higher than anticipated for real convergence to begin. Incomplete structural reforms are largely responsible for this lower than needed rate of growth. For now, GDP per capita in the Western Balkans, in purchasing power parity terms, remains half that of Eastern European countries and a quarter of Western EU members (Sanfey et al.).

II. THE PROMISE OF EU ACCESSION AND THE REALITY OF FITFUL REFORM

13. The economic slowdown and shifting politics within the EU itself has not been without political implications for the Western Balkans. Sustaining political and economic reform in a period of weak growth and recession has proven very difficult. Resistance to difficult reforms assumes myriad forms including populist nationalism, anti-liberalism, sectarian and ethnic tensions and a rejection of Euro-Atlantic integration. When reform is slowed due to such resistance, it creates an almost self-fulfilling prophecy. Those who argue that European integration is a pipe dream for the Western Balkans not surprisingly often also seek to weaken the impetus for political and market reforms, thereby pushing off the prospect of more sustained growth, higher investment and deeper integration in Euro-Atlantic structures. In other words, scepticism itself generates sub-optimal performances in economic and governance terms. The promise of closer ties to the European Union and, to a lesser extent, to NATO have been key drivers for reform in the Western Balkans. But the power of this promise has waned in the public's imagination with the passage of time. The European Union's internal crisis is part of the reason, but so too is the failure in most of the countries of the region to sustain much needed political and economic reforms.

14. The EU has sought to counter the negative aspects of its own mounting scepticism through the so-called Berlin Process. This intergovernmental initiative has sought to reinvigorate multilateral ties between the Western Balkans and selected EU member states, while deepening regional cooperation in the Western Balkans on matters pertaining to infrastructural and economic development. Some in the region, however, see this as a poor substitute for an accession prospect, particularly as it seems to have deemphasised political matters like strengthening democratic institutions and pushing forward reconciliation (De Borja Lasheras). Some democratic reformers in the region worry that Europe is now sending implicit signals that illiberalism is fine as

long as some reasonable foundation for economic development is preserved and order is maintained in what they believe Europe now sees as a “borderlands”—a notion that the recent migration crisis has only reinforced (NATO PA, Mission report, Visit to Serbia, June 2017). Some analysts, however, suggest that the democratic reform cannot be delinked from economic reform and they criticise the EU for what appears to be a decision not to censure more vigorously governments in the region for human rights and governance shortfalls.

15. The EU is also engaged in multilateral efforts to encourage greater regional cooperation. The Western Balkans Summit in Trieste on 12 July assembled the Heads of Governments, ministers of foreign affairs, ministers in charge of economic development and ministers of transportation from the Western Balkans, senior officials from other Berlin Process participating countries (Germany, Austria, France, Italy, the UK, Croatia and Slovenia), and key officials from the European Union. The focus of the discussions was strengthening connections in the Western Balkans as a way to bolster regional and European integration processes, strengthen economic cooperation - particularly in the field of small and medium enterprises, the IT sector and science, youth cooperation, the rule of law, the fight corruption, terrorism, extremism and radicalism, and migration issues. The Consolidated Multiannual Action Plan for a Regional Economic Area in the Western Balkan Six was considered at the Summit, and the EU announced an initial 7 million Euros support for this Plan, with an aim of initiating the activities envisaged by it and seven projects in the field of infrastructural regional connections for which the investments amounting to over 500 million Euros have been envisaged.

16. But the process of EU integration has proven far more fitful for this region than it had been for Central Europe. Four out of the six Western Balkan states, however, have been accorded EU candidate status – the former Yugoslav Republic of Macedonia in 2005, Montenegro in 2010, Serbia in 2012, and Albania in 2014. Progress in accession negotiations has generally been slow. Serbia and Montenegro, for example, have each closed two and three of 35 negotiation chapters respectively. Montenegro has opened 28 negotiating chapters and is preparing to open three or four more by the end of the year. Its government believes it will be ready for accession over the next four to five years (European West Balkans). Serbia now has opened 10 Chapters for negotiations in a process that was launched in January 2014. The opening of chapters has been made conditional, in part, on progress in the rule of law chapters (23 and 24) and in chapter 35 which deals with the normalisation of relations with Kosovo. The common EU position on Chapter 35 states that "Serbia should engage in reaching further agreements, furthering the normalisation in good faith, with a view to gradually lead to the comprehensive normalisation of relations between Serbia and Kosovo, in line with the negotiating framework. The Commission and the High Representative of the Union for Foreign Affairs and Security Policy will monitor closely and continuously Serbia's fulfillment of the following first set of interim benchmarks and report “at least twice yearly”, on this issue, to the (European) Council" (b92 15 December 2015). There is a perception in much of Europe that neither Pristina nor Belgrade are approaching the bilateral relationship in a much-needed spirit of compromise.

17. Indeed tensions between Belgrade and Pristina persist and nationalist rhetoric continues to infect the tone of relations. Not coincidentally, playing this nationalist card gives each greater leverage in domestic politics. But while this might work in domestic political terms, it hardly serves the broader goal of regional reconciliation and European integration. Kosovo's recent announcement that it wants to transform its security forces into a full-fledged military and a lack of progress in implementing an agreement regarding the establishment of the Community of Serb Municipalities have become major irritants to progress even on practical matters that do not pertain to final status (Gotev). NATO Secretary General Stoltenberg and a number of Allied governments have made it clear that the establishment of an army in Kosovo would imperil Pristina's relations with the Alliance. All sides could do much more to restore practical cooperation to improve the lives of those living in affected areas.

18. It is also worth mentioning that Kosovo is not recognised as an independent country by five European member states – Spain, Slovakia, Cyprus, Greece, and Romania – although it entered into a Stabilization and Association Process (SAP) with the EU in 2016. EU leaders are not happy that Kosovo has balked at implementing the 2013 Brussels Agreement and particularly the Statute of the Community of Serb Municipalities which would afford several Serb majority municipalities a degree of self-government by entitling participating municipalities to cooperate in exercising their powers collectively through the association. The Association would have full overview of the areas of economic development, education, health, urban and rural planning. Such unresolved tensions across the region invariably spill over into discussions about accession and have sparked a degree of enlargement pessimism not only in the Western Balkans, but in European capitals as well.

19. The former Yugoslav Republic of Macedonia and Bosnia and Herzegovina have yet to begin acquis negotiations. A start date for accession negotiations with Albania has not been agreed and the Commission has communicated to Tirana that it will not begin these talks until two conditions are met: 1) The government must reopen political dialogue with the parliamentary opposition, and 2) Albania must deliver quality reforms in the areas of public administration, rule of law, corruption, organised crime, and fundamental rights, including minority rights.

20. The Union's own crisis of identity has clearly not helped in all of this. The Euro crisis, the slow response to the refugee and migration crisis, Brexit and changing politics in European societies have all contributed to the sense of drift and uncertainty in the region. This doubt almost invariably has spilled over into the politics of Western Balkan states. Narratives of exclusion and xenophobia are now commonplace and are exploited by nationalist and authoritarian movements throughout the region. Political crisis, pervasive corruption and poor governance have delegitimised the region's governments and, by extension, Europe's vision and ambition for the region. All of this calls for broad reassessment, reengagement and a revived push for democratic and political reform and, of course, genuine regional reconciliation premised on shared interests including economic development and European integration.

21. These were some of the themes of a set of meetings in the regions held on 2-4 March 2017 by EU High Representative for Foreign Affairs and Security Policy Federica Mogherini. Over those two days, Ms Mogherini visited Montenegro, the former Yugoslav Republic of Macedonia, Serbia, Albania, Kosovo and Bosnia Herzegovina. However, according to some observers, the visit also marked a shift in focus away from the accession process to several of the more serious geopolitical threats to the region. A brief review of Ms Mogherini's bilateral talks, however, captures several very serious problems the region now confronts.

22. In Montenegro, a country that has just acceded to NATO, 20 people were recently arrested for planning a coup d'état partly in reaction to Montenegro's membership aspirations. A special prosecutor and some observers suggested that Russia had encouraged this extreme expression of opposition in a failed attempt to undermine the country's candidacy for NATO membership. Worryingly the Montenegrin opposition has also been boycotting parliament. In a meeting with opposition leaders, Mogherini urged opposition MP's to return to parliament while encouraging Prime Minister Dusko Markovic to work out a political solution to the crisis. Mr. Markovic recently told the Parliamentary Assembly of the Council of Europe that the government has made judicial reform and the fight against corruption and organised crime top priorities but continues to struggle with populist politics. The opposition boycott there continues.

23. The situation in the former Yugoslav Republic of Macedonia is also troubling, although progress has been made. President Gjorge Ivanov originally refused to confer the opposition leader Zoran Zaev a mandate to form a government even though Zaev had struck a deal with ethnic Albanian parties which gave the coalition enough votes to create a government. Ivanov had charged that the language concessions Zaev had extended to ethnic Albanians in the coalition undermined the former Yugoslav Republic of Macedonia's sovereignty, independence, and

territorial integrity. The standoff highlighted enduring ethnic tensions in that country and reluctance of embedded elites to cede power even in the face of election losses. Indeed, the then governing party led by Nikola Gruevski had refused to step aside and the country subsequently entered into a full blown political crisis that also paralysed relations with Europe. These events elicited warnings from the EU and NATO that democracy was at risk as was Western support for the government.

24. With strong pressure from Brussels and Washington, President Ivanov finally gave a mandate to Zoran Zaev to form a government which he did on 31 May 2017. MRO-DPMNE's leader and former prime minister Nikola Gruevski and other party leaders now face charges of abuse of power, illegal wiretapping and corruption. The new ethnic-Albanian party "Besa" did not join the government cabinet that has engaged another ethnic Albanian party, the DUI, as well as the SDSM. Despite this turmoil, Prime Minister Zaev has expressed his intention to put both EU and NATO Accession at the top of his government's governing agenda. The new government has announced plans to take on deeply rooted corruption and to make Albanian one of the official languages of the country. Tax reform, a higher minimum wage and greater social protection are also featured in the new government's mandate. Of course, it will take time to see if this new government will be positioned to move the country beyond the many impasses that have blocked reform and the accession processes—including the name dispute with Greece, inter-ethnic tensions, corruption and clientelism (Bliznakovski).

25. In Albania as well, the opposition had threatened to boycott June elections and had been boycotting parliament despite EU appeals to the opposition to return to the assembly in order to enact judicial reform. The reform includes the vetting of 750 judges, which, Federica Mogherini told Albanian officials, is an essential prerequisite to kick off accession talks. Some progress has since been made. In late June Prime Minister Edi Rama and Lulzim Basha, leader of main opposition Democratic Party, set up an arrangement designed to encourage the opposition to participate in the general election that will now be organised and overseen by a caretaker government. The opposition will return to parliament in order to vote on the bodies which will vet judges and prosecutors. Prime Minister Rama also agreed to replace Deputy Prime Minister Niko Peleshi and six ministers from his government with politicians nominated by the opposition. The vetting of judges has been a key priority for the European Commission as it sees this as fundamental to the process of much needed judicial reform in that country (SEENews). This is all very good news as it bespeaks a new-found spirit of compromise that is essential to moving democracy in Albania forward.

26. In Bosnia and Herzegovina strong ethnic and sectarian tensions continue to undermine economic reforms and efforts to cope with very serious governance problems which are rooted both in the complexities of the country's constitution and the lack of good will among some of the country's leaders to make government work. The leader of the Republika Srpska pointedly set off to travel to Moscow for consultations when Federica Mogherini visited the country; however due to a delay, he did meet with the High Representative. In any case, the message was not particularly welcoming of the EU and reflected the very divided and tense state of affairs in that country. Not surprisingly, public anger and alienation are on the rise in Bosnia and Herzegovina as elsewhere in the region. A recent NATO PA Rose Roth Seminar focused on the challenges confronted by Bosnia and Herzegovina in some detail (NATO PA, Seminar Report, 20-24 March 2017).

III. STRUCTURAL ECONOMIC WEAKNESSES OF THE WESTERN BALKAN ECONOMIES

27. Between 2004 and 2007, 10 Central and Eastern European countries acceded to the European Union. These 'New Member States'³ (NMS) have long been converging with Western Europe, with a Gross National Income (GNI) per capita⁴ that has more than tripled since the beginning of the accession process. Indeed, perhaps the most striking feature of the NMS economic transition has been the pace of convergence with advanced EU economies. Their rate of growth and convergence was significantly higher than that of the Western Balkan states at the same stages of transition. For example, Accession negotiations with Montenegro, the most advanced South Eastern European state in the EU accession process, commenced in 2012. Since then, three negotiating chapters have been closed. By comparison, over the same span of time, several of the first New Member States had already completed the full accession process (the Czech Republic completed the process between 1998 and 2002 and Slovakia did so in only two years between 2000 and 2002).

28. The New Member States enjoyed several advantages as they moved into the transition phase. First of all, many began the transition with a higher per capita income than most of the Western Balkan states. Perhaps even more importantly, despite the trauma of leaving the Soviet orbit, they had not undergone an extended period of war and violence, as had much of the Western Balkans. Those tragic wars, in fact, were a primary reason the economies were in such poor condition. Finally, except for Albania, the states of the Western Balkans were newly sovereign as they were the product of the break-up of the old Yugoslavia. This meant that in addition to market transition, democratic overhaul and rebuilding from war, they were also compelled to construct the basic institutional foundations of nation states from scratch while generating support for these new institutions from their often-divided publics. Nation and state building is almost by definition a slow and arduous process, and so it has been in the Western Balkans.

29. Finally, there is also an element of geographical determination in assessing why the pace of reform and integration has been far more sluggish in the Western Balkans than it was in much of Central Europe. Put simply, by virtue of proximity to the very centre of European markets and existing transportation networks and economic ties, Central and Eastern European countries that acceded to the EU were able to link into Western European supply chains more easily and quickly than their counterparts in the Western Balkans (IMF, 2015). Stalled structural reforms, political divisions and persistent problems of infrastructure have only exacerbated the enduring problem of distance.

30. The 2008 financial crisis also revealed fundamental weaknesses in the financial and banking sectors of Western Balkan countries. The region had undergone rapid credit growth in the run-up to the crisis, much of it denominated in foreign currency. This capital had financed significant increases in consumption, which contributed to a widening of current account deficits⁵ and a surge in private debt (Economist Intelligence Unit). Rapid credit growth was coupled with a rather lax approach to prudential lending. Many loans turned sour when the global crisis spilled into the region, and this had an explosive impact. Service on many of these loans simply halted, and the

³ The 'New Member States' refer to the Central and Eastern European countries from the 2004 Enlargement (the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia, and Slovenia), as well as Bulgaria and Romania who joined the EU in 2007.

⁴ The GNI per capita is the dollar value of a country's final income in a year, divided by its population. It reflects the average income of a country's citizens.

⁵ The current account is the difference between the value of exports of goods and services and the value of imports of goods and services. A current account deficit means that the country imports more goods and services than it is exporting. The current account can also be expressed as the difference between national (both public and private) savings and investments. A current account deficit may therefore reflect a low level of national savings relative to investment.

large stock of nonperforming loans⁶ (NPLs) accumulated by Western Balkan banks continue to clutter the region's banking system. Reliance upon the Euro for transactions, lending and saving has limited the options for policy makers. Seventy-five per cent of the stock of domestic credit in 2009 was either denominated in or indexed to the Euro and 60% of bank deposits were euro denominated. This too left the region poorly equipped to insulate itself from the shock of the Euro crisis (European Commission, 2009).

31. Another side effect of large capital inflows and loose credit was unsustainable large current account deficits. If these deficits had reflect the importation of capital goods designed to increase productivity over the longer term, the situation would not have been so worrying. But much of this inflow underwrote consumption or less productive investments, for example, in the housing sector, leaving the region vulnerable to any reduction in credit. The Western Balkans have also relied heavily on remittances to sustain incomes. This has been particularly the case in Albania, Bosnia and Herzegovina, and Kosovo, where repatriated income averaged 10% of GDP in the period 2005-2013 (Tunali). Again, the inflow of foreign currency underwrote domestic consumption, but also negatively affected the trade balance. A large influx of foreign capital ultimately spent domestically can trigger currency appreciation which, in turn, decreases the export sectors' competitiveness and boosts imports. To varying extents, this pattern played out in much of the region.

32. Western Balkan economies have also been burdened by uncompetitive industrial sectors inherited from the socialist era. These were not rapidly and sufficiently downsized after the end of Socialism as they were in much of Central Europe. War in much of the region was one reason, as was the fact that the region's engagement in market reform, including reforms accompanying the dialogue with the EU, were delayed. Most SEE countries registered a fall in manufacturing value added over the 2000-2012 period. Albania and Bosnia and Herzegovina underwent modest reindustrialisation over the 2000s, but they were beginning from a very low base (Damiani and Uvalić). The critical point, however, is that the region's industrial base requires restructuring, new investment and new market outlets, and it has not had any of these in sufficient quantity. Serbia's publicly owned industries are another delicate matter. Most economists would suggest that these state subsidised loss makers constitute a genuine economic burden and are now impeding growth in that economy. It is politically difficult to end state support particularly if doing so results in job losses. Longer-term considerations are often difficult to make when economies are not strong and this dilemma continues to undermine Serbian growth. There are similar situations throughout the region and this is an important reason why the region has not grown at rates that might have been expected and which are needed to converge with the EU.

33. The state of the region's service sector is also complicating the convergence process. This sector is primarily focused on domestic markets and is not a major generator of foreign exchange (Damiani and Uvalić). The low level of regional economic integration is one reason that the service sectors are so nationally focused and fragmented. The problem of relatively poor regional economic integration obviously extends to other markets, and commercial exchanges among neighbouring countries and with the rest of Europe are further undercut by under-developed transportation infrastructure.

34. The pervasive underutilisation of human capital in the region constitutes another challenge. The phenomenon of "jobless growth" – a gap between job creation and the number of people seeking employment – has assumed dramatic proportions in a region with an unemployment rate that averaged 25% in 2016. The youth unemployment rate is about double that of the working-age

⁶ "A loan is nonperforming when payments of interest and/or principal are past due by 90 days or more, or interest payments equal to 90 days or more have been capitalised, refinanced, or delayed by agreement, or payments are less than 90 days overdue, but there are other good reasons—such as a debtor filing for bankruptcy—to doubt that payments will be made in full." (IMF)

population. This is both a political problem and it points to serious structural problems in the labour market including a skills mismatch. Jobless young people with poor economic prospects are more vulnerable to demagoguery and misinformation. Populist and nationalist political movements trafficking in this kind of mobilisation politics are unlikely to improve matters over the long run so there is a risk that the region could fall into a vicious cycle of meagre economic prospects reinforced by poor governance.

35. That said, there has been some progress made in addressing the underlying employment problem. Recent economic growth and labour market reforms have triggered an uptick in job creation, even though employment levels currently remain below pre-crisis levels. The region's governments, however, could do more (Sanfey et al., 2016). Labour market rigidities, including regulations that discourage employers from hiring new workers also tend to undermine the potential advantages for a relatively well educated and low wage population. For example, tax rates are higher for part-time and low-wage jobs and this naturally discourages the market from hiring in these two areas.

36. Serbia has recently begun to make progress both in terms of fiscal consolidation and unemployment. In the midst of the financial crisis Serbia had negotiated a three-year standby arrangement with the IMF which provided backing for a range of reforms that the country needed to undertake. The goal has been to put the economy on a sustainable footing and the IMF believes that Serbia is now in a significantly more stable position than it was previously. Fiscal deficits have fallen to 1.4% of GNP, governments deficits narrowed to 1.4%, the lowest since 2005, while growth was 2.8% in 2016 –a figure that outperformed expectations (IMF). There are precedents for this in countries where the fiscal situation is unsustainable and spending reductions and fiscal consolidation actually trigger growth. This is due, in part, to the fact that the spending reduction measures have boosted domestic and international confidence in the economy. This uptick in growth also helped drive down unemployment from 20 to 13 % by the end of 2016.

37. Current account deficits in Serbia have been falling and now stand at 4% of GDP. Foreign investment is partly underwriting these shortfalls. The level of non-performing loans in Serbia has also started to come down, but this positive development is largely restricted to private banks. State-owned banks are in considerably greater difficulty. The short-term outlook for Serbia is positive, and the country could reach growth rates of 4% over the medium term if its reform agenda stays on track. Low interest rates reflecting increased confidence in the Serbian economy will help boost growth which will be driven, in part, by an expansion of private consumption as employment and wages pick up. Rising demand will lead to an increase in imports while exports are likely to grow less slowly, particularly in light of the ongoing need for deeper structural reform. It is also important to recognise that 4% growth is not sufficient for Serbia if the goal is to begin to converge with the economies of the European Union. The IMF suggests that convergence requires growth rates approaching 5.5%. Sustaining growth at this level will be impossible without implementing more serious structural adjustment programmes particularly regarding state-owned companies.

38. The pervasive informal sector poses another major labour market challenge to South Eastern Europe. It has had a corrosive impact on the overall business environment and competitiveness of SEE economies and it undermines the tax system while contributing to a climate of lawlessness. Sporadic efforts to address the problem have largely proven ineffective, and large grey economies continue to operate in the interstices between a shrinking public sector and an overly regulated private sector. In Montenegro, for instance, 52% of firms polled in a 2013 EBRD survey cited competition from the informal sector as their primary problem, up from 27% in 2007. It is estimated that the level of employment in the informal sector ranges between 30 and 40% (Zeneli, 2014). Workers in the informal sector do not enjoy normal protection accorded employees in the legal market, and this only exacerbates the level of social inequality and the sense of injustice. This problem has proven particularly acute both in Bosnia and Herzegovina and the former Yugoslav Republic of Macedonia but it is not restricted to these two countries.

39. But there are important signs of progress as well in the region. Serbia, for example, moved 7 places up the list on the World Bank's Ease of Doing Business Index between 2016 and 2017 and now stands at 47th place. It stood at 91st place in 2015. By comparison Albania ranks 58th, Bosnia and Herzegovina 81st, Kosovo ranks 60th, former Yugoslav Republic of Macedonia 10th up from 31st place last year (the highest ranking in Europe) and Montenegro 51st (World Bank, 2017). The former Yugoslav Republic of Macedonia's very high ranking can be attributed to highly commendable regulatory reforms. Ten years ago, it took 48 days to start a new business in that country. Now it takes 2 days to do so. In recent years, it has made online registration free of charge. Minority investor protections were strengthened by requiring prior review of related-party transactions by an external auditor. In addition, resolving insolvency is now easier thanks to a framework for electronic auctions of debtors' assets, streamlining and reducing the time for insolvency proceedings and appeals, and a framework for out-of-court restructurings (World Bank, 2014). Clearly therefore daring reform in this region is possible and needed. The key question is whether politics will make reform possible.

IV. SOCIO-POLITICAL ENVIRONMENT AND MACROECONOMIC REFORM/STABILITY

40. As this report has suggested, although the Western Balkan economies confront important structural challenges that partly account for relatively poor economic performances and incomplete transitions, politics and governance constitute an even more compelling challenge. In its 2016 *Nations in Transit* report, Freedom House noted that the level of democratic development in the Western Balkans has regressed six years in a row. The region's overall Democracy Score now stands at a level equal to that of 2004. Twenty years after the Dayton Peace Accords and despite substantial international initiatives to support governance enhancement projects in the Western Balkans, much of the region is consumed with the challenge of poor governance, the rights of opposition, media restrictions, and pervasive corruption.

41. At this point, further convergence with European norms is running up against the compelling need to strengthen the rule of law and unwind powerful systems of political patronage, state capture and wide-spread corruption. According to Transparency International's Corruption Perceptions Index 2016, all Western Balkan countries score below 45 (on a scale of 0 – highly corrupt – to 100 – very clean), and suffer endemic corruption in the public sector. The problem can, at times, seem intractable, and far more needs to be done to combat it. The European Court of Auditors, for example, recently reported that only 2% of the European Commission's Instrument for Pre-Accession Assistance (IPA) – a EUR 11.5 billion budget – is spent on the fight against corruption and organised crime (Dolan, 2016).

42. In the Western Balkans, the rule of law is often undermined by powerful elite networks which can circumvent formal laws to perpetuate their hold on state institutions including public owned economic assets. This hold, in turn, provides leverage for both political and financial gain. According to the findings of Freedom House's *Nations in Transit* 2016 report, of the six South Eastern European countries, two are classified as semi-consolidated democracies (Montenegro and Serbia), three as hybrid regimes (Albania, Bosnia and Herzegovina and the former Yugoslav Republic of Macedonia) and one as a semi-consolidated authoritarian regime (Kosovo). Throughout the Western Balkans, corruption, clientelism, vote rigging and fraud are all linked to the problem of state capture by elites who sometimes seem less interested in advancing the substance of democracy even though the form of democracy suits their purposes. One scholar, Alan Riley, has written that "[w]hat the region has experienced in the last 20 years is a process of 'refeudalisation', where power is held by informal networks that run through every state institution and the private sector" (Van Ham).

43. The consequences of this are serious not only for the region's political stability but also for its economic prospects. Citizens throughout the region have lost confidence that their leaders are

positioned to deliver meaningful change, and their scepticism is perfectly rational. Corruption levels have not changed over the past ten years, and this has undermined state legitimacy, weakened the impetus for economic reform and, by extension, gravely hampered the region's economic development. Enduring sectarian and ethnic cleavages are only reinforced by elite capture, patronage and corruption. Ironically, elites from competing ethnic and sectarian groups often surreptitiously cooperate with their political opponents simply to ensure that each is positioned to maintain their privileged stranglehold over captured state and regional institutions as well as critical economic assets and the media. In other words, sectarian, ethnic, and populist politics is often little more than a smoke screen purposefully engineered to obfuscate pervasive clientelism and corruption. What emerges unfortunately is the very antithesis of meritocratic societies which reward talent and hard work.

44. Instead the region is saddled with clientelist structures which are more akin to mutual enrichment societies of privileged insiders who reward each other with funds furnished by tax payers, consumers, and, to varying extents, the international community. Not surprisingly, much of this behaviour veers into criminal activity and establishes an ethical standard that implicitly encourages a broader criminalisation of economic activity. Organised crime networks accordingly flourish particularly in those spaces where state authority and the rule of law are weak or subsumed by clientelist practices and public venality (McDevitt, 2016). It is no coincidence that these networks at times intersect with those of the governing elite. Of course, honest and well-meaning civil servants and politicians, of which there are many, also pay a high price in such systems.

45. The OECD Guidelines on Corporate Governance of State-Owned Enterprises (SOEs) call for a rigorous separation between political parties and the management of SOEs. Yet in the Western Balkan countries, SOEs are often virtually run by political parties. The parties or their proxies are thus able to appoint CEOs and board members and involve themselves directly in operational decision making. The situation has become particularly acute in strategic sectors like energy where the level of accountability is as low as the amount of money generated for the well-connected is high (Southeast European Leadership for Development and Integrity).

46. According to Transparency International the key problem for the Western Balkans , “is the lack of independence of the judicial processes and the enormous power held by political leaders over most institutions. An independent and effective judiciary, aided by free, critical media and strong civil society are vital to upholding the rule of law and to stamping out corruption. Too often the political elites can simply avoid prosecution for corruption or even exposure of their corrupt actions [...] Although many of the countries in the study have taken important steps to develop and strengthen their anti-corruption systems, progress has been slow and mostly only on paper. Laws have been introduced but they have not been implemented. Media independence and civil society are also under threat.” (Transparency International, “Western Balkans and Turkey).

47. South Eastern European states are all party to the United Nations Convention against Corruption (UNCAC), which, among other things, recommends the establishment of specialised anti-corruption bodies. In the Western Balkans, these bodies tend to focus on policy coordination and public education and leave the responsibility for prosecuting corruption to national justice systems, many of which are weak and penetrated by precisely those forces that are engaged in corrupt practices. They are therefore woefully compromised. The European Union and other external actors have worked assiduously with the region's governments to enact justice reform, which is critical not only to Euro-Atlantic integration but also to triggering sustainable economic development. The rule of law Chapters of Accession negotiations (23 and 24) deal with these issues and they will continue to pose a real stumbling block for the region if the problem is not addressed in a more comprehensive fashion. Unfortunately, the results of these efforts have been mixed as resistance to justice reform and a more comprehensive fight against corruption is deeply

ingrained among those who are able to shield themselves from legal scrutiny and thus able to act with impunity.

48. The burdensome legacy of red tape and heavy bureaucratisation is also part of the problem. Bureaucratic overreach and prodigious amounts of red tape paradoxically provide other opportunities for discretionary decision making, which, in turn, can lend itself to corrupt practices. The oversized state apparatus in Bosnia and Herzegovina provides a case in point. Overlapping institutions and complex decision-making processes in that country not only overwhelm the fragile private sector, but they also generate numerous opportunities for corrupt officials to impose illegal fees for processing decisions that would otherwise remain stuck in the back files (Blagovcanin and Divjak, 2015). In the region, on a yearly average, one in six citizens has either been directly or indirectly exposed to an act of bribery by a public official (UNODC, 2011). This has generated enormous public frustration throughout the region and has triggered several protests over the past three years, including a series of protests in Bosnia and Herzegovina in February 2014 and in Serbia after recent Presidential elections. If genuine change is not in the offing, more unrest should be expected. Failure to take on the problem of corruption and state capture will also delay the accession process as societies that are riddled by corruption have clearly not met the basic EU accession (Copenhagen criteria), which includes ensuring the rule of law and a high degree of state capacity to implement the law.

V. RUSSIA AND OTHER EXTERNAL ACTORS

49. Russia has learned that by fanning the flames of discontent in Serbia, Kosovo, Montenegro and the former Yugoslav Republic of Macedonia, it can cheaply complicate the region's integration with the EU and NATO—one of the Kremlin's central strategic ambitions in Europe. Russia exercises leverage through diplomatic channels, investments particularly in the energy sector, media funding and covert support for extremist nationalist movements and those opposed to NATO and EU accession. Russia has sought to pursue similar policies in the West, but there are limits to what Russia can achieve in countries where democratic institutions are deeply rooted and where civil society is inclined to push back in a strong and united fashion as recently occurred in the French elections and is now underway in the United States. But the situation in the Western Balkans is far more unstable, civil society is less resilient, divisions along political, national, and sectarian lines are far more apparent, and the potential for manipulation is simply greater.

50. Moscow has not recognised the independence of Kosovo, which hardly makes it unique; several NATO member countries have also refrained from doing so. But unlike those countries, it has done little to encourage reconciliation between Belgrade and Pristina and seems more intent on playing the nationalist card. It also appears to be encouraging the Republika Srpska in Bosnia and Herzegovina not to cooperate with Federal officials on a range of issues and reforms, although it has so far not publicly advocated for the breakup of the country even if this is the position of some of its closest interlocutors in Republika Srpska. The Kremlin was also believed to be supporting some groups opposing Montenegrin accession to NATO (Gotev, 2017; The Guardian, 2017).

51. Russia has clearly identified the Western Balkans as a fertile ground to challenge NATO and EU influence. Because the region is so unstable, it has been able to do so at relatively low cost. Its presence in the Western Balkans provides an opportunity for some elites there to play off the great powers and to use the presence of one to gain concessions from the other. This is a dangerous game and does not serve the long-term interest of the region at all, particularly when this involves encouraging resistance to democratic reform and reconciliation. Indeed, there is growing pressure from some elites in the region for the EU to soften some of the challenging rules of conditionality in the European accession process. Not coincidentally, some of those rules undermine their privileged position in national politics and economics. The presence of Russia in the game endows

these reluctant reformers with a degree of leverage, at least in their minds. And Russia does what it can to portray the West as a harsh task master demanding blood, sweat and tears but offering nothing in recompense. This is sheer propaganda but fits well into Russia's broader narrative. Indeed, Russia seems to offer a more indulgent kind of friendship which can be particularly rewarding to elites who share its geopolitical vision and who, not coincidentally, profit from the current stasis. It hardly helps matters that the EU is in the midst of a period of introspection and redefinition, and in the eyes of many in the region, is no longer sincere in its desire to see the region fully integrated into the European order (De Borja Lasheras et al., 2016).

52. A recent Belgrade Centre for Security Policy Poll of Serbian citizens found that the majority of Serbian citizens favor EU membership, oppose NATO membership, and are essentially satisfied with the existing level of cooperation with Russia. But public perceptions of NATO seem to have worsened in that country. This is also the case for the EU perhaps because of the length of the accession process but also due to negative media coverage. Among the interesting findings of that important survey are that 52% of Serbs see Russia as a highly successful military power, while only 26% see the United States in these terms. The figure for Germany is 3%. In the evaluation of economic power, 34% of Serbs see the United States as highly successful, Russia stands at 15% and the EU--Serbia's most important trade and investment partner is only seen by 5% of Serbs as highly successful. In a ranking of the credibility of investors 34% of Serbs saw German as a highly successful investor while the figures for Russia were 16%, the United States 14% and the EU 8%. In terms of technological power, 33% identified China as highly successful. The corresponding figure for the United States was 27%, for Russia 13%, for Germany 12% and 4% for the EU. The study concluded that while the influence of Germany, China and Russia is generally regarded as positive in Serbia, that of the EU and the United States is generally seen in a negative light. The study also suggests that Serbs believe that membership in the EU would attract foreign investment and more employment while an alliance with Russia would enhance national security. More Serbian citizens would favor EU membership but this would not be the case if recognition of the sovereignty of Kosovo were required (Belgrade Centre for Security Policy).

53. It is interesting to note that although the Serbian military has carried out some exercises with Russian forces and is purchasing equipment from Russia—as did Yugoslavia during the Cold War, it exercises far more frequently with NATO or NATO member forces and participates in a range of partnership programmes. Serbia joined the Euro-Atlantic partnership Council in 2006 and in 2015 it agreed to deepen cooperation with NATO through an Individual Partnership Action Plan (IPAP). Indeed, Serbia is actively cooperating with NATO on matters related to the KFOR mission, to peacekeeping, fighting terrorism, the migrant crisis and joint training although it has not participated in any NATO operations. It has recently carried out 130 activities through its Programme for Bilateral Military Cooperation with the United States, seven of which have been joint military exercises. The problem is that the public in Serbia is not always very well informed of this activity, and the press tends to publish very negative and often false assessments of NATO and its role in the region (Belgrade Center for Security Studies). It is important to stress that NATO and NATO member countries fully respect Serbia's sovereign decision to remain a neutral country and recognise that this, in no way, should impede the development of mutually beneficial partnership that will help build security in the region.

54. The problem from the perspective of Europe and North America is not that Russia is cultivating friendships in the region. That is, of course, to be expected and is perfectly normal and legitimate. The real problem is that it offers an entirely different governance and economic message which is at once sectarian, illiberal and appeals to those very forces that seem to be profiting from sectarianism and are often evading genuine market reforms. This could prove very problematic for the stability of this highly fragile and still traumatised region. Russia is not only explicitly opposed to the idea of the countries in the region working with NATO, it also implicitly wants to discourage their deepening relations with the EU. There are reports, for example, that Russia is known to press Serbian leaders to deepen cooperation with its Eurasian Economic

Union—a move that would be utterly antithetical to Serbia’s EU aspirations and is illogical given current trade patterns (The Economist, 4/11/16).

55. Russia has not only been following a spoiling strategy in the Western Balkans, but is also gradually establishing itself as a key energy player in the region. Under normal conditions, this would not be a problem; yet Russia far too frequently deploys its energy assets for strategic (i.e. anti-Western) purposes across the Western Balkans and is purchasing support for its particular geo-political vision. State-owned companies Gazprom and Zarubezhneft have made significant investments in Serbia and Bosnia, including the 2008 purchase of a majority stake in the Serbian energy giant Naftna Industrija Srbije (NIS), which holds a monopoly over oil and gas production in the country (De Borja Lasheras et al.). Lukoil holds roughly 80% of Beopetrol, a large Serbian gas-station chain. The state-run Russian Railways, which is headed by Vladimir Yakunin, who is on an EU list of individuals banned from entering any EU country, is upgrading a 350-kilometre train line in Serbia. These investments are significant and could be conditioning Serbia’s view of the Kremlin and the values it espouses, although Serbia’s overall trade remains far more oriented toward Europe. Serbia’s top export destinations in 2015 were Italy (\$2.1B), Germany (\$1.66B), Bosnia and Herzegovina (\$1.08B), Russia (\$752M) and Montenegro (\$638M). Its largest source of imports are Germany (\$2.15B), Italy (\$1.76B), Russia (\$1.59B), China (\$1.3B) and Hungary (\$1.02B). It should be noted that Serbia is not participating in sanctions against Russia, although its leaders have expressed opposition to Russia’s illegal annexation of Crimea and they recognise the territorial integrity of Ukraine which they naturally link to the Kosovo question (OEC).

56. Although the European Union remains the region’s primary trading partner, other new players are emerging on the scene. Turkey has become an important trading and investment partner while the Gulf countries and China are offering closer economic ties including investments in the region’s critical infrastructure. The skyrocketing Montenegrin tourism industry has benefited from Chinese investment developments in the framework of the “16+1 format”⁷ (Atli, 2016). China Pacific Construction Group has signed a \$3.19 billion deal to construct a highway between Montenegro and Albania and China Civil Engineering Construction Corporation has launched a four-year programme to construct the Montenegrin portion of the Bar-Belgrade highway. This project, financed by a \$1 billion EXIM (Export-Import Bank of the United States) loan to the government of Montenegro, was considered a threat to fiscal stability by the International Monetary Fund and the World Bank, which, in turn, withdrew a \$50 million budget support loan to Montenegro (Reuters, 2014).

VI. IMPEDIMENTS TO REGIONAL COOPERATION AND INTEGRATION

57. The EU’s Stabilisation and Association Process (SAP) rests on four pillars including “regional cooperation and good neighbourly relations”. It characterises development along these lines as a condition for EU membership. Regional cooperation in the Western Balkans is obviously vital to long-term stability and is generally understood as a possible catalyst for reconciliation and political dialogue. The region’s governments have also advanced the notion of deeper integration both bilaterally and in a multilateral fashion. Serbia, for example, has been particularly active in promoting the idea of establishing a customs union to facilitate regional trade and make the region more attractive for foreign investors. The European Union has sought to foster a range of cross-border agreements covering a number of sectors to advance these goals. These include the free

⁷ “The 16+1 format is an initiative by the People’s Republic of China aimed at intensifying and expanding cooperation with 11 EU Member States and 5 Balkan countries (Albania, Bosnia and Herzegovina, Bulgaria, Croatia, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Montenegro, Poland, Romania, Serbia, Slovakia, Slovenia, the former Yugoslav Republic of Macedonia) in the fields of investments, transport, finance, science, education, and culture” (Ministry of Foreign Affairs of the Republic of Latvia, 2017)

circulation of goods, services and people. This is critical because one of the most compelling structural economic weaknesses are the limited size and the fragmentation of the regional economic space, both of which have greatly hindered economic growth. There are currently six SAPs in force: with the former Yugoslav Republic of Macedonia (2004), Albania (2009), Montenegro (2010), Serbia (2013), Bosnia and Herzegovina (2015) and Kosovo (2016). The agreements aim to progressively establish a free trade area between the EU and the Western Balkans. Where trade is concerned, they focus on liberalising trade in goods, aligning rules on EU practice and protecting intellectual property. Implicit in all of this is a liberalising trend among the countries of the region as well.

58. The Central European Free Trade Agreement (CEFTA), linking the Western Balkans and the Republic of Moldova since 2006, is one of the main instruments supported by the EU for the liberalisation of regional trade and services targeting over 55 million consumers. CEFTA, however, has not served as a powerful catalyst for regional trade, which has actually declined over the past two years. As suggested above, the EU is the Western Balkans' largest trading partner, accounting for over 76% of the region's total trade. The region's share of overall EU trade, in turn, was 1.3% in 2016, with Serbia accounting for 0.59%, Bosnia and Herzegovina (0.26%), the former Yugoslav Republic of Macedonia (0.24%), Albania (0.12%), Montenegro (0.03%) and Kosovo (0.03%) (European Commission, Trade Website).

59. To enhance regional partnership, the leaders of the South-East Europe Cooperation Process (SEECP) have established a cooperative framework – the Regional Cooperation Council (RCC) – aimed at promoting European and Euro-Atlantic integration, as the successor of the EU's Stability Pact for South Eastern Europe. The RCC aims at developing close working relationships in a range of areas including economic and social development, energy and infrastructure, and justice and home affairs. This broad approach to regional cooperation is reflected in the ambitious SEE 2020 Strategy which targets unemployment, intra-regional trade, GDP growth and government effectiveness. The agenda of the Regional Cooperation Council is intended to reflect the strong support of citizens for a higher degree of regional cooperation. Indeed, more than three quarters of people in the region believe that regional cooperation can contribute to prosperity in the SEE region according to the RCC's Balkan Barometer 2016.

60. It is also worth noting that the EU and member governments are strongly promoting the accession of the countries of the region to the World Trade Organization (WTO). Albania (2000), the former Yugoslav Republic of Macedonia (2003) and Montenegro (2011) are already WTO members while Serbia and Bosnia and Herzegovina are negotiating the terms of accession to the world trade body. Once all are in the global trading body, by definition, they will have accepted its rules and norms. This could help foster a higher level of regional integration, while developing a global trading profile for the region.

VII. THE MIGRATION CRISIS IN THE WESTERN BALKANS

61. The mass migration crisis of the last two years has generated renewed attention along the so-called Western Balkan route⁸. In 2015, the region recorded 764,000 cases of illegal border crossings by migrants, a 16-fold rise from 2014 (Frontex). Subsequently, Western Balkan countries with Western support have now managed to reduce illegal border crossings. However, these severe strains of migrant flows have exposed deeper political and economic tensions in the region (Lange, 2016).

⁸ The Western Balkan Route is composed of two migratory flows: one from the Western Balkan countries, and the other by migrants having entered the EU via Turkey, in Greece or in Bulgaria, and trying to reach the Schengen Area.

62. The crisis peaked in 2015 when Hungary closed its border with Serbia, which, in turn, diverted migrants across its border to Croatia. The deal struck between the EU and Turkey dramatically stemmed the tide of asylum seekers into Europe but thousands have been left in camps throughout the Western Balkans caught in a legal and humanitarian limbo. 62,000 have been left in Greece and roughly 6,000 are living in camps in Serbia. Throughout the region, conditions for these migrants are difficult (Squires). The International Organization for Migration (IOM) told members of this sub-committee that Serbia responded with skill and generosity under very trying conditions and actively coordinated its response with its neighbours. But conditions are difficult and both the Serbian government and UN are working with those people who cannot qualify for asylum to return to their countries. Roughly one million migrants transited through region and nearly 6,000 have remained in Serbia and are receiving support from the Serbian state as well as the international community and a range of NGO's.

63. The flow of refugees in the region is particularly emotive as similarly large movements of people occurred during the region's wars in the early 1990s. There are still 142,000 refugees and internally displaced persons who have not returned home in the wake of the Balkan wars of the 1990's (Lehne). Some illegal border crossings throughout the Western Balkans route continue and the Greek former Yugoslav Republic of Macedonian border has been a particular source of concern. Bosnia and Herzegovina, for example, openly acknowledges that another wave of migrants could pose enormous burdens on its fragile economy. Although it can manage flows of those in transit, it is not prepared to handle a large influx of migrants remaining in the country. The fence recently constructed between Serbia and Hungary could divert migrants through Bosnia and Herzegovina, and this could seriously test its financial capacity and political stability. Only 218 illegally crossed into Bosnia and Herzegovina in 2016, but that figure cannot be used to predict the future (Spaic).

64. Finally, the uncontrolled mass migration also created an opportunity for some Western Balkan inhabitants to migrate to Western Europe albeit in an irregular fashion. This was alarming because it reflected a lack of confidence in the future of the region by many of those who were suffering from the region's economic malaise. At the very least, it points to the need to redouble reform efforts to foster a sense of opportunity in countries where too many have begun to lose hope. But it also expressed, in graphic terms, the region's 'European aspirations. If the West will not come to the Western Balkans, many Western Balkan people will move west. In this sense, this mass migration has been both an expression of frustration and aspiration at once. It is now up to the region and its supporters to decide in which direction the region moves.

VIII. CONCLUSIONS

65. The Western Balkans have been caught in a vicious cycle of confrontational politics, state capture, failing power sharing arrangements, and a Euro-Atlantic community that seems increasingly remote. Of course, Euro-Atlantic integration is hardly a panacea for all the challenges the region confronts, but both the EU and NATO provide the kind of institutional support and incentives that will make it possible to give the liberal democratic idea a fighting chance to flourish in the region. Both institutions need to remain deeply engaged for the region to make progress toward political stability, security and prosperity. By extension, they also need to hold out a genuine membership prospect for those countries that have met all the qualifications.

66. As this report has suggested, the Western Balkans are not immune from the challenge of disinformation and destabilisation campaigns, which have become a staple of Russia's foreign and military policies. Russia has little to offer the region in terms of economic opportunity or building sustainable regional stability—few Western Balkan migrants head for Moscow or St. Petersburg. The Western Balkans are economically, politically, and socially vulnerable, and as one scholar recently noted: "The Russians see the Balkans as the West's underbelly and they use it to throw

their weight around and project power on the cheap” (Surk). Obviously, Russia will play a role in the region’s economies as well, but its own serious economic difficulties belie the widespread notion in the region that it is an economic power rivalling the EU and the United States. That points to a worrying gap between perception and reality and it suggests that the region’s governments, public institutions and media could do more to align perceptions with fact. Obviously, there is a role for the EU and its member governments to play on this front as well. For its part NATO too needs to do more to correct misperceptions about its role and purpose and this is particularly important in those areas where the public holds increasingly negative views of the Alliance often based on half-truths pushed through the media.

67. Indeed, it is far easier to set fires in this region than it is in Western Europe or North America for that matter, and Russia has come to see nationalist rabble rousers as natural allies. The weaponisation of ethnic identity is highly dangerous anywhere but particularly in a region that was recently beset by sectarian and ethnic war. This particular tactic has also facilitated state capture in the region by small groups who capably exploit fear and mistrust to perpetuate their lock hold on power. Constant efforts are needed to counter this kind of politics, deescalate tensions which have been rising in recent years and construct coalitions premised on the politics of economic reform, democracy building and European integration. This is not an easy task but the ambitions should be clear and it should unite reformers with those in the international community that share those goals and understand that it is the only way forward for this still troubled region.

68. This too makes it incumbent for the EU and NATO as well as key allies like the United States to remain deeply engaged in the region to provide a framework through which regional actors can advance democratic reform and achieve broader reconciliation. More support is needed for judicial reform, and a broad effort is essential to foster a more independent media capable of casting a light on governments that prefer to keep a good share of their dealings in the shadow. Ultimately the people of the Western Balkans need to develop their own sense of vigilance about these matters. But they also require good information and frameworks for constructive civil engagement. Corruption and good governance are simply impossible without an engaged civil society informed by an active and independent media.

69. One of the most compelling risks to the region, and even to Western democracies more generally, is the inherently contradictory notion that illiberal democracy which oddly combines a high concentration of power in the hands of a few with nationalist ideologies and ostensibly liberal economic policy. These kinds of combinations are dangerous for the region, antithetical to European and democratic values and are a dead end for the Western Balkans. Authoritarianism is not a formula for success in the Balkans where the problem has been the absence rather than a surfeit of democracy. The problem is that such notions are given sustenance as well by concerns about the importation of more radical interpretations of Islam to the region. There has been a problem of foreign fighters moving to Syria and elsewhere to join radical forces fighting in the Middle East and North Africa. Efforts are underway to develop deradicalisation programmes but these efforts need to be redoubled. These groups pose a threat to the region and that threat is further multiplied insofar as it inspires violent nationalist reactions that feed populist and anti-democratic politics in the region. (Mandaci). It is helpful that the Islamic community in a country like Bosnia and Herzegovina has a recognised head of the faith and a reasonably centralised organisational structure which is dedicated to countering violent extremism and encouraging tolerance.

70. Corruption and rule of law matters in the Western Balkans remain a serious concern and continue to constitute a daunting problem that must be overcome on the way to EU accession. The political systems of the region need to become more transparent and accountable. Media has a potentially important role to play here, but when the media is controlled by political and economic elites bound together in patronage networks, this potential power is curtailed. This is yet another reason that media reform is essential. There is also some scope to develop regional approaches to

the corruption problem including information sharing and the development of best practices. Judicial reform is also essential in the region. There are concerns that judges far too frequently reinforce state capture and are not genuinely in the business of administering justice, enforcing contracts etc. This is of concern not only to democratic reformers but also to potential investors who need confidence in the court systems to manage risk.

71. Faith in the political and social institutions of the Western Balkans has begun to weaken and this is enhancing the appeal of strong leaders with little patience for democratic consensus building. For these leaders, democracy is not an end in itself, and only offers a vehicle for the consolidation of authority in the hands of those who believe that solutions to highly complex issues can only be solved by the anointed few. Needless to say, this is a highly dangerous notion and one that needs to be countered by those from the region and beyond who advocate for open transparent societies, democratic and free market reform and who loudly condemn actions that undermine cross border and cross community cooperation, democracy, and civil society development and engagement. Support for the tools of building democratic dialogue and institutions remains essential, and it is imperative that current and future leaders of these societies are directly exposed to the ways this has worked in the West. Europeanisation must be recoupled with democratisation and this will require a revived sense of partnership with these countries. Failure here will only mean further drift away from democratic ideals and integration (Feilcke). Obviously, there is a role here for Western European countries that are not in or that are leaving the EU but which remain dedicated proponents of liberal markets, democracy and international cooperation. In light of concerns about the abuse of power, media domination and voter intimidation, intensive international election monitoring should remain a priority throughout the region and should include scrutiny of the campaign process.

72. It is essential to communicate to the government and directly to the people of the region that the Euro-Atlantic community is a community of democratic values and one that places a premium on free markets, social solidarity, and good governance. There is no one size fits all approach in this regard. But what is and is not democratic is generally fairly apparent. The principles of free speech, free press, the right of majority coalitions to form governments, the development of an autonomous civil society, religious freedom and tolerance, democratically controlled militaries, good governance standards that make corruption ever more difficult, and market rules that create an even field for market players are among the core standards that these countries must seek to build and sustain whether or not they expect to join the EU or NATO, membership of which is ultimately their choice. There can be no compromise on these issues. For its part, the international community, the EU, NATO and their member states must provide critical and sustained support so that this region has a better chance of achieving these standards.

73. Greater efforts are needed to correct public misunderstanding of the role and purpose of critical institutions like the EU and NATO and special efforts are needed to reach out to the media which far too often relies on peddling sensationalist misinformation that has begun to have a very corrosive impact on public attitudes toward government. Support to foster higher quality, independent reporting is much needed throughout the Western Balkans and governments need to be more frank about their level of cooperation and economic integration with the West. When publics consistently misunderstand the nature of these relationships, a growing dissonance between government and the public becomes more likely and this is destabilising and ultimately undemocratic.

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