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INSIDE

Central and Eastern Europe and the Global Financial Crisis: Heightened Risks and Rising Vulnerabilities

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Sharon Fisher is Senior Economist at IHS Global Insight. She spoke at an EES Noon Discussion on March 18, 2009. The following is a summary of her presentation. ***Meeting Report 361.***

Over the past few months, the Emerging Europe region has seen a sharp deterioration in its outlook, as analysts have warned about rising risks and vulnerabilities, and GDP growth projections have been steadily reduced. The recent shift in sentiment has marked a significant change from the situation just one year ago, when surging GDP growth and falling jobless rates made labor shortages one of the key problems facing the region, at least in the more advanced economies. Now, many countries in the region are struggling to maintain macroeconomic balance, though complete collapse is unlikely.

Rising imbalances

Benefiting from the accession of 10 former communist countries into the European Union (EU), average GDP growth in Central Europe and the Balkans (CEB) reached some 6 to 7 percent annually from 2004 to 2007. Meanwhile, growth in the Commonwealth of Independent States (CIS) countries was even more robust during those years, ranging from about 7 to 9 percent annually. Strong GDP growth was accompanied by a sharp drop in unemployment rates in most of the new EU member states and candidate countries. Indeed, by 2007, rising labor shortages were seen as one of the main problems facing the Emerging Europe region, representing a key hindrance to the maintenance of high GDP growth rates in the years to come.

Although GDP surged and unemployment declined, a key problem was manifesting itself: sharply expanding current-account deficits. In the CEB region, the current-account deficit jumped from 4.1 percent of GDP in 2003 to 7.0 percent in 2008. The CIS, by contrast, continued to register a large current-account surplus through 2008, thanks mainly to energy-rich countries such as Russia and Azerbaijan. Still, Ukraine's current-account balance shifted from a 5.8 percent-of-GDP surplus in 2003 to an estimated 7.1 percent-of-GDP deficit in 2008.

While a portion of those deficits was covered by foreign direct investment (FDI) inflows, a rising share was financed through external lending. Indeed, foreign debt in the CEB region reached an estimated $1,255 billion by the end of 2008, which was more than double the figure from four years earlier of $545 billion. Excluding Turkey, these figures stood at $959 billion and $385 billion, respectively. As a share of regional GDP, external debt in the CEB region—excluding Turkey—jumped from 50 percent in 2004 to nearly 63 percent in 2008. Among the new EU member states, the 2008 ratio of external debt to GDP varied substantially from country to country, ranging from around 50 percent or less in Poland, Romania and the Czech Republic to over 100 percent in Latvia, Estonia and Slovenia.

Slovenia is relatively protected thanks to its accession to the Eurozone in 2007. Slovakia is the only other country in the region to have adopted the euro, having done so in January 2009, and will therefore be similarly protected. Despite serious delays in joining the Eurozone elsewhere in Emerging Europe, foreign-currency denominated loans have risen rapidly in much of the region during recent years, as

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borrowers have been attracted by low interest rates and seemingly low currency risk. The Czech Republic and Slovakia were the main exceptions to this trend.

When the financial crisis struck in the United States and Western Europe last year, Emerging Europe initially appeared to be relatively immune. While Estonia and Latvia underwent economic decline in 2008, as their housing bubbles burst, many other countries continued to experience strong GDP growth, at least through the third quarter of 2008. The banking sectors appeared quite stable, as regional banks (mostly owned by West European financial institutions) had avoided investments in U.S. sub-

Rising external borrowing costs amid the ongoing global credit crunch have put highly indebted countries at great risk, as rolling over maturing loans has become problematic. This is especially true in countries with large current-account deficits and high levels of short-term debt, many of which have seen deteriorating sovereign ratings.

prime securities. The optimism among government policy makers that the region would escape the crisis was highlighted by the 2009 state budget bills: in a number of Central and East European countries, the budget drafts had initially assumed that GDP growth would reach some 4 to 5 percent this year.

The crisis hits

In the final months of 2008, declining demand in Western Europe finally started to hit industrial output and exports in the Emerging Europe region. Many countries have seen industrial production and exports drop by some 20 to 30 percent year-on-year in recent months, contributing to a sharp rise in unemployment rates. At the same time, falling fuel and commodity prices have had a strong impact on the economies of Russia and Ukraine. Although the region would benefit from an easing of lending restrictions, West European parent banks have been less willing to top up their liquidity in order to pump out domestic loans in Emerging Europe. As a result, household borrowing and investment have been limited, and business and consumer confidence have fallen sharply.

Rising external borrowing costs amid the ongoing global credit crunch have put highly indebted countries at great risk, as rolling over maturing loans has become problematic. This is especially true in countries with large current-account deficits and high levels of short-term debt, many of which have seen deteriorating sovereign ratings. The country facing the greatest risks with regards to the external liquidity gap (calculated based on the current-account balance, short-term debt, interest on long-term debt and principal repayments) is Latvia.

In addition to rising lending costs, the region is also faced with the prospect of sharply declining inflows of FDI, as global companies scale back their investments. Finally, another key source of foreign-currency earnings—remittances from citizens working abroad—is also expected to become scarcer this year. Declining remittance inflows will have an especially negative impact on poorer countries such as Moldova and Bosnia, which rely heavily on such transfers for boosting foreign-currency reserves. As a result of more limited capital inflows, external deficits are likely to narrow sharply this year, forcing a correction of domestic demand. Indeed, this is already happening in some countries.

Exchange-rate regimes are having a key impact on governments' abilities to address the crisis. The region's two Eurozone members (Slovakia and Slovenia) are viewed as quite safe, aided by currency stability and the sharp drop in interest rates by the European Central Bank in recent months. Still, these countries may see a decline in exports to other Emerging Europe trade partners, many of which have been hit by sharp currency depreciations. Most countries with floating exchange rates (including the Czech Republic, Poland, Hungary, Romania, Russia, Ukraine and Serbia) have experienced severe depreciations since mid-2008. Although those declines should eventually go some way towards helping the economies recover by boosting exports, for now they have been quite destabilizing, sending foreign-exchange reserves sharply downwards, and making the repayment of external debt more expensive. The third group includes countries with fixed exchange rates (including the three Baltic states, Bulgaria and Bosnia). These countries will have problems maintaining pegs, and may see a sharper decline in GDP growth than those with adjustable exchange rates. However, a devaluation could be devastating, both for the maintenance of short-term stability, and for the repayment of foreign-currency debt.

Potential solutions

In searching for ways to alleviate the impact of the current crisis, monetary policy is not currently an option for most CEB countries. While this is nothing new in countries with pegged exchange rates (where monetary policy is not a policy tool option), countries with floating exchange rates have also been prevented from making substantial interest rate cuts in recent months, following a sharp decline in the value of regional currencies in relation to the euro. Even the Czech Republic, which has good financial indicators, low external debt and a foreign-trade surplus, has seen a severe drop in its currency since last summer, falling from a monthly average high of 23.53 koruna/euro in July 2008 to 28.46 koruna/euro in February

2009. Although interest rates in the Czech Republic and Poland are currently quite low, at 1.75 percent and 3.75 percent, respectively, the other countries with floating currencies have interest rates ranging from 9.0 percent in Croatia to 15.0 percent in Serbia.

On the fiscal side, government deficits are expected to rise sharply in 2009 as a result of falling tax revenues and the need for more spending on unemployment benefits and other social measures. Some governments have approved stimulus packages aimed at boosting domestic demand; however, many states are too poor or troubled to cover these costs alone. Hungary, Latvia, Serbia, Ukraine, Belarus and Romania have already turned to the IMF for help in financing current-account and budget deficits, and several others are likely to follow. Still, these agreements may carry a high political price tag for governments, as complying with IMF recommendations often requires sharp cuts in public spending. In addition to the possibility of receiving IMF funds, EU member states that are not in the Eurozone will also benefit from the emergency bail-out funds approved on March 20, 2009.

One solution for the region that has recently been suggested by a number of analysts would be an easing of Eurozone entry requirements for such countries as the Baltic states, Bulgaria and Hungary, all of which are currently at least several years away from adopting the euro. Until now, any country hoping to join the Eurozone has been required to meet the so-called "Maastricht criteria," which include:

* Inflation within 1.5 percentage points of the three lowest EU member states
* A budget deficit under 3 percent of GDP and government debt below 60 percent
* Long-term interest rates of no more than 2 percentage points above the three lowest EU member states
* Exchange-rate stability for two years, with no devaluations

None of the new EU member states outside the Eurozone currently meet all of these requirements, and rising government deficits in 2009 will further complicate Eurozone entry for aspiring countries. Although the Baltic states would be relatively easy to swallow due to their small size, taking in a country such as Hungary would be more difficult, especially as Hungary has yet to join the the Exchange Rate Mechanism (ERM-II), which is considered to be the Eurozone waiting room. In any case, the relaxation of the Maastricht criteria is unlikely, given the general inflexibility of EU institutions.

Which countries will be hardest hit?

The near-term prospects for the Emerging Europe region depend on a number of factors, including the size of a country's external imbalances, its level of export dependence, the size of its foreign-reserve buffer, the currency regime and the overall stability of the banking sector. These indicators vary widely among the economies of the region. Although many analysts have treated the region as a single unit, Emerging Europe can be divided into three general groups:

Group 1: Slovakia, Slovenia, Poland, Czech Republic
Group 2: Estonia, Latvia, Lithuania, Bulgaria, Romania, Hungary, Croatia, Turkey
Group 3: Ukraine, Serbia, Bosnia and Herzegovina, Albania, Montenegro, Macedonia

All four of the countries in Group 1 have relatively modest current-account deficits, at around 6 percent of GDP or less in 2008. Slovakia and Slovenia also benefit from their membership in the Eurozone, and the Czech Republic and Poland have been able to maintain stability despite relatively low interest rates. The main short-term risks for Group 1 countries relate to the export-dependency levels, which are very high for all countries except for Poland. Indeed, Slovakia ranks first in the entire region in that regard, making the country very vulnerable to downturns in demand of key trading partners.

On average, Group 2 countries have higher levels of external debt and wider current-account deficits than their counterparts in Group 1. In order to maintain stability, Group 2 countries with floating currencies (Hungary, Romania, Croatia and Turkey)

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have been forced to keep interest rates much higher than those in Group 1, and they currently range from approximately 9 to 12 percent. In addition, Group 2 countries tend to have weaker banking systems, as demonstrated by the scores provided by Global Insight's Banking Risk Service. While Slovenia is not included in the service due to its small size, Slovakia is the only country in the region with a "Stable" Banking Risk rating and a "Stable" ratings outlook.

Group 3 countries are quite varied with regard to external vulnerabilities, particularly concerning the size of their current-account deficits, which are very large in the Balkans, but more modest in Ukraine. Although the Balkan countries tend to have low levels of export dependence, they are heavily reliant on inflows

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of transfers from international donors, and remittances from citizens working abroad. The latter factor in particular raises their vulnerability during the coming year, as jobs are cut in more advanced markets.

In the case of Ukraine, the country faces a number of risks amid the current global crisis, given its highly skewed export structure, a banking sector that is close to collapse, stubbornly high inflation, and low public trust in the currency. Although prospects for the Balkan countries currently

It currently seems unlikely that this catastrophic scenario will play out, at least for the EU member states. Indeed, the collapse of any EU member state would have severe implications for the others, especially for banks from Austria, Italy and Sweden, which are heavily invested in the region.

appear to be somewhat better, Ukraine provides a picture of how the Balkans could end up if steps are not taken to rectify the macroeconomic imbalances and protect the stability of the banking sector. That is especially true for Serbia, which has seen sharp downward pressure on its currency in the past several months.

Russia has been left out of the above rankings, given the special circumstances facing the country. Although Russia's still impressive foreign-exchange reserves and early repayment of external debt have brought financial risks down to a marginal level, serious economic risks remain. This is especially true regarding the over-reliance on the oil and gas sector to drive economic growth and generate export earnings, leaving the country vulnerable in the face of sharply lower world market energy prices. Although Russia';s current-account surplus is projected to disappear this year, there is little risk of default, given the vast resources available to the government.

Outlook and implications

In recent weeks, the international press has highlighted the possibility of a region-wide crisis, as problems in certain countries spill over into the rest of Emerging Europe, moving onwards to West European banks that are heavily invested in the region. In the worst-case scenario, there would be a halt in external-debt refinancing, as defaults rise sharply. Companies would go bankrupt, and households would default on mortgages. Banks would face serious difficulties, creating problems for parent institutions. Currencies would depreciate further, and some countries with currency boards would be forced to abandon their pegs.

It currently seems unlikely that this catastrophic scenario will play out, at least for the EU member states. Indeed, the collapse of any EU member state would have severe implications for the others, especially for banks from Austria, Italy and Sweden, which are heavily invested in the region. While Group 1 countries are now expected to see a downturn this year, due to falling external demand, the longer-term impact of the financial crisis should be relatively limited. Group 2 countries, by contrast, will have more difficulties, as they are forced to introduce major structural changes.

Still riskier are the Group 3 countries, which do not benefit from the stability of EU membership or candidate status. Although some of the Balkan countries may continue to grow this year, thanks to foreign assistance and relatively low export dependence, they may face sharp reductions in domestic demand as they struggle to reduce immense current-account deficits. Nevertheless, in order to help ease the impact of the crisis this year, the Balkans and Ukraine can count on balance-of-payments support from the IMF, as long as governments are willing to meet certain budgetary demands. As a result, sovereign default is unlikely except in cases of total political disarray. ■

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Party Systems and the EU Accession Process in Croatia and Serbia

Andrew Konitzer

Andrew Konitzer is Associate Professor of Political Science at Samford University. He spoke at an EES Noon Discussion on February 25, 2009. The following is a summary of his presentation. The author welcomes questions and comments on this ongoing project. Please send correspondence to ackonitz@samford.edu. ***Meeting Report 360.***

According to a growing body of political science research, a key factor contributing to potential member states' compliance with EU conditionality is the establishment of a consensus on EU membership among the state's political parties. Frank Schimmelfennig points out that "under the condition of random election effects, the long-term prospects for democratic consolidation not only depend on the cost-benefit calculations of the government currently in power but of potential future governments as well." Moving on from this premise, "all major parties…must therefore make a political cost-benefit assessment in favor of compliance with the [EU's] conditions." In the absence of a pro-European "party constellation," there is little to guarantee that a country's EU accession process, once initiated by a pro-European government, would not experience delays or even a reversal after that government's defeat by a Euro-skeptic party or coalition.

Most existing studies of conditionality draw heavily from international relations theory. As a result, the domestic side of this inherently cross-level issue remains under-conceptualized and under-explored. While a key role is assigned to the construction of a pro-European party consensus, little attention has been paid to the process of creating such consensuses. This observation suggests a possible nexus between research on EU enlargement and conditionality and the existing literature on party change and adaptation. Changes in party constellations may result from the disappearance and creation of parties of various types, but another important mechanism for change is the political reincarnation of major existing parties. However, party adaptation literature indicates that such reincarnations place great strains on political organizations and frequently result in the splintering or outright destruction of parties. This naturally poses the question as to why certain parties are capable of adaptation while others fail.

The cases of Serbia and Croatia provide an opportunity to advance our understanding of the domestic side of conditionality by offering new insights into the issue of party change and the creation of pro-EU party constellations while deepening our understanding of the specific challenges of EU expansion in the Western Balkans. An overview of events following the end of Franjo Tudjman's regime in Croatia and Slobodan Milosevic's regime in Serbia indicates that the success or failure of major parties to adapt to new circumstances may help explain the continuing divergence in the two countries' efforts to join the EU. Instances in which parties or party factions attempted to adopt more EU-friendly platforms include the transformation of the Croatian Democratic Union (HDZ) in 2002-2003, the Serbian Socialist Party's (SPS) attempt to reshape itself as a "European social-democratic" party in 2008, and the fragmentation of the Serbian Radical Party (SRS) during autumn of the same year.

At this stage of research, the establishment of pro-EU party consensuses in Croatia and Serbia appears to depend on at least four different factors. First, the presence of outstanding territorial issues is a major sticking point in that it not only complicates the "mechanics" of a state's accession into the EU, but it also presents potent political ammunition for Euro-skeptic parties who can accuse the Union of having designs on the states territorial integrity. This key issue obviously sets the cases of Serbia and Croatia apart as the former still faces uncertainty with regard to the Kosovo issue (and to a lesser degree, Vojvodina) while the latter essentially "resolved" its territorial challenge during military operations undertaken in 1995, which resulted in the exodus of the bulk of the Serbian population from the Dalmatian hinterlands (location of the secessionist Republika Srpska Krajina) and western Slavonija. With this essay's focus on the issue of party adaptation, this factor will be dealt with in greater detail elsewhere, but it nonetheless rates a mention as a crucial background dimension which may have at least indirect effects on the party adaptation issue.

> ***If European actors essentially "ban" an EU skeptic party from office by threatening to break off relations with the state in the event that said party enters into government, this substantially decreases the incentives for the party to transform and may promote the further radicalization of the party.***

Second, the international community's treatment of anti-European or Euro-skeptic parties also impacts the likelihood of consensus-promoting party change. If European actors essentially "ban" an EU skeptic

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party from office by threatening to break off relations with the state in the event that said party enters into government, this substantially decreases the incentives for the party to transform and may promote the further radicalization of the party.

Third, the nature of the existing party also influences the likelihood of successful transformation. Drawing on Herbert Kitschelt's classification of European post-communist parties, a party's status as a predominantly "charismatic," "clientelistic," or "programmatic" organization will facilitate or hinder that party's ability to successfully adapt a new program. As demonstrated in the case studies briefly described below, all parties contain some mixture of Kitchelt's three characteristics. A party's adaptive potential is therefore linked to the dominance of certain characteristics over others.

Faced with the threat of a coalition consisting of SPS-DSS-SRS after the 2008 elections, western diplomats gave their blessing to a new government which included both the pro-European ZES and the SPS. In taking this pragmatic approach, international actors thus opened the way for a (perhaps cosmetic) pro-European party change without "banning" the party.

Finally, since party adaptation necessarily involves a change in programmatic position, a party's adaptability also depends on the existing state of the party system and the number, strength and location of different parties along its programmatic continuum. Parties that remake themselves may find that they now share a new political "brand" with an existing party. In this instance, the transforming party must either "liberate" programmatic space from the existing party or risk irrelevance as voters stick to the more established, and politically similar, organization. The number of party alternatives adjacent to the transforming parties "old" position is also relevant. If close political alternatives exist, the party is more likely to lose "believers" (supporters attracted to the party's program) to parties that have maintained their euro-skeptic position. In the worst case, a transforming party may lose its existing base to adjacent parties while failing to attract new voters because its new brand is already well-represented by an established party.

The transformation of Franjo Tudjman's nationalist HDZ into a pro-European Center-right party is the former Yugoslavia's single most successful party adaptation story. Following the HDZ's electoral defeats in 1999 and 2000, the once-dominant party entered a crisis with public opinion polls showing its popular support falling to the single digits. Between 2000 and 2003, new party president Ivo Sanader played a shrewd political game simultaneously undermining support for the incumbent government led by Ivica Racan, outmaneuvering challengers within his own party, and cultivating the image of a newly reformed, pro-European HDZ without catalyzing a major party-threatening split among HDZ loyalists. The HDZ played a critical role in mobilizing and coordinating protests against the Racan government's efforts to extradite war crimes indictees and highlighted any failures of the Racan government in order to craft an often unjustified image of the government's incompetence. At the same time, Sanader also increased his rhetoric about turning the focus away from HDZ's past and transforming the organization into a "democratic, European and open party." A key event in this transformation was the HDZ's April 2002 party congress and election for party president, when a ruthless struggle between Sanader, representing the moderate wing of the party, and Ivic Pasalic, representing the party's hard right, ended in a narrow win for Sanader amidst charges of intimidation and fraud.

With Sanader firmly in control of the HDZ, the party went on to win elections in 2003. While western observers expressed some concern about the implications of an HDZ government for Croatia's relations with Europe, Sanader defied expectations by including the Serbian minority party in HDZ's new government and declaring that the government would cooperate fully with The Hague, work for the return of Serbian refugees and comply with other key EU conditions. Under the reformed HDZ, and with a solid pro-EU party constellation now in place, Croatia continued to make significant strides towards EU membership, completed its cooperation with ICTY and now sits at the threshold of the EU. During the 2007 elections, despite some indication of waning support, the HDZ gained enough seats to form another coalition government which has now brought Croatia into NATO and hopes to complete the last stages of the EU accession process.

How did the HDZ successfully avoid the traps of party transformation and successfully adapt? While some analysts focus on Croatian society's coming to terms with its past as an explanation for the HDZ's transformation and the success of Croatia's membership bid, survey evidence provides little evidence to support this argument. As polls conducted by the University of Zagreb's Department of Political Science indicate, the HDZ's popular base actually shifted away from EU values during and after the HDZ transformation. Other survey data on attitudes towards the war, The Hague and the European Union also fail to show a reliable relationship between societal attitudes in Serbia and Croatia and these countries' progress towards the European Union. Instead, the answer appears to lie with specific features of the HDZ and Croatian party system which gave Sanader a free hand to transform the party without incurring the negative costs of party change.

Four factors appear to be particularly important. First, although the party had been out of power for three years, it still enjoyed a significant base of "clients in waiting" within the Croatian economy. In light of the Racan government's reluctance or incapacity to revisit the crooked privatizations of the late Tudjman era, this clientele base preserved its control over key assets within the economy. Such clients maintained a key interest in seeing a return of their HDZ patron to power—regardless of its stance on issues such as cooperation with the War Crimes tribunal or other finer points of the EU membership process. Hence, the leader of an electorally successful HDZ could rely on the support and substantial resources of this elite regardless of the leadership's stance on the issues in question. Second, the HDZ benefited from having a clearly defined program during the 1990s which effectively dominated the right-wing of the Croatian political spectrum leaving few viable programmatic alternatives. This served the party well during its transformative stage by denying program-oriented voters viable political alternatives. "Believers" in the 'pre-reform' HDZ might be unhappy with the new party program, but they had few other alternatives on the political right. Third, the HDZ's internal party structures—undemocratic even by the standards of the region—provided Sanader with the political levers to unilaterally expel any political opponents from within the party. Combined with the lack of strong alternatives on the political right, this further reinforced Sanader's ability to keep the party ranks intact. Finally, as indicated by the 2003 governing coalition negotiations, the international community's cautious, yet accommodating, stance towards the HDZ raised the perceived benefits of a pro-EU transformation. While the EU did exert considerable pressure on the HDZ to break off coalition negotiations with the extreme-right Croatian Party of Rights (HSP) and to avoid placing HDZ hardliners in politically sensitive ministries, it at no time indicated that a HDZ government would be unacceptable to Europe. Had the EU continued to "ban" the party from government, then Sanader would have little incentive to undertake the risky task of transforming the party.

The HDZ's programmatic transformation naturally raises speculation about a similar transformation among Serbia's euro-skeptic and anti-EU parties. While the SPS and SRS have occasionally mentioned improving relations with or even joining "Europe," such statements were generally taken as empty posturing by parties that maintained their previous identities. However, events surrounding Serbia's May 2008 elections suggested that both organizations were taking serious steps towards recasting themselves as pro-European parties. Furthermore, considering the strong showing for the pro-European "For a Democratic Serbia" (ZES) electoral coalition and the attendant "shock" that it delivered to Euro-skeptic parties, the theoretical literature on party change would predict that parties experiencing this exogenous shock might attempt to respond through substantial party change.

Nevertheless, while Serbian analysts and political actors spoke of party transformations, the political maneuvering following the 2008 election illustrated the substantial obstacles that remain for a party transformation similar to that executed by Croatia's HDZ. In the remainder of this essay, I briefly examine the cases of the SPS and the SRS-Serbian Progressive Party (SNS) split with an eye towards identifying critical differences between these parties' transformation attempts and that of Sanader's HDZ.

The SPS's programmatic and political maneuvering following the 2008 elections provides the first example. After the sharp collapse of SPS support during the 2000 elections, the party suffered a gradual decline in its remaining electoral base. By 2008, many political analysts ceased treating the Socialists as a major actor on Serbia's party scene. At the same time, the party exhibited few means to remake itself and attract new voters to its slowly diminishing ranks of Milosevic-era holdouts. Until the death of Milosevic in March 2006, efforts to reform the Socialist Party were largely inhibited by its president "in exile," but even following Milosevic's death, new leadership made only vague reformist statements while maintaining planks in their platform which placed it at odds with any European project.

Following another weak showing in the May 2008 elections, the SPS nonetheless found itself in an advantageous role of "kingmaker," since it could choose to lend its 20 seats either to the formation of a For a European Serbia (ZES)-led coalition or a coalition including the nationalist and national-democratic SRS and Democratic Party of Serbia-New Serbia (DSS-NS). Seizing an opportunity to enter government and stem the party's continuing decline, it took a decisive step towards reconfiguring its policy platform by recasting itself as a "European" Social Democratic party and joining Serbia's post-election pro-European government.

Applying the factors discussed at the beginning of this essay, one can gain insights into both the causes and prospects of the SPS's adaptation attempt. Turning first to the western international community, while the US and various European actors had frequently expressed strong opposition to any government including the Radical party, opposition to SPS participation was largely muted following the party's 2000 electoral defeat and subsequent decline. Faced with the threat of a coalition consisting of SPS-DSS-SRS after the 2008 elections, western diplomats gave their blessing to a new government which included both the pro-European ZES and the SPS. In taking this pragmatic approach, international actors thus opened the way for a (perhaps cosmetic) pro-European party change without "banning" the party.

Nonetheless, the western international community's accommodation would neither save the SPS from its own internal weaknesses nor from the logic of the Serbian party system. With no substantial clientele base and lacking a strongly charismatic leader, the move to recast the party as a European social democratic party sparked an exodus of remaining "believers" to the readily available programmatic

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alternatives of the SRS and DSS (and later, SNS). To make matters worse, the "social democratic" label was already included among an array of other titles within the programmatically expansive and much stronger DS. The SPS's attempted transformation thus caused it to lose its existing voting base to adjacent Euro-skeptic parties while presenting it with the very difficult task of convincing voters of a social-democratic persuasion that their support would be better directed towards the recently-reformed Socialist party. Polling results in the months following the elections provide sufficient evidence that the SPS has failed in this latter task.

Turning to the second Serbian case, the fragmentation of the SRS constitutes the most important event in Serbian party politics since the collapse of the Democratic Opposition of Serbia (DOS) coalition. Following its disappointing showing in the May 2008 elections, the SRS and its second-in-command Tomislav Nikolic found itself at an impasse. The party's apparent inability to seize power, despite strong showings in elections after 2003, resulted in decreasing turnout among typical SRS voters and contributed to a growing sense of party crisis.

With the international community effectively excluding any possibility of working with an SRS government, this lowered the perceived rewards of taking a more moderate stance towards Europe. If a major SRS political actor such as Nikolic wished to chart a more pro-European course, he would be better positioned to do so within the context of a new, "laundered" party.

Against this background, Nikolic announced in early September that his party would vote to ratify an amended version (with guarantees for Serbia's territorial integrity) of a Stabilization and Association Agreement. In light of this sudden turn of events Bozidar Dzelic (DS) triumphantly declared that Serbia had achieved a consensus on joining the EU. However, within days Tomislav Nikolic announced his departure from the SRS after party president Vojislav Seselj countermanded his order to vote for the SAA. Nikolic and 17 SRS deputies then formed a new "Serbian Progressive Party" (SNS). After the split, Nikolic portrayed the SNS as a "modern" right-of-center party with European goals and openness to dialogue with international actors and Serbian parties from across the political spectrum. Subsequent polls and election results suggest that roughly two-thirds of the SRS's electorate is currently supporting SNS. This indicates that the party could establish itself as a more "moderate" version of the SRS, and that voters are being drawn both to this message and to Nikolic's image as a "modern" radical.

What factors led to the split in the SRS and what are the prospects for the establishment of a pro-European party consensus in the aftermath? With regard to the first part of this question, causes for the split may once again be found in the factors described at the beginning of this essay. First, as a programmatic party with at least two charismatic leaders and no significant clientele base, any attempt by one of the charismatic leaders to remake the party would likely generate a party split rather than a general transformation. Had a significant client base existed, expectations about the success of one leader or another may have yielded a bandwagon effect as clients aligned with the strongest patron. Instead, Nikolic's rift with Seselj apparently divided believers along a moderate-hardliner axis with other supporters being drawn to the personal characteristics of either leader. One should also not discount the role of the international community in inadvertently shaping actors interests in such a way as to increase the likelihood of a split. With the international community effectively excluding any possibility of working with an SRS government, this lowered the perceived rewards of taking a more moderate stance towards Europe. If a major SRS political actor such as Nikolic wished to chart a more pro-European course, he would be better positioned to do so within the context of a new, "laundered" party.

Similar factors also provide some insights into the possible future trajectory of the SNS and the Serbian party system as a whole. The division of a rather broad-based party such as SRS poses fewer challenges for new party actors than a situation in which a party must redefine itself and "liberate" programmatic space from an existing party. Establishing itself as a moderate, center right party, the SNS can claim the programmatic space previously occupied by the moderate wing of the Serbian Radical Party. Nonetheless, a danger does exist that the SNS leadership, in its efforts to cultivate a more accommodating image towards the EU might alienate its voters who could readily switch votes and allegiance to either the DSS or rump SRS. However, in the short term, these two parties are sufficiently discredited that the SNS has significant freedom to redefine itself.

In the aftermath of the SNS-SRS split, speculation abounds about the establishment of a new Serbian right and a pro-EU consensus based upon DS and SNS. Here again, the different factors presented at the beginning of this essay provide some means for speculation. If indeed the SNS's pronouncements constitute substantive moves towards a more pro-EU stance, then the possibility of establishing a pro-EU consensus depends critically on two issues. The first centers on the outcome of the next republican elections and whether it promotes the consolidation of the Serbian party system. A recent presentation by political analyst Vladimir Goati, suggests that elections could result in something approximating a two-party parliament consisting of DS and SNS. Under these circumstances, the creation of a pro-EU consensus would hang on the decision of the SNS to take substantive steps towards establishing itself as a true pro-EU party. Continued fragmentation would inhibit this process as the lingering

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Trade as a U.S. Development Tool: Notes from Southeast Europe

Ioannis Tsorbatzoglou

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As a tool to bring peace and democracy to the war-torn region of the former Yugoslavia, the Southeast European Cooperative Initiative (SECI) was truly innovative when it was presented by Ambassador Richard Schifter. Even after a two hour press conference in December 1996, it was still hard for the participating journalists to understand the concept. How can the US and EU not be members and why? Why was there no extensive discussion on human rights and democratization?

It is not surprising that the journalists present had difficulty understanding the concept. The mid-1990s were marked by conflict and transformation in the region of Southeast Europe, and it was generally perceived that the involvement of the US and the EU in the region was absolutely necessary for the prosperity and security of the region. Yet the SECI plan had purposefully placed those goals to the side, and viewed the US and EU members as supporting states, offering only advice and guidance to the participating countries. In Ambassador Schifter's presentation of the SECI initiative, there was no long-winded moralistic speech addressing democracy and human rights but rather a pragmatic reference to economic problems and the evident need for the countries of the region to work together to build a better future.

Furthermore, knowing that a huge infusion of funds from donor countries was unlikely, Schifter emphasized the importance of encouraging private enterprise to help stimulate the regional economy. SECI would help attract investors by binding the countries of the region together, and thereby provide investors with access to a larger regional market, rather than smaller national markets.

The United Nations Economic Commission for Europe (UNECE) lent validity to the project through its UN affiliation and was asked to provide technical assistance. The US and EU, both of which had interests in the region's stability, negotiated and signed a Memorandum of Understanding formalizing a common agreement regarding how SECI would function and their respective roles in the initiative. With this concept in mind, several states were invited to participate, most of which readily accepted. The initial signatories included Albania, Bosnia and Herzegovina, Macedonia, Greece, Hungary, Moldova, Turkey, Croatia and Slovenia. Although Yugoslavia was included in discussions in the late 1990s, it did not formally join until after Slobodan Milosevic was defeated in the 2000 elections.

Believing that economic progress was the key to political stability, Schifter envisioned a regional organization that would not be a top-down initiative imposed by outsiders, but instead appear to be wholly implemented by local member states, working together to rebuild the region. The expression often used in development literature to describe this is "regional ownership," but in most cases it is just rhetoric: an inspirational statement that seems obligatory for any reconstruction speech but without any concrete suggestions on how that "ownership" would be achieved. SECI went beyond the typical rhetoric by filling its institutions and offices with local actors.

The so-called "Agenda Committee" was created to discuss mutual economic concerns. Although the US and EU sat on the committee as supporting states, only regional states were given voting rights. In order to counter the fear that economic and trade issues would not be realistically presented and dealt with if only diplomats and politicians participate, a Business Advisory Council (BAC), primarily composed of local businessmen, was established to serve as a reality check to the Agenda Committee. Most of the members of the BAC were not simply business executives, but rather owners of companies operating on the ground, or who would be open to making investments once circumstances improved. Their financial strength would also carry weight with their respective governments and could help push the process forward. And although the BAC was not given any formal powers, its participation was modeled according to a public-private partnership, so that its role was equally important as the Agenda Committee's. This structure helped achieve spectacular results in the region.

Setting parameters for regional cooperation

Looking at the first six priorities set by the Agenda Committee (with input from the US and EU) for the initiative in early 1997, the areas of interest are all technical in nature and there seems to be a careful avoidance of themes that could be perceived as conflict provoking, moralistic or difficult to quantify. These priorities included:

1. Border Crossing Facilitation: Actions to Overcome Operational Difficulties.
2. Transport Infrastructure Development along the main international routes.

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3. Energy Efficiency demonstration zones network
4. Interconnection of Natural Gas Networks, Diversification of Gas Supply and Improvement of security of supply
5. Financial Policies to promote small and medium enterprises (SMEs) through microcredit and credit guarantee schemes
6. Recovery programs for rivers, lakes and adjacent seas.

The first two targets relate to transport and trade facilitation focusing on the need to increase regional trade by making it easier to cross the border lines that were, at the time, still dominated by practices established by the communist regimes and hardened by the rise of nationalism in the region. The third and fourth are energy related and when viewed from today's prospective seem absolutely logical. Yet, at the time they were conceived, they were far from being assessed as a top priority for the region. The fifth seeks credit mechanisms for small and medium businesses, aiming to allow private enterprise to grow. The SME category excluded the large industries inherited from the communist system from gaining the benefits provided by SECI, perhaps with the hope that this would provide an incentive for governments to restructure and privatize those industries. Finally the sixth priority links economic growth with environmental sustainability. It is again an evident step viewed from today's conceptual framework, but at the time it was presented, sustainable growth was hardly a universally accepted concept.

Recipient countries were expected to contribute something to the program themselves, either in terms of personnel or funding, in order to advance the project. Giving parties an incentive to participate by showing clear economic benefits, rather than focusing on ephemeral notions such as prosperity in the future or love for fellow countrymen, proved to be the most successful strategy.

Although the priorities were rather ambitious, within several years, agreements and Memorandums of Understandings on all of the above areas of interest had been signed. These agreements included: the Framework Agreement on the Sava River Basin created the International Sava River Basin Commission and later the Danube Cooperation Process; an agreement on the exchange of information among securities markets in the SECI countries; and MOU on Cooperation on Electricity transmission. To respond to the priorities of fostering trade and easy transport, SECIPRO was created, as a regional forum for the public-private partnerships created in every country to address issues relating to transport facilitation. Subsequently, an MOU was signed as well, which involved the World Bank, and created Trade and Transport Facilitation in Southeast Europe (TTFSE), a multi-annual program for the region. Finally, the discussion related to transport and trade brought to the surface the need for cooperation to address cross-border crime, which subsequently served as the basis for the creation of the SECI Regional Center for Combating Transborder Crime, based in Bucharest.

Most of these initiatives were achieved with minimal funding from the US or other donors. And in the projects for which funding was necessary, Schifter and his team at the Department of State employed innovative strategies to coordinate the work of multiple international institutions. The execution of the World Bank's TTFSE offers a glimpse into this process. In the late 1990s, it had become more difficult than ever to move goods in Southeast Europe. With increased nationalism came an emphasis on each country's control over its borders and the enforcement of its own unique regulations. At every border, there were representatives from multiple government ministries and their agencies staking a claim and asserting their jurisdiction. Typical wait times for trucks could exceed 30 hours, which greatly hindered regional trade. It was determined that SECI could have a significant impact, with minimal investment, by focusing on small, logical reforms, rather than focusing much time and money on large infrastructure projects. Funds were needed for the training of the private sector under the TTFSE program and following the practices established by the World Bank. In cooperation with USAID, the World Bank would write the terms of reference for the training program, and USAID would open a procurement process to award contracts to the training teams.

The SECI team at the Department of State wanted a local consortium to bid for the USAID contract, in order to send a message about the value of regional partnerships, and ultimately found a mechanism to award the contract to a Greek-Turkish-Bulgarian partnership. Initially, the decision was viewed as risky by the World Bank, as some experts feared that using development money as a tool for bringing antagonistic groups together to work on a project created the potential for the act of cooperation between the partners to become more important than the ultimate goal of encouraging larger regional cooperation and development in the Balkans. Nevertheless, the partnership produced a teaching curriculum, based on UN international standards, which would train and certify professionals in all target countries. The result was so successful that it has since been translated into more than 10 languages. Thus, contrary to expectations and with clearly identifiable benefits for all, the partnership was a success and soon the World Bank embraced the effort.

Local SECIPRO committees then took up the cause, investing their own resources into the border reform's publicity and success. In Albania, TV ads gave phone numbers for those experiencing problems at the border, showing government ministry workers responding to problems—something previously unheard of in the country. In Bosnia, barriers were broken down as Serbs and Bosnian Muslims requested joint training, which were completed successfully. Training was conducted primarily in peripheral towns, rather than in the capitals, making them accessible to much wider range of people. This type of execution also forced the local chambers, previously uninvolved, to build their own capacities. Local chambers of commerce used their networks to promote the initiative and from 2001-2004 more than 7,000 professionals were certified in the region.

Overall, the World Bank TTFSE project, which combined the private sector training offered through SECI, the border agency assistance through the World Bank and SECI STAT teams (technical assistance teams composed of US Customs experts), along with limited infrastructure work, produced substantial results. By 2005, there was a 65 percent reduction in waiting time at border crossings and a 46 percent increase in trade volume for the region as well as an 81 percent increase in revenue brought to state coffers by the relevant border agencies.

Lessons learned

The success of the TTFSE project raises the question of whether the institutional structure of other aspects of the project might be replicated in other regions or in other spheres. The experience of SECIPRO clearly shows that US commitment and political presence was essential for encouraging parties in Southeast Europe to work together. If US interests are perceived to be waning, projects falter or even fail. It is important to note that waning interest by the US is not linked to financial assistance but to simple political declarations at the local, regional and international level. In Southeast Europe, presence is the biggest US asset.

Another important factor in the success of the TTFSE project is that the countries involved felt that they had ownership of the project. In this case, international “experts” were not driving the process, and therefore escaped the typical criticisms launched against international aid officers—that they are paid exorbitant amounts of money to make short trips to the region, only to rebuke locals for their practices, or offer seminars and training through the use of interpreters with an almost colonial attitude. In the case of SECI, everything was approached from an economic—rather than a moralistic—perspective. Recipient countries were expected to contribute something to the program themselves, either in terms of personnel or funding, in order to advance the project. Giving parties an incentive to participate by showing clear economic benefits, rather than focusing on ephemeral notions such as prosperity in the future or love for fellow countrymen, proved to be the most successful strategy.

The experience of SECI shows that, especially in a period of serious political and social unrest, it is best to deal only with the technical side of things. This allows international actors to “fly under the radar,” avoiding unnecessary controversy on politically divisive issues. SECI officers constantly looked for ways to improve efficiency without fundamentally changing what was happening on the ground. For example, where there were 12 agencies collecting information at the border, SECI asked ministries to unify their aims and adopt a single administrative document. Rather than having a representative from each agency, SECI suggested that information be collected from just one window, so that traffic can pass through the border more smoothly. The same amount of money would be collected, but the process would be streamlined, which is what SECI set out to accomplish. Visible short-term improvement sets the stage for greater advances and allows people to believe that change is possible.

— Konitzer

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presence of small to medium strength Euro-skeptic parties would complicate consensus building.

However, were the Serbian party system to consolidate around two parties, the incentives for the SNS to adopt a more pro-EU stance would depend in part on the western international community’s notions regarding the acceptability of a reformed SNS under the leadership of former SRS Vice President Nikolic. If western diplomats apply the same approach towards SNS that they applied to SRS, then Nikolic stands to gain little from the inherently risky process of defining a program significantly different from that already supported by former SRS moderates. Conditional acceptance of the SNS by western diplomats would not only increase the perceived benefits of adopting a pro-EU stance, but might even push the SNS to adopt more centrist policies.

Of course, such a strategy carries certain risks. SNS opponents, human rights activists and other political actors will criticize western diplomatic accommodation for rewarding past actions of former SRS members. There is also a risk that Nikolic and the SNS are simply building a pro-EU façade (a charge that was also leveled against HDZ), which would quickly fall away in the event that a SNS-led government came to power. However, when assessing these risks, one must consider that similar issues faced the western diplomatic community in Croatia immediately following the 2003 elections and that the existing situation in Serbia, where pro-EU governments hold onto bare majorities in the parliament and face a continuing risk of being ejected by less EU-friendly parties, poses a major impediment to Serbia’s progress towards the EU. In not accepting the risk of working with the SNS, western diplomats may effectively consign Serbia to a permanent or at least extended outsider status.

Calendar of Events

Please Note: Events are subject to last minute changes. For the most up-to-date information on events please visit our website at http://www.wilsoncenter.org/ees.

Wednesday, 6 May: Federal Conference, 9:00-5:00
Innovative Strategies for European Integration of the Western Balkans
6th Floor Auditorium
Speakers TBA
this meeting is co-sponsored by the Southeast Europe Project and the West European Studies Program
RSVP required: email - ees@wilsoncenter.org

Wednesday, 13 May: Noon Discussion, 12:00-1:00
Serbia's Transition to a Market Economy: Achievements and Failures
6th Floor Boardroom
Milica Uvalic, Professor of Economics, University of Perugia and current WWICS Public Policy Scholar

Wednesday, 20 May: Noon Discussion, 12:00-1:00
Social and Political Responses to Economic Crises: Reflections of the State of Democracy in EU Member States Bordering the CIS
6th Floor Auditorium
Ginta T. Palubinskas, Undergraduate Program Director, Department of Public and International Affairs, George Mason University

Wednesday, 27 May: Noon Discussion, 12:00-1:00
Moving forward in High Seas: The Balkans in 2009
6th Floor Boardroom
Ivan Vejvoda, Executive Director, Balkan Trust for Democracy

Wednesday, 3 June: Noon Discussion, 12:00-1:00
Democracy, Memory and Moral Justice in Postcommunist Europe: The Case of Romania
6th Floor Boardroom
Vladimir Tismaneanu, Professor of Political Science, University of Maryland-College Park and WWICS Fellow

Wednesday, 9 June: Symposium, 1:00-5:00
Evaluating the Effects of EU Accession: Lessons for Southeast Europe
5th Floor Conference Room
Speakers TBA
RSVP required: email - ees@wilsoncenter.org

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