

## **Reconstructing the Balkans**

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## **I. Introduction**

The last of the six Balkan Wars of the twentieth century is over. But it is by no means certain that a durable peace is at hand. After vast death, destruction, and savagery lasting almost a decade can the peoples of the former Yugoslavia live together again in peace? If so, the region will require sustained help and support from the West. The United States and its European partners are in the midst of mustering the necessary resources and political will.

There are numerous uncertainties complicating efforts to proceed with the reconstruction of the area. Whatever the international community may proclaim, the borders of Serbia, Kosovo, Bosnia, and Croatia could well change. The management of Kosovo's status and its relationship to Serbia is likely to produce serious tensions within the Alliance and between NATO and Russia. What politically will emerge from a beaten and traumatized Serbia no one can predict. Nor is it clear that Montenegro will remain as part of Yugoslavia, particularly if Milosevic continues to rule. An ethically fragile Macedonia has been badly weakened by the war and the inflow of three hundred thousand Kosovar deportees. Albania barely hangs together as a state. Neighboring Rumania and Bulgaria have avoided violence and begun to remake their societies, but they have suffered economically from the wars.

The area of reconstruction is small and the population limited; the task at hand certainly is not of the dimensions of restoring post-war Europe. But the problems are daunting. Without security there will be no development. NATO forces will be needed indefinitely to keep the peace in Bosnia and Kosovo. Much more must be done to promote political and economic reform in the region, requiring vision and planning. The states of the region will first need urgent help to stabilize their economies and manage enormous humanitarian problems. They must also be able to envisage a better future, one that holds out the prospect of bringing them into Europe's political and economic mainstream. Realizing that goal will require profound changes in their economies and institutions as well as in their relationships with each other.

Faced with these challenges, Western countries and a host of international institutions have begun to address how to foster the broad reconstruction of the area. The EU-sponsored stability pact, adopted in Cologne in June, is the beginning attempt at a multifaceted, coordinated approach to the problem. The G-8 has agreed on a broad program of financial assistance, and the EU has pledged 1.5 billion dollars for aid to Kosovo alone. Numerous follow-up conferences are already planned. Much more work has to be done to give reality and coherence to such efforts.

Balkan reconstruction will be a protracted undertaking. It will require extremely difficult commodities - a comprehensive approach and the will, resources, and mechanisms to implement the effort. It is mostly to such a long term approach that this

preliminary working paper addresses itself. It does not deal with the immediate requirements of refugee return and humanitarian assistance nor the urgent repair of human and material infrastructure. The World Bank and the IMF in cooperation with many other international organizations and interested countries are coordinating the assessment of needs and costs and have issued preliminary reports. The purpose of this

working paper is to provide a broad political approach and to highlight the three key components of a comprehensive, long-term strategy: building security, integrating the region into the European Union, and fostering economic and political reform.

For the purposes of this paper, we consider the region to be Serbia, Kosovo, Montenegro, Bosnia, Bulgaria, Macedonia, Albania, Croatia, and Rumania. This is somewhat arbitrary and these states are at different stages of political and economic development. The problems of Rumania and Bulgaria are quite different than Serbia's and Kosovo's; Croatia is much further advanced than next door Serbia and Bosnia. They all have to be dealt with separately, and no single state should hold back the progress of others in entering Europe. But they also face a collective future and the region will enjoy a lasting peace only if all its states leave the past behind and move decidedly to join the wider community.

## **II. NATO: The Security Component**

Moving forward with a program for Balkan reconstruction cannot await resolution of the numerous political uncertainties that severely complicate decision making. Instead, the international community must insure stability while these uncertainties are resolved. Only NATO has the capability and unitary command needed to erect a regional security regime that contains ongoing threats to stability and enables countries of the region to proceed with political and economic reconstruction. This security regime should be guided by the following principles:

First, a robust NATO military presence is needed to preserve peace and provide the opportunity for political and economic reconstruction. That means a sizable and indefinite presence in Bosnia and Kosovo. Its troops must have rules of engagement necessary to establish effective control of the territory. NATO troops will also have an important, though less demanding, mission in promoting stability in Macedonia and Albania.

Second, NATO needs to contain Serbia until Slobodan Milosevic is replaced by a government willing to abide by established international norms. As long as the Milosevic regime survives, the international community should refuse post-war financial assistance to Serbia except for what the alliance defines as urgent humanitarian needs. Excluding Serbia from reconstruction efforts will continue to take a toll on every country; the best shipping and trucking routes in the region run through Yugoslavia. But NATO cannot afford to let Milosevic get back on his feet.

Finally, the West must look beyond the near term and lay out a path for integrating the region into the Atlantic security order. Even before the Kosovo crisis, fear of falling into Europe's gray zone and being excluded from an enlarged NATO exacerbated insecurity in the region. Assuming that enlargement continues, NATO should ensure that some countries from southeastern Europe are in the second wave. Romania is a prime candidate. In the meantime, the Partnership for Peace should be used in the region to channel political energies westward and encourage multilateral military cooperation, civilian control of defense establishments, and greater sharing of information on defense budgeting and planning.

## **III. The European Union: Integrating the Balkans into Europe**

As NATO puts in place a stable security regime for the Balkans, economic reconstruction can begin in earnest. We believe that economic development and political reform requires the peoples and states of the Balkans to look beyond the region. In practice this means the ultimate integration of southeastern Europe into the European Union. The full accession of Balkan states to the EU will take a long time and require far-reaching political and economic reform among prospective members. But attaching the Balkans to Europe's mainstream should be the target of reconstruction efforts for three main reasons.

First, the prospect of joining the EU holds a powerful allure throughout the region and will help increase the social and political momentum needed to carry out domestic reforms. Working toward integration into Europe will help focus the Balkans on the future, rather than the past; the goal of joining Europe's mainstream transcends residual inter-communal hostilities. Concentrating on intra-regional economic integration is not a viable alternative. The experience in Bosnia has made clear that it takes time before estranged ethnic communities are prepared to embark on joint economic enterprises. The international community should where possible promote inter-communal ties through economic integration. But this should not be a primary aim. In addition, intra-regional integration and reconciliation will be easier with the region's gradual integration into the EU. Economic reform, compliance with the political requirements for entry into the EU, and the growth of a private sector and middle class will all have positive spillover effects on inter-communal ties and Balkan cooperation.

Second, the EU is the institution best suited to carry out the tasks at hand. It has considerable experience in monetary stabilization, market liberalization, and infrastructure development - key elements of the economic program outlined below. The EU's experience in dealing with the new democracies of Central Europe will be of direct relevance in the Balkans. The EU has the human capital, assistance funds, and vibrant private sector needed to sustain a major economic initiative in the Balkans and tailor it to individual countries. The EU is also the most appropriate vehicle for building a lasting peace in southeastern Europe. NATO can stop the fighting and buy time for economic development and reconciliation. But, as in Western Europe, it will be the steady process of integration through the EU that makes it more likely that the peoples of the Balkans can live in permanent peace.

Third, the EU needs to assume primary responsibility responsible for Balkan reconstruction if it to realize its goal of more effective political leadership in Europe. So too would the EU's willingness to share burdens more equitably with the United States strengthen the Atlantic link. In the wake of an air campaign carried out primarily by U.S. forces, President Clinton has declared that the U.S. is looking to Europe to take the lead on postwar reconstruction. An appropriate division of labor between NATO and the EU will help strengthen Europe and transatlantic relations at the same time it facilitates a stable peace, economic development, and reconciliation in the Balkans.

The precise form and timing of integration would take advantage of existing European Union rules. There is already a well functioning, multi-tiered economic structure involving non-EU European partners. This can be adapted quickly and effectively to a Balkan integration agenda. We believe a phased plan consisting of the following sequential steps makes sense:

- A free-trade area, modeled after current arrangements with EFTA.[1]

- A custom union, modeled after the current arrangements with Turkey and Cyprus.
- A full common market, requiring implementation of all EU single market directives, modeled after the current EEA[2] arrangements.

A free trade area should be launched as early as possible. It is a decisive step and would send the appropriate signal to the region. It is intended to replace the current structure of complicated measures to protect domestic industry. Countries will differ in their initial capacity to join, determined largely by their previous progress toward economic reform. Thereafter, differentiation will continue, allowing increases in productivity and expanded trade to determine advancement toward further integration. Countries can join the customs union and common market according to a flexible and differentiated timetable, allowing the most zealous reformers to enjoy the benefits at the earliest possible time.

As a natural consequence of such a broader European integration scheme, Balkan countries would be obliged simultaneously to eliminate trade and investment barriers among themselves. Thus what might be politically impossible, or at least more difficult, on an intra-regional basis can be better achieved on a pan-European one. This sequencing has happened before, as illustrated by the EU accession of Spain and Portugal in 1986. Without any prior Iberian integration arrangements, both have since firmly entrenched democratic government, produced GDP growth that has outpaced the EU average, reduced inflation to near the EU average, and established excellent bilateral political relations.

#### **IV. Economic Priorities**

##### **1. Macroeconomic Stabilization**

The establishment of macroeconomic stability is a precondition of both political stability and economic growth in the region. Many Balkan countries have experienced high rates of inflation. Multiple currencies abound. Exchange rates have demonstrated great volatility. In such circumstances there has been relatively little foreign investment and modernization in the region.

These are not circumstances that favor long-term economic expansion. A first requirement is assuring that revenues match expenditures. At the outset, there will be external economic assistance to meet the special, and differential, needs of recovery from the war. Thereafter, however, national governments must expand their receipts and curtail wasteful and unnecessary outlays if inflation is to be avoided.

A second necessity is an effective exchange-rate policy. Increasingly, as a result of the financial crises of recent years, it has become ever clearer that two options present themselves: commitment to an exchange rate peg or fluctuating exchange rates that reflect current and expected market conditions.

In the world of ever greater trade integration with Europe, as we have already described, common movement toward the Euro seems the inevitable choice. The EU could make a major contribution by offering to "euro-ize" these countries well in advance of possible EU membership. Such an option should enjoy popular support across southeast Europe, and provide the countries of the area with tangible evidence of the EU's commitment to unifying the continent, rather than "balkanizing" the southeastern periphery. By coming

sooner than full trade liberalization, moreover, early progress toward adoption of the Euro would reinforce reform efforts.

The establishment of national or multinational Euro-based currency boards (as in Bulgaria and Bosnia) can be a useful intermediary step. However, currency boards should not be advocated as a permanent alternative. They will require political credibility in the market, something difficult to attain for countries that still have before them major economic reforms. Only Euro-ization will eliminate the prohibitive risk premiums demanded from the region's borrowers in international capital markets. But the process of qualification will still take time.

Under Euro-ization, central banking functions would be transferred from the region to the European Central Bank. There would be no internal lender-of-last-resort standing behind the national banking systems; significant financial sector reforms would be thus required in advance of Euro-ization. Western banks would need to increase substantially their presence on the ground. Internal risk management and external supervisory practices and personnel will have to be upgraded: outside technical assistance will be necessary.

The adoption of the Euro throughout the Balkans provides a direct goal for macroeconomic policy in the region. The requirements for acceptance into the Euro zone are well publicized and known. There is no need to deviate from them. The key requirements are the willingness of states in the Balkans to adhere to macroeconomic discipline and the willingness of the EU to accept the Balkan countries as full members.

## 2. Microeconomic Reform and Private Sector Development

The problems afflicting many of the economies in Southeastern Europe go well beyond the immediate ravages of war. The economies of the region are still stuck in the past, and suffer from entrenched patronage systems and widespread corruption. Liberalization has proceeded unevenly. Official commitments to market reforms are often more rhetorical than real. Many governments still operate as if direct supervision were necessary, rather than believing in price signals.

External financial assistance for reconstruction, essential as it is, will not by itself be adequate. The objective must be to promote a robust capitalism within the area, a goal that is far more ambitious and requires fundamental institutional and legal changes in the region. To this end, it makes sense to impose some requirements on the form of short-term aid and longer-term financial flows:

- Financial assistance coming from multilateral and bilateral sources should involve the local private sector to the greatest degree possible.
- Foreign resources should involve equity involvement, as well as bonded debt. The best way for long-run development to take root is through widening private ownership, shared with those from outside.
- Projects should consciously include cross-border infrastructure endeavors. This is a small geographic area. Efforts at shared undertakings can reduce the fears and hatreds in the region.
- A vast and immediate expansion in personnel exchanges with the EU is essential. The region needs a regular flow of expertise on such issues as customs, taxation and market regulations.

The Marshall Plan clearly provided an opportunity for economic recovery in Western Europe. As important as the external resources were, it was the mobilization of local private initiative that ultimately generated continuing growth and increases in income. Nothing less is needed in the Balkans.

## **V. The American Role**

The recommended division of labor between NATO and the EU reflects the comparative advantages that the United States and Europe bring to the table. American leadership continues to be an essential catalyst for timely NATO action, and U.S. forces and military intelligence are critical to erecting and sustaining a viable security regime for the Balkans. The European ground presence over time should become relatively larger. . But for the foreseeable future, the United States will have to take the lead on Balkan security.

The EU should take the lead on reconstruction, and appears ready to do so. The financial contribution of the United States is likely to be restricted; President Clinton has made clear that Europe will bear the major costs. Congress supports this division of labor, arguing that the United States assumed the primary burden of the air campaign, and that it is now Europe's turn, especially because the Balkans are a natural area of responsibility for the EU.

While all parties agree that the EU should be the primacy vehicle for funding and managing reconstruction, the United States must contribute enough to ensure influence over the enterprise. Without an important economic stake, U.S. input and leverage would decline over time. And U.S. involvement is essential to catalyzing the process and keeping Balkan reconstruction an urgent and continuing priority.

Active U.S. involvement is important on two other fronts. First, the U.S. must bring to bear the enormous skills and resources of American NGOs to promote human rights, democratic reforms and civil society. Second, while it will be difficult to get private investment into the Balkans, the skills and resources of the U.S. private sector are urgently needed. The U.S. Government should make every effort to encourage private sector engagement.

## **VI. Conditionality**

Conditionality remains a controversial policy instrument. Some argue that making aid contingent upon reform offers the West essential leverage over recalcitrant regimes. Others contend that conditionality has been counterproductive in the Balkans and only succeeds in denying assistance to those states that most need it.

Despite the lack of a consensus on its effectiveness, conditionality is a guiding principle of current EU assistance policy toward southeast Europe. Each state is eligible for staged access to preferential trade arrangements, financial resources, and ultimate membership. Qualifications include the following: adherence to democratic principles, respect for human rights and protection of minority rights, implementation of the rule of law, introduction of a market economy, and regional cooperation. Conditionality has been used to guide aid deliveries to the separate political entities inside Bosnia and occasionally to Croatia.

As for Serbia, most Western leaders have ruled out financial assistance while Milosevic remains in power. In practice, however, it will be difficult to separate humanitarian assistance from rebuilding infrastructure, such as restoring electric power. No consensus has emerged on the remaining trade sanctions, notably oil. Some argue that keeping trade sanctions in place is essential to facilitating a regime change; others contend that continuing sanctions only furthers the criminalization of the Serbian economy and makes economic and political reform more difficult. They also note that trade sanctions harm and distort neighboring economies like that of Macedonia.

We recommend a case-by-case approach to conditionality. Most of the countries of southeast Europe are far from model democracies. Many have serious ethnic tensions and minorities populations that continue to be threatened and marginalized. How hard to pressure them toward reform will depend on the situation in each country. Progress on political and economic reform is necessary before these countries join Western institutions. But the process of economic integration itself is, in many cases, more likely to promote economic and political reform than punitive measures.

As the West develops and implements a regional reconstruction program we believe:

- that the EU should continue its requirement that staged access to its economic programs requires political reform;
- that countries that regularly abuse human rights and move further away from democracy should be denied financial assistance in specific cases;
- that the remaining trade sanctions against Serbia be lifted to prevent further regional distortions, but that any access to financing requires not only the removal of Milosevic, but also some movement toward more democratic government.

## **VII. Implementation - the Need for Strength**

Implementation is a crucial issue - perhaps the most crucial issue -- in any effort of this size. Reconstructing the Balkans is an enormous undertaking. It follows on an ongoing effort in Bosnia, which has run into serious problems, in part due to the unwillingness of Western governments to act forcefully and in unison. There is perhaps no bigger or more difficult decision in this enterprise than determining how it is to be run and who is to run it.

The first requirement of leadership is devising an overall strategy and getting agreement both within the EU and across the Atlantic. Political agreement at the highest levels will also be needed to sustain the required financial resources, especially as the initial ardor and sense of urgency wanes. As the experience in Bosnia has made clear, coherent and forceful leadership will be no less important in implementation. The problems of focus, priority, and coordination are very serious. Kosovo has a NATO military commander, a UN appointed governor, a reconstruction effort sponsored by the EU, and numerous other multilateral agencies with onerous responsibilities. Sorting out Kosovo's relationship with Serbia will itself be complex, with different conceptions already emerging among the many outside actors.

At this early stage, coordination among the different offices and organizations operating in Kosovo is occurring on an ad hoc basis. If this pattern continues, the international



community will in the end repeat the mistakes of Bosnia. To ensure effective implementation, a clear line of authority needs to be established, both on the ground in the Balkans and within the international community. Strong personalities with political clout are needed, individuals who can get adequate political guidance, turn that guidance into action, and secure significant coordination among all the relevant parties.

As the international community embarks on an ambitious, long-term strategy for building a lasting peace throughout the Balkans, coordination among the many different initiatives will be essential. We recommend that the EU and the U.S. establish a Joint Commission for Balkan Integration to provide the necessary leadership and oversight. The Commission should have two co-equal heads, one American and one European. Such a commission to have maximum influence must be headed by persons of considerable stature, particularly for the first few years. Individuals of the visibility and political clout of Robert Rubin and Jacques Delors come to mind. The body should be given broad powers to design and implement policies. In Kosovo, as the experience of the Office of the High Commissioner in Bosnia has made clear, only an authoritative structure headed by decisive individuals will be able to manage effectively within an unwieldy international community and amidst the domestic logjams likely to characterize Balkan politics during the initial stages of reconstruction and reconciliation.

## **Notes**

1 European Free Trade Association: Iceland, Liechtenstein, Norway and Switzerland.

2 European Economic Area: EU plus Norway and Iceland.

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