South East European Studies
at Oxford

workshop report

The Western Balkans and the Berlin Process

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South East European Studies at Oxford

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This report draws on discussions at the workshop on "The Western Balkans and the Berlin Process" held at St Antony's College, Oxford, on 13 June 2018, and organized by SEESOX in cooperation with the Bank of Albania. The participants included academics from the Western Balkans, University of Oxford, and LSE, as well as officials from the European Bank for Reconstruction and Development (EBRD), and representatives from Oxford Analytica. The report represents SEESOX's interpretation of discussions—which were held under the Chatham House Rule—and does not purport to reflect the views of any particular participant.

Convenors: Othon Anastasakis, Adam Bennett and Peter Sanfey

Preamble

In recent years, regional cooperation in the Western Balkans has been boosted by the development of the "Berlin Process" – a series of annual meetings of the six Western Balkan prime ministers and seven EU member states with a strong interest in this region.[1] The next meeting within this process will be hosted by the UK and will take place in London in July 2018. This meeting comes at a challenging time, both for the EU and for the Western Balkan countries themselves.[2]

The SEESOX workshop [3] was convened to assess the current state of the political economy of Western Balkan countries, in light not only of the July 2018 London conference but also in view of the adoption in February 2018 of a new strategy by the European Commission for the region. The programme covered issues related to functional integration—the main theme of the Berlin Process—as well as the complementarities with the enlargement agenda. Discussions focussed (inter alia) on the key areas where Western Balkan states lag behind EU countries, including transport connectivity, the digital economy, education, foreign direct investment, and financial services. The

[1] The Berlin Process is a diplomatic initiative linked to the future enlargement of the European Union. It was initiated by Chancelor Angela Merkel in order to sustain the dynamics in EU integration process in the light of increased euroscepticism and a serious slowdown of the accession process. It began with the 2014 Conference of Western Balkan States in Berlin, and was followed by the 2015 Vienna Summit, the 2016 Paris Summit, and the 2017 Trieste Summit. The goals of the Process were outlined in the Final Declaration by the German Chair in 2014: "To make additional real progress in the reform process, in resolving outstanding bilateral and internal issues, and in achieving reconciliation within and between the societies in the region", as well as to enhance "regional economic cooperation and lay the foundations for sustainable growth".

[2] The Western Balkans, for the purposes of the Berlin Process, comprise Albania, Bosnia and Herzegovina, FYR Macedonia, Kosovo, Montenegro and Serbia. This workshop took place one day after the agreement between Greece and FYR Macedonia on 12th June 2018 to change of the country to "North Macedonia".

[3] For a SEESOX led analysis of the evolution of the political economy of South East Europe (including the Western Balkans) through 2014, see *Economic and Policy Foundations for Growth in South East Europe: Remaking the Balkan Economy*, by Adam Bennett, Russell Kincaid, Peter Sanfey and Max Watson, Palgrave Pivot, 2015.

meeting was structured around three themes: the EU's enlargement agenda, the Western Balkans regional economic area, and the Western Balkan financial architecture.

The Berlin Process and the enlargement agenda – trends and tensions

Participants debated whether the Berlin Process was a substitute for the EU's enlargement agenda, or complementary to it. While the former role was clearly the spur in the wake of fading enthusiasm (both within and without the EU) for further expansion, it was suggested that a reinvigorated enlargement effort on the part of the EU could allow the Berlin process to facilitate accession in a complementary manner. Comparisons were made with the European Economic Area (EEA). The EEA's establishment was originally intended for the EU to engage with members of the European Free Trade Association (EFTA) without EU enlargement (the goal being EU deepening rather than widening). However, by the time the EEA became operational in 1994, nearly half of the EEA signatory EFTA countries were poised to join the EU.[4] In this context, the role of the Berlin Process host country—the UK—in the July Summit could be construed as perverse. Why should Western Balkan countries enthuse about joining the EU when the UK was angling to leave? Some participants questioned the motives for the Berlin Process, seeing it as a vehicle to better protect German investment in the region without any real intention of seeking the region's integration into the EU.

There was also discussion about whether it was best to treat the Western Balkans collectively in this process, in order to avoid cherry-picking future EU members, or to try to generate peer competition to encourage those further behind the reform process to catch up with the leaders. Efforts to foster greater regional cooperation (of which more below) would argue for the collective approach. Yet the demonstration effect of successful early accession of one country (with visible benefits) could provide those in the region who have grown tired of EU mandated reform agendas—with little result so far—with the incentive to renew the reform effort and override the vested interest of the entrenched elites. Some of the latter see little to gain from the strictures of EU membership, and feel they are doing quite nicely where they are operating under questionable governance on the edge of but outside the EU.[5]

Of the UK's Summit's agenda, some participants questioned the emphasis on security.[6] Some felt that the British

[4] Of the seven states that were EFTA members at the time of signing the EEA agreement in 1992, Austria, Finland, and Sweden joined the EU in 1995. Switzerland promptly rejected membership of the EEA in a referendum, leaving Iceland, Lichtenstein and Norway as the remaining (non-EU) EFTA members in the EEA.

[5] The long recession in the region that followed the onset of the global financial crisis in 2008 affected those former Yugoslav countries (Slovenia and Croatia) that were by 2014 members of the EU as badly as (if not worse than) the Western Balkan countries remaining outside the EU and subject to the Berlin Process. Since 2015, on the other hand, all countries in the Western Balkans (as well as EU members Slovenia and Croatia) have been growing steadily.

[6] According to the British Government host, the London Summit will focus on 3 key aims: (i) increasing economic stability with a view to improving the business environment, encouraging entrepreneurship, addressing youth unemployment, and promoting regional inter-connectivity; (ii) strengthening regional security co-operation to help tackle common threats, including corruption, serious and organised crime, trafficking of people, drugs and firearms,

Government was overly concerned about security issues, and that the agenda was unduly weighted towards the interests of the UK (which is concerned about importing terrorism, organized crime and the Russian threat) rather than those of the region. Fears were expressed that strengthening the security apparatus in the region could also reinforce illiberalism, with enhanced surveillance being directed to suppressing internal political opposition rather than combating organized crime or terrorism. Others recognized, however, the extensive corruption in the region—including at the highest levels of government—and its pernicious effects on governance. Lack of progress in reducing corruption, and improving security and the rule of law, were seriously affecting the scale and impact of foreign investment in the region. Participants nevertheless highlighted the need for the Berlin Process agenda to place greater emphasis on other issues as well, such as education, entrepreneurship, inequality, and youth development.[7]

Regional Economic Area – meaning and potential.

Under the Multilateral Action Plan (MAP) for a Regional Economic Area (REA) agreed at the Trieste Summit in 2017, efforts are to be focused on: (i) promotion of further trade integration; (ii) introduction of a dynamic regional investment space; (iii) facilitation of regional mobility; and (iv) creation of a digital integration agenda. This initiative has produced a very wide-ranging list of measures and steps to be taken to further the above objectives. Participants queried the ability of the Regional Cooperation Council (RCC) to oversee this programme's implementation, bearing in mind that it is intended to be complementary to the European Union's (EU) Europe 2020 Strategy and notwithstanding that it is to be assisted by the secretariat of the Central European Free Trade Association (CEFTA).[8]

There was some criticism of the growth of Special Economic Zones in the region (arguably a manifestation of objective (ii) above), which competed with each other in a race to the bottom in tax breaks and subsidies. It was feared that they did little more than shift (rather than create) investment with a resulting fiscal loss. With subsidies linked to employment, it was not clear if this was good value for money, though it was acknowledged that unemployment (which had been extremely high in the region especially after the recession) has been falling rapidly. The point of the REA should be to stop this kind of fiscal competition within it, and instead have fiscal

terrorism and violent extremism; and (iii) facilitating political co-operation – to help the region resolve bilateral disputes and overcome legacy issues stemming from the conflicts of the 1990s and strengthen democracy and gender equality.

[7] There was an extensive discussion about inequality during the workshop, with Bosnia and Serbia having the highest rates of inequality in the region. The region's most prosperous former member – Slovenia – had the lowest rate. These high rates of inequality were linked to regressive or non-existent tax and benefit systems. High rates of inequality were seen as bad for growth and a source of economic and political instability.

[8] The RCC was established in 2008 with the goal of "promoting mutual cooperation and European and Euro-Atlantic integration of South East Europe". CEFTA was established in 1992 to facilitate the engagement of Central and Eastern Europe with the European Union. As countries joined the EU, they ceased to be members of CEFTA. CEFTA members as of 2018 comprise the Western Balkans as defined in this report plus Moldova.

incentives harmonized across the REA. Moreover, some of the subsidies would violate EU State Aid rules, so go in the wrong direction as far as EU accession is concerned. Some of these schemes are also very opaque, and provide opportunities for corrupt practices.

Labour mobility within the region was seen as important in order to ensure that the right skills were available to support the investments undertaken.[9] However, the most damaging mobility has been the emigration out of the region of the most skilled workers, exacerbated by the inadequate rule of law or by their exclusion from key positions by the ruling elites. The role of the region's diaspora was discussed. While they are recognized as an important source of remittances, entrenched interests often view returning migrants as competitors and put in place obstacles to taking positions (e.g., in the universities) in the region—despite officially welcoming their return. Returnees would bring with them not just their skills, but their "social remittances" and new ideas in the application of political economy earned and acquired while abroad in Western Europe and elsewhere. Ways therefore need to be found to make it easier and more attractive for the region's diaspora to return. Nevertheless, two-way traffic in migration is also needed to help the Western Balkans integrate with the EU. To this end, there were calls for a further relaxation of visa requirements to the EU.[10]

Developing a Financial Architecture

Participants reviewed the history of financial intermediation in the region since the beginning of transition. Between 60 and 90 percent of banking in the region prior to the onset of the global financial crisis in 2008 was undertaken by the subsidiaries of European banks (especially Austrian, Italian and Greek banks), which in turn channelled large scale capital inflows into the region in the early phase of transition through 2008. Following the crisis, banks halted these capital flows and would have reversed them rapidly had it not been for the Vienna Initiatives in 2009 and 2011.[11] While exposure of EU banks is now some 30-40 percent lower compared to what it was just prior to the crisis, this decline was managed by the two Vienna Initiatives sufficiently gradually to

[9] An anecdote was cited about the problems in restarting a railway system in Kosovo, despite the equipment and infrastructure being installed. All but one of Kosovo's trained engine drivers were Serbian, and had therefore left.

[10] Apart from Kosovo, citizens of the Western Balkans (since 2009) enjoy visa free travel in the Schengen area for 90 days in any 180 period. The UK and Ireland have opted out of this scheme. It was ironic in the context of this workshop that two of the key envisaged participants from, inter alia, the central banks of Albania (which was cooperating in convening the event) and FYR Macedonia were prevented from attending by delays to approving their UK visas. It was observed that if the UK wants to be a serious player in the Berlin Process, it must not allow such visa snafus to be repeated.

[11] Under the 2009 Vienna I Initiative, officials at the EBRD and IMF and other international financial institutions gathered together representatives of the main commercial banks involved in the region and persuaded them to maintain their exposure, in exchange for commitments from the countries to which they were exposed to enter into arrangements with the IMF, as well as financial support for the affected banking groups from the EBRD and the EIB. The agreements formally covered Bosnia and Herzegovina, Hungary, Latvia, Romania, and Serbia, all of whom entered into IMF programs in 2009. This initiative was followed by the Vienna II Initiative in 2011, which recognized that banks could not commit to frozen exposures indefinitely.

allow domestic deposits to replace foreign capital and thereby avoid an overall contraction of finance in the region.

Notwithstanding the success of the Vienna Initiatives, and the decline in non-performing loans across the region, long term funding in the region has declined since 2008, and has been replaced by a reliance on short term (albeit resident) deposits. The dominance of banking therefore needs to be reduced. Participants welcomed the recent Western Balkans Fund initiative, but underlined that efforts were needed to develop non-bank sources of finance, such as equity funding, as well as the use of corporate debt instruments. Work is needed to align regulations in the region with those in the EU to permit the growth of such markets in the Western Balkans. Finance was also needed to support innovation and help improve the productivity of a declining population and labour force. Banks are not well placed to provide this kind of finance, which is better suited to venture capital vehicles. The UK, with its financial sector expertise, could provide leadership in helping the region replicate such modalities of finance.

There was also discussion about the need for the EU to soften the unintended impact on the region of the flood of post-crisis regulation. The tightening of rules on the definition of capital and risk weights attached to different types of security has had a severe effect on the ability of subsidiaries of EU banks to operate in the region, and explains in large part the retreat of foreign capital that the Vienna Initiatives were designed to slow. While the financing vacuum can be filled in part by banks from other countries such as China and the Emirates, these bring their own problems as well as governance issues and they also suffer from a lack of familiarity with the region (which explains their reluctance to open retail branches in the region). It was argued that the EU and ECB should not treat the Western Balkan region as a "third country" (and thereby bottom of the pecking order in the definition of eligible bank capital) and should follow the lead of the European Banking Authority in treating the region differently on the grounds of their close "vicinity" to the EU and aspirations for EU membership. It was nevertheless recognized that the Western Balkans region is not alone among emerging markets in being victims of the tightening of EU banking standards—which are after all a global phenomenon among the top financial centres. Ultimately, these regulators are responsible to the taxpayers in the home countries of their global banks and their regulations are designed to protect these taxpayers, not those of the borrowing countries.

With special thanks to the Bank of Albania for sponsoring this event

Watson Points

The following ten points were compiled by the convenors as the chief takeaways from the workshop.[1]

1. **Security**; while this is an important concern, it should not be allowed to dominate the London Summit discussions at the expense of other issues. Rules on visa issuance by the UK government for citizens of the western Balkans need to be urgently reviewed.
2. **Reform Fatigue**; there is a need to re-energize engagement between the EU and the Western Balkans, perhaps focussing more on the more human dimensions—on education, entrepreneurship and youth issues—in order to highlight the long term benefits from eventual EU membership.
3. **Coherence**; there needs to be better coordination between the EU accession reform agenda and the REA agenda and a strengthening of the capacity of the RCC to coordinate and help implement the REA.
4. **Regional approach**; the right balance must be struck between treating the Western Balkans as a single region (and thereby, for example, avoiding counterproductive internal fiscal competition), and as individual countries (and thereby rewarding the good performers with resulting peer pressure on reform laggards to up their game).
5. **Third country approach**; consideration should be given to elevating the Western Balkan countries from "third country" status in banking and other fora, taking into account their "vicinity" and EU accession aspirations.
6. **Successes**; more could be done to publicize the positive benefits resulting from implementing the EU's reform agenda in the Western Balkans. This might help those in the region to galvanize support for a renewed reform effort.
7. **Incentives**; (i) the incentives of some political elites in the region are not always well aligned either with those of the EU or with their own people. This dilemma needs to be tackled by, inter alia, emphasizing the importance of the rule of law; and (ii) the fiscal race to the bottom in investment incentives in some Special Economic Zones in the Western Balkans should be avoided.
8. **Missing elements**; the REA is rightly focussed on trade issues, but the agenda could be strengthened to further promote the region's trade in services; more could also be done to address other considerations, such as governance, entrepreneurship, inequality, and youth development
9. **SMEs**; finance for SMEs could be developed using the expertise of the City of London, drawing on its experience in raising long-term finance through equity issuance, venture capital, and crowd funding.
10. **Education**; the UK—a world leader in academia—could help strengthen academic institutions in the region, and help overcome local resistance to allowing the region's diaspora currently located in top universities in Europe and the USA to join (or re-join) the staff of universities in the Western Balkans.

[1] SEESOX conferences and workshops have traditionally been summarized in "ten points" following the practice of the late Max Watson (1946-2014), the former political economy coordinator of SEESOX and the founder of the programme on the Political Economy of Financial Markets (PEFM) at St. Antony's College.

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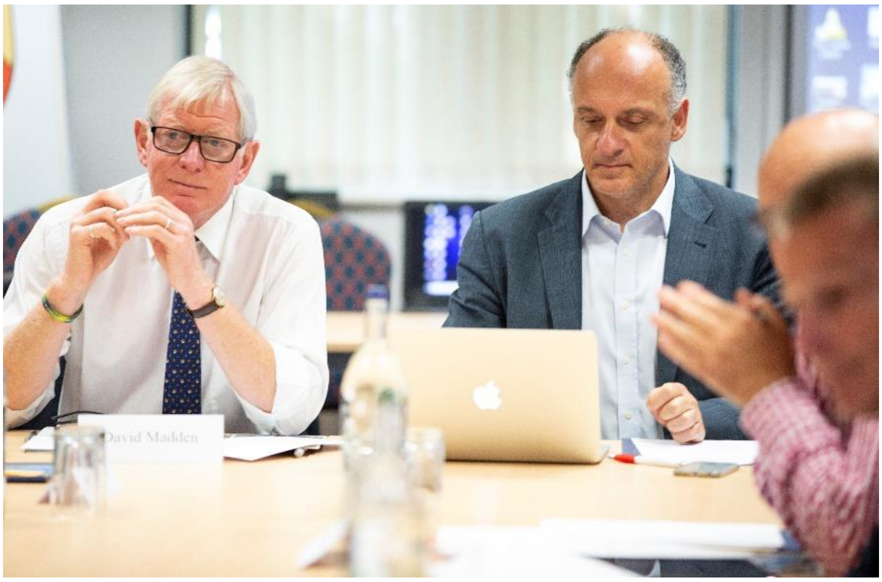
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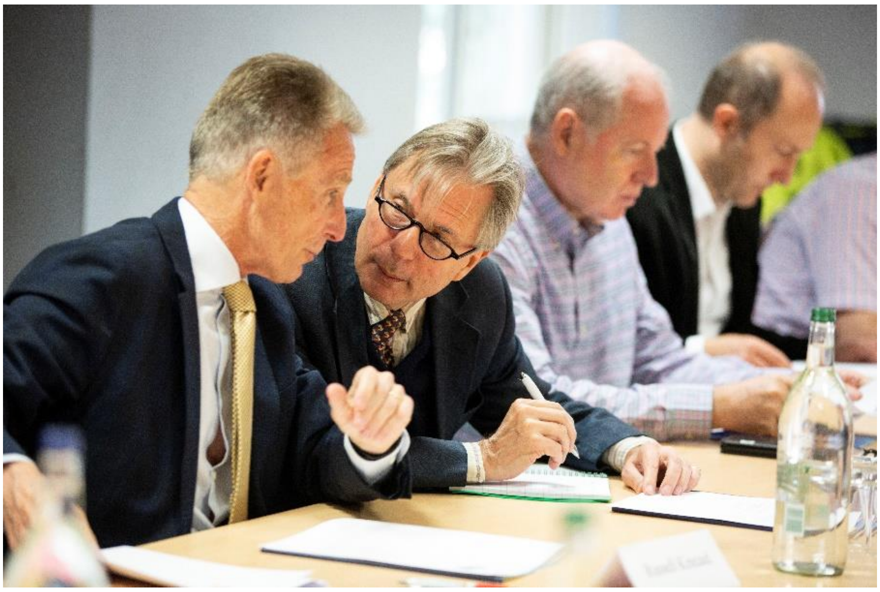

ABOUT SEESOX

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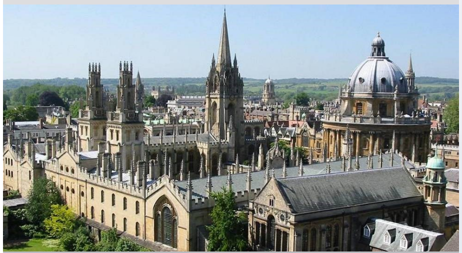
South East European Studies at Oxford

South East European Studies at Oxford (SEESOX) is part of the European Studies Centre (ESC) at St Antony's College, Oxford. It focuses on the interdisciplinary study of the Balkans, Greece, Turkey and Cyprus. Drawing on the academic excellence of the University and an international network of associates, it conducts scholarly and policy relevant research on the multifaceted transformations of the region in the 21st century. It follows closely conflict and post-conflict situations and analyses the historical and intellectual influences which have shaped perceptions and actions in the region. In Oxford's best tradition, the SEESOX team is committed to understanding the present through the *longue durée* and reflecting on the future through high quality scholarship.

SEESOX has the following objectives:

- To support high-quality teaching and research on South East Europe;
- To organise conferences, workshops and research seminars;
- To promote the multi-disciplinary study of the region within the University of Oxford (e.g. politics, international relations, anthropology, sociology, economics) working in collaboration with other Centres and Programmes within the University, including student societies;
- To spearhead intellectual exchanges and debate on these issues among networks of individuals and institutions beyond Oxford;
- To foster cooperation between the academic and the policy making communities.



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