A European "new deal" for the Balkans

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Western publics are being told that the path has been laid for resolving the decade-long crisis in the Balkans. But nothing could be further from the truth. The Balkans have reached a fork in the road. The political will in Europe and North America to act in Kosovo will not last. The two to three years remaining before Western attention turns elsewhere give little time to provide a framework for reform. An explicit strategy is needed now. It is naive to think that sound money and free-trade will end the Balkan crisis. That they are essential in raising living standards and halting the baleful trend of nationalist politics. Until this happens, issues of borders, sovereignty and political orders will remain unresolved and exploitable.

FULL TEXT

GREAT EXPECTATIONS

THE NATO CAMPAIGN in Kosovo has been hailed as a decisive turnaround in Western policy toward southeastern Europe. With Yugoslav security forces out of Kosovo and the inauguration of the European Unions Stability Pact at the Sarajevo summit of July 30, committing the EU to eventual acceptance of the area's states as members, Western publics are being told that the path has been laid for resolving the decade-long crisis in the Balkans. But nothing could be further from the truth.

The basis for long-term stability and non-nationalist politics in southeastern Europe lies in its economies, and here the picture is bleak. Croatia, once celebrated for its macroeconomic reform, is on the brink of a financial nosedive with 20 percent unemployment. The recent enthusiasm for Romanian economic reforms has given way to doomsday scenarios. In Albania and Macedonia, the economic effects of the Kosovo crisis have interrupted serious progress on recovery and reform and now threaten plummeting growth rates and political instability. A sharp decline in foreign aid for Bosnia will hit well before the reforms needed to create jobs are complete. And the great expectations for the Eu's Stability Pact remain blocked at the region's center by the apparent durability of Slobodan Milosevic's regime. Without a solid foundation for jobs, growth, and improved social welfare, the region could settle into a stalemate of chaos and Western crisis management for years to come-as locals already gloomily predict.

Beyond immediate humanitarian relief and reconstruction aid, the international community's current answer to this problem is conditionality: reform yourself, and then we'll talk. Reform is indeed vital. But the origins of the Yugoslav crisis lie in the collapse of reform efforts precipitated by the immediate post-Cold War political, economic, and security vacuum. As long as the West continues to view the crisis in terms of endemic nationalist conflict and ethnic hatred, rather than in terms of its own (remediable) policy failures, progress on reform will not be made.

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THE LIMITATIONS OF AID

FOR THE UNITED STATES and Europe, the immediate legacy of the war in Kosovo is urgent humanitarian and reconstruction tasks. But the larger the bill becomes, the more tempting it is for the West to assign the cost to a larger and qualitatively different task: limiting further armed conflict and reforming dysfunctional political and economic systems. Financial aid will not accomplish this.

As in other war-torn parts of the world, the dangerous myth is being spread that much-needed private foreign investment will naturally follow major international aid. Bosnia proves the contrary After $4.5 billion of multilateral commitments in 1996-98 and a massive inflow of bilateral aid, the Bosnian economy is scarcely more viable than it was when the Dayton Accord was signed in 1995. Reports of financial corruption among Bosnian officials who manage public and donor funds, combined with delays in creating the cumbersome Daytonprescribed economic institutions, have driven away Western corporate investors. Meanwhile, as the international community shifts its attention to Kosovo, Bosnia faces the dismal prospect of beginning repayment on the principal of its foreign debt in 2002.

Whether one looks at the slow delivery and disappointing results of aid, at the costs of debt repayment, or at official corruption and aid dependency, the conclusion is the same: Financial aid will not bring about a self-sustained, self-governed peace. Indeed, aid can even hinder it. Peace requires fundamental political and economic reform. Western assistance can be instrumental in achieving this. What is required is nothing short of a European "New Deal."

EUROPEANIZATION

IN THE WAKE of Yugoslavia's violent dissolution, southeastern Europe's economy has become dangerously fragmented. Current political dynamics will keep it that way indefinitely. Insecurity over borders, national identity, and tenuous claims to sovereignty sustains trade, tax, and tariff regimes that aim at solidifying political control and enriching those in power at the expense of ordinary people.

The process of European integration has inadvertently fueled disintegration across the southeast. Nations such as the Slovenes and the Croats have struggled to detach themselves from the region and recast themselves as lost sheep of the West, returning to the European flock. Meanwhile, poorer areas are left out in the cold, since wealth is the primary criterion for Eu attention. The end of Europe's Cold War political division should have enlarged the southeastern market and gradually incorporated it into stabilizing European economic and security systems. Instead, the conditionality approach to Eu accession has encouraged a new division in Europe based on economic disparities. The result is a hardening of Balkan borders-bringing tariffs, smuggling, bribery, organized crime, and mutual suspicion instead of trade and investment flows.

Outsiders push Balkan integration schemes to counteract this development, but such efforts are doomed to fail in the face of local insecurity and political resistance. The Balkans need the leverage that can be achieved only by satisfying the region's single common aspiration: "Europeanization."

In practice, Europeanization means extending the cross-border monetary, trade, and investment arrangements that already operate within the Eu across Europe's southeastern periphery. Upon absorption into enlarged European arrangements, each state must also eliminate corresponding economic barriers with neighbors that have already entered the fold. (Individual states will be free to make the required domestic reforms on their own schedules.) What the region is not achieving politically on an intraregional basis can therefore be achieved within a few years under the aegis of Europeanization. This "New Deal" should apply to all states in the region-Albania, Bosnia, Bulgaria, Croatia, Greece, Hungary, Macedonia, Romania, Slovenia, Turkey, and Yugoslavia-with no state's existing Eu affiliations jeopardized or set back through participation.

By pursuing purely economic integration with the southeast, the EU would avoid having to impose political conditionality for participation, an approach that has proven dismally unsuccessful to date. Indeed, conditionality would be entirely self-defeating. Early staged entry into liberal European economic regimes will encourage private-sector development, reduce the state's economic role, underpin the rule of law, and increase the benefits of forswearing violent conflict over resources and national boundaries.

THE MONETARY IRON CURTAIN

FIRST, the new integration agenda should tear down the monetary iron curtain that currently divides western Europe from its southeastern periphery. The EU could contribute enormously to stability by spreading Europe's single currency (the euro) to the region prior to full EU membership.1This would enjoy local popular support and provide the most tangible evidence possible of the EU's commitment to unifying the continent rather than marginalizing the Balkans.

Macroeconomic stability is vital to both political reform and economic growth. Without it, a state could face the same fate as Indonesia, where the political system and the economy were dangerously undermined by a collapse of the exchange-rate regime. Furthermore, foreign assistance for private-enterprise development will be useless unless macroeconomic stability-a clear prerequisite for rational business planning and investment-backs it up. World Bank and International Finance Corporation (IFC) projects have performed poorly, and foreign private investment is lower, in countries with high inflation, bloated fiscal deficits, and steep trade barriers.

In turn, monetary and exchange-rate regimes must be backed by sufficient financial resources and credible institutions to weather the inevitable economic shocks. But the standard tools used to ensure price stability in developed countries, such as inflation targeting and moneysupply targeting, are not enough in undeveloped states where the central bank lacks credibility and economic volatility is much greater. Hence a different approach is needed. One option is exchange-rate pegging, which has frequently been used to import monetary discipline and credibility from major trading partners with internal price stabilityparticularly the United States and Germany-to shakier economies. The deutsche mark has provided this monetary anchor in Croatia since independence and more recently in Macedonia. These currency regimes, however, may suddenly collapse when a country runs up a large current account deficit or investors fear a faltering commitment to the peg-as seen most notably in Thailand, Indonesia, Malaysia, South Korea, Russia, and Brazil. Such regimes may be buttressed by capital controls, but this means giving up much foreign investment. A radical but sensible alternative is to abandon national currencies and adopt a major currency-in this case, the euro.

Why the euro? First, monetary independence is often not conducive to high levels of foreign investment, economic growth, and political stability. Indeed, a sovereign currency in a developing country often acts as a risk factor that raises the cost of access to international capital; monetary sovereignty can also provide governments with an excuse for taking "exceptional" political measures that limit personal freedom and harm private business interests. Second, the deutsche mark already serves as a strong parallel currency in southeastern Europe, especially for large transactions. It is now Kosovo's currency under the international transitional administration. The people's monetary preference is demonstrably unaffected by nationalist sentiment. Debates over how well an expanded euro zone would approximate an "optimal currency area" could keep economics journals well stocked for years but have little practical meaning when the populace does not wish to hold the "official" national money.

Moreover, currency boards of the sort that currently operate in Bulgaria and Bosnia are a poor alternative to spreading the euro. Even Argentina's eight-year-old regime is not robust enough to keep investors from viewing peso deposits as riskier than dollar deposits; peso deposits normally yield around three percentage points higher than their dollar counterparts, rising to double digits during international market turbulence like the Mexican crisis of 1995. Nothing short of adopting the euro will eliminate these costly risk premiums in the Balkans.

Under an expanded European monetary union, the Balkans' central-bank functions would be either transferred to the European Central Bank or eliminated. Since there would be no traditional lender of last resort standing behind the national banking systems, financial reforms (requiring up to two years to implement) must be completed before this takes place. Better-capitalized Western banks would need to increase their presence on the ground, and much greater market discipline must be imposed on Balkan banks. To reduce insolvency risk, the governments should obligate local banks to issue bondssay, equivalent to two percent of their total deposits. Bondholders would be barred from receiving government bailout money in case of a bank collapse. Bond yields would rise and fall as they are traded on the market according to investors' perception of the banks' insolvency risk. An extreme rise in bond yields would then provide regulators with a clear signal that the time to intervene has come. By using such market signals to gauge the health of these banks, the region's fledgling supervisory systems would significantly enhance their limited monitoring capacity. Such reforms are desirable in their own right. And although cynics could point to failure in much of the region's financial reform to date, preparing for the euro would be a far more effective catalyst for government action than conditional loans from the International Monetary Fund (IMF) and the World Bank aimed at reforming the banking system.

It is no secret that the euro's origins were political, not economic. But no political gesture could now better unify Europe, generate prosperity beyond the Eu's borders, or raise the EU's world profile than extending the euro to southeastern Europe. Such a gesture would require no amendment to EU treaties and no expansion of monetary policy control beyond the current euro-zone membership.

EXPAND THE COMMON MARKET

ALONG WITH monetary stability, the Balkans' economic revival depends on a broad liberalization of foreign trade and investment. While the countries of the region have become less integrated with each other this decade, their comparative advantage in many sectors has favored growing ties with western Europe. Indeed, trade with the EU is becoming increasingly important to the region's economies. Even Macedonia now conducts 42 percent of its trade with the Eu-not far below U.K. levels. On the other hand, economic integration plans limited to southeastern neighbors would achieve little. The region's governments will resist any external initiatives that might block their rapid and full integration into the West.

As with monetary policy, the EU must take the lead in trade and investment liberalization. It already has economic ties with non-EU countries like Switzerland and Norway that could adapt quickly to an integration agenda for southeastern Europe. In the course of meeting the legal requirements for participation, Balkan countries would have to slash trade and investment barriers among themselves. Thus what would be politically impossible on a purely subregional basis can be achieved on a European one.

Such a "New Deal" for the Balkans would first establish a freetrade area, modeled after the European Free Trade Association, which would slash all internal tariffs. That would be followed by a customs union-modeled after current Eu arrangements with Turkey or Cyprus-to harmonize external tariffs with nonmembers. This push would conclude by establishing a full common market with all EU Single Market requirements based on the current European Economic Area, guaranteeing free movement of labor and capital. A free trade area could realistically be launched as early as next year. Countries could join the customs union and common market on a flexible timetable, so the most zealous reformers would enjoy the benefits soonest. Agricultural protectionism is the biggest stumbling block for trade liberalization on both sides, but a new World Trade Organization round must address the issue in any case.

Spain and Portugal are good examples of how Europeanization can bring lasting political and economic benefits. Without any prior intra-Iberian preparation for integration, both states joined the EU in 1986. Today, they have firmly entrenched democratic government, GDP growth above the Eu average, declining inflation, and excellent bilateral political relations.

The effects of war in the former Yugoslavia might suggest that the Balkans are different-but the right context can foster a similar transformation. Consider Bosnia, where the extremely low return rate for minority refugees is often seen as Dayton's primary failure. But the current obstacle to return is no longer security fears but economic concernsnotably the absence of jobs and houses. An expanded European common market would give a new, moderate Croatian government the economic carrot and political cover to let Serbs return from Bosnia, thus freeing up Bosniac and Croat houses in Bosnia. It would also benefit Bosnian internal integration. The NATO bombing campaign allegedly had the positive political effect of diverting the trade of the Bosnian Serb entity, the Republika Srpska (R.S.), from Yugoslavia to the Bosnian Federation. But it did so only at the cost of tripling the R.S.'s import bill, due to high tariffs on goods originating from Slovenia, Croatia, Hungary, and Austria. Eliminating

such tariffs would not only sustain but also expand this trade dramatically, helping the R.S.'s moderate prime minister, Milorad Dodik, at the expense of radical Serb nationalists.
Farther south, Montenegro's independence movement is fueled primarily by anger over economic stagnation and growing anxiety that time is running out for economic reform. But a concrete Europeanization program would offer a viable alternative to a very risky political gamble on outright independence that could threaten further instability and violence in the region. Throughout southeastern Europe, centrist, pro-Western liberals are reemerging in politics. The Western mistake in 199o-91 was providing insufficient support for these reformers. It would be a tragedy to repeat that error.

KEEPING THE STATE IN CHECK

THE WEST should manage economic development aid by principles different from those guiding humanitarian and postwar reconstruction aid. The latter addresses immediate economic needs, whereas the former should foster market economies. But development aid channeled through state institutions is more likely to hinder than help such a transformation. Corruption and mismanagement of public and donor funds, particularly egregious in Bosnia, are only one part of the problem. The other pitfall of channeling aid through governments is that it reinforces state patronage and protectionism and inhibits new private businesses and cross-border economic ties.

Outside aid will complement the strategy of Europeanization most effectively if it supports nonstate actors. Development assistance should therefore be extended directly to private local institutions or be used to leverage private Western financing of Balkan projects. Cross-border projects will have the added benefits of exploiting regional economies of scale and stimulating complementary investment and trade. Since they promote cross-border cooperation on the basis of mutual economic self-interest, they would be less likely than state initiatives to be disrupted by political disputes. Finally, the West should make equity investments in Balkan business a priority. The region is already awash in debt. Diversified equity portfolios of new and existing enterprises in transition economies have historically yielded much better returns than debt for given levels of risk, making equity investment far more cost-effective from the donor's perspective.

THE PROBLEM OF SERBIA

ANY STRATEGY aimed at ending the Balkan crisis will fail if it does not include the region's center: Serbia. Western governments face a serious political dilemma as long as Yugoslavia is ruled by leaders indicted for war crimes. Time matters, and the continuing isolation of Serbia makes the process of political change and economic reform far more difficult and prolonged.
If paired with a clear message and European commitment to the Serbian population, the indictments do provide a way out of this dilemma that the sanctions regime did not. By distinguishing between culpable leaders and the Serbian people, and between specific indictable offenses and ethnically defined guilt, the West can construct a real policy toward Serbia as a normal part of the region. It must first communicate its commitment clearly after years of shifting goal posts and pursuing policies that have helped Milosevic instead of the opposition. No positive political change can occur until the damaging psychological effects of isolation are reversed and the legitimacy of a pro-Western platform is restored after the damage done by the NATo bombing campaign. A concrete Europeanization program will provide the basis for anti-Milosevic dissidents to transform themselves into a genuine political opposition, for professionals and lawmakers to prepare the technical groundwork necessary for Serbia's political reintegration into Europe, and for the West to resolve its dilemma without compromising its principles.

NO ECONOMY WITHOUT SECURITY

BECAUSE CURRENT Balkan border controls are based partly on genuine security fears, a staged liberalization of the flow of goods, capital, and ultimately labor will actually increase these concerns. But technical solutions exist. Along with the economic program, security assistance should be provided to enhance surveillance of maritime and land borders, enable the use of fraud-resistant documentation by contiguous countries, increase information-sharing among national authorities, and improve the management of such information by law enforcement agencies. The initial work of the Southeast European Cooperative Initiative demonstrates that officials and professionals can cooperate over border issues if given the opportunity.

At the same time, the enormous amount of money and effort now devoted to developing the Bosnian border police and their customsrevenue collection runs counter to the liberalization necessary for ending corruption and political contests over economic resources. Since border controls and continuing fights over political autonomy serve the interests of rent-seeking politicians, smugglers, and criminals, the fact that actors outside the political system can benefit directly from a European "New Deal" is critical for its success. Until there are alternative avenues to wealth and welfare, independent of political loyalty, there can be little hope of true democratization.

NATo and the United States must maintain a presence in the region for some time to establish a stable environment for reforms. But beyond providing temporary security for the peace process in Bosnia and Kosovo, NATO must clearly underscore its commitment to Europeanization. NATo accession rightly requires conditionality to ensure the alliance's continued effectiveness. But this is a long-term process, and significant interim steps can be taken that would help stabilize the region. Just as NATO was essential to the Marshall Plan's postwar peace and European integration after 1947, it can reprise that same role in southeastern Europe today. The proliferating military bases in the region already provide the support for a NATO land headquarters. NATO should build on its new consultative frameworks to replace a strategy of containment with one of incorporation.

The EU's Stability Pact and its new accession process (the Stabilization and Accession Agreements) are a major step forward in Western policy. For the first time, the Eu has committed a real prospect of membership to the states in the Balkans. But that is all it has done. It remains a shell without a strategy-and all the evidence suggests that progress will be painfully slow. By failing to send its message clearly, the Eu threatens to worsen cynicism in the region rather than stimulate reform. As for the Eu's regional approach, its conditionality principle remains the same: if a country meets certain standards, the rewards of staged relations will follow. But this approach has failed, keeping southeastern Europeans hostage to the interests of a handful of politicians while offering little prospect for a genuine regional transformation.

It is naive to think that sound money and free trade will end the Balkan crisis. But they are essential in raising living standards and halting the baleful trend of nationalist politics. Until this happens, issues of borders, sovereignty, and political orders will remain unresolved and exploitable.

Footnote

1This position is also advocated in a recent working paper of the Center for European Policy Studies in Brussels, A System for Post-War South-East Europe" (1999).

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