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Economic Development in the Western Balkans: On the Road to Competitive Market Economies?

Valbona Zeneli *

Introduction

Today, more than ever, economic security is the main challenge facing the Western Balkans.¹ Poverty, unemployment and inequality threaten the everyday security of average citizens in the region. Indirectly affected by the world economic recession through trade and finance spillover channels and strong dependence linkages with European Union markets, this region became highly vulnerable, falling into a double dip recession.² The economic downturn has worsened socio-economic conditions, diminishing consumers' confidence in markets, socially dividing the societies in terms of income and wealth levels, declining living standards and shaking social foundations, and threatening the hopes of eventual convergence with advanced countries. To reverse the downhill slide, the Western Balkans need to change gears, revising the model of growth by accelerating socio-economic reforms and speeding up measures to develop its economy. In desperate need of modernization, institutional transformation and sustained economic growth, countries should rely on deeper regional cooperation and integration with the EU as the foremost option for positive development. The most important driver of growth will be the catch up with technologies and market-friendly institutions of the advanced countries.

State of Play in the Western Balkans

The rapid growth of a decade ago and the catching-up process of the Western Balkans' economies came to an abrupt end in 2009, with a GDP contraction of an average of 3.9 percent. Continuing to struggle with another recession in 2012, the GDP shrank again by 1.2 percent.³ It appears the region exited the recession only in 2013, with anemic growth

* Dr. Valbona Zeneli is a professor of National Security Studies at George C. Marshall European Center for Security Studies. She holds a doctor of science degree in political economy from the University of Study of Bari, Italy. She earned a postgraduate diploma on international marketing from Georgetown University, Washington D.C. and graduated with honors in business administration from the University of Bologna, Italy. Her areas of expertise include Economic Security; International Trade & Development; Globalization; Anticorruption; Good Governance; and Southeast Europe/ Transition Countries.

¹ The countries taken into consideration include Albania, Croatia, the Former Yugoslav Republic of Macedonia (FYROM), Bosnia & Herzegovina, Serbia, Montenegro, and Kosovo.

² World Bank, *South East Europe Regular Economic Report: From Double-Dip Recession to Accelerated Reforms*, No. 3 (18 December 2012), available at: http://www.worldbank.org/content/dam/Worldbank/document/SEERER_3_Report_FINAL_eng.pdf.

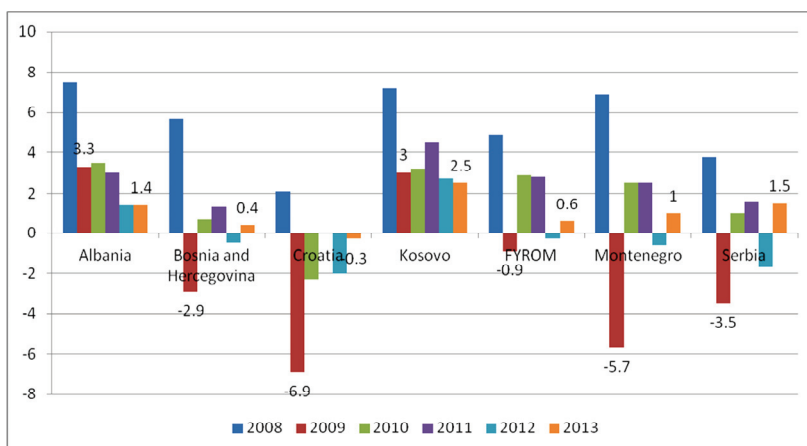
³ "Serbia: A double-dip recession in the Western Balkans," *The Economist Intelligence Unit* (28 December 2012).

reflecting the prolonged recession in the Euro zone and particularly the weak economies of Greece and Italy. Also, the prospects ahead show weak growth rates and a sluggish recovery, as shown in Figure 1.

The lagging reaction of the Euro zone crisis still continues to burden the fragile transitioning economies of the Western Balkans, which are battling a sluggish recovery, weak economic output, unemployment and dangerous high public debts.

The main negative contagion channels have been the fall of foreign direct investment (FDI) in the Western Balkans, experiencing the sharpest decline of any emerging market in 2009 with a contraction of more than 30 percent on average;⁴ the decline in exports and trade in general; and the fall of remittances from expatriate works. The ongoing credit crunch in the Western Balkans is perpetuated by foreign ownership of the banking system and the serious impact of the Greek economic crisis, the latter being a strategic investor in the region and one of the main trading partners.

Western Balkan economies lag behind the rest of Europe with very low incomes and living standards. The average income levels in the region are as low as 36 percent of the EU-27, varying from Kosovo, with only 22 percent of the EU 27 average, to 61 percent in Croatia.⁵

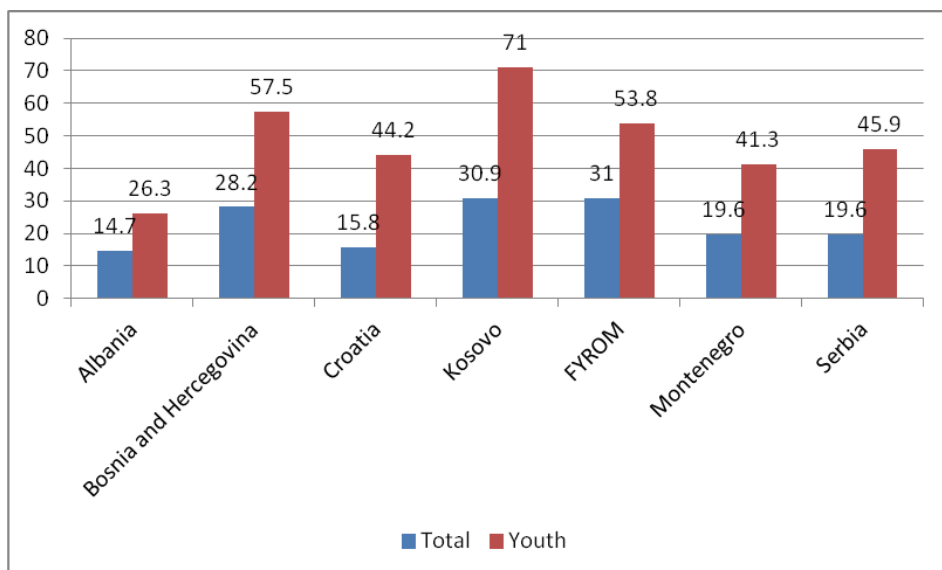


Source: IMF World Economic Outlook, April 2014.

Figure 1: GDP Growth Rates in the Western Balkans (2008-2013).

⁴ Marios P. Efthymiopoulos and Valbona Zeneli, "From Transition to Opportunity: Security through Economic Development & Institutional Strengthening," *Research in the World Economy* 2:2 (Toronto, ON: Sciedu Press, September 2012), <http://www.sciedu.ca/journal/index.php/rwe/article/view/1725>.

⁵ Western Balkans Investment Framework, "Challenges to successful employment policy in the region: towards more jobs, quality labour force and greater competitiveness," Discussion paper (London, UK: The London School of Economics and Political Science, European Institute, November 2012), available at http://www.lse.ac.uk/europeanInstitute/research/LSEE/Events/PDF_Files/MASTERChallengestoSuccessfulEmploymentPolicy.pdf.



Source: World Development Indicators, World Bank database

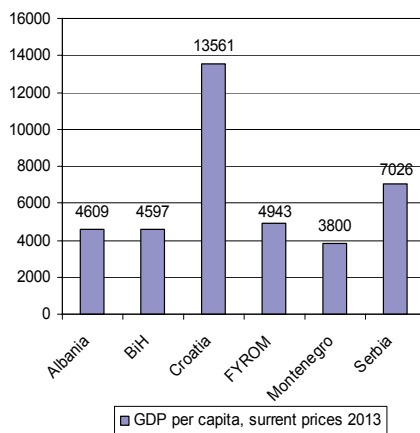
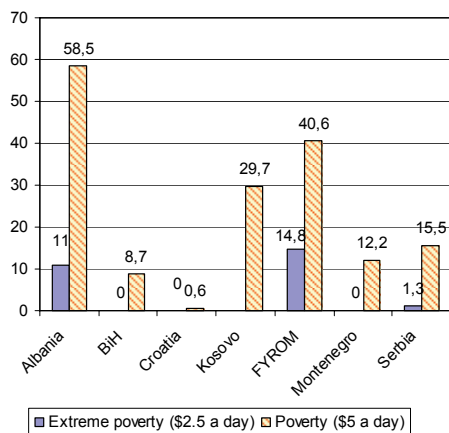
Figure 2: Unemployment in the Western Balkans 2012, % of population (total and youth).

At the same time, unemployment in the Western Balkans is the highest in Europe, with an average of 24 percent, twice the West European average. The economic crisis worsened this picture, with more plunging incomes, rising poverty and unemployment.

Although GDP per capita almost doubled in the last decade, unfortunately it was a jobless growth that did not translate into increased employment. Western Balkan countries suffer comparatively low participation rates and a lack of opportunities for young workers. Simultaneously, the incidence of informal unemployment continues to remain large in the still transitioning economies of the Balkans, with estimated levels to be between 30 and 40 percent.

The most devastating consequence of the high incidence of joblessness is poverty.⁶ Levels of poverty are highly persistent in the neighboring region of Western Europe. The incidence of poverty is extremely high in Albania and FYROM with 58.5 percent and 40.6 percent, respectively, of the population living with less than \$ 5 a day. The best performing economy in the region is Croatia, with only 0.6 % of the population living under the poverty line. However, on average, this situation has worsened across the

⁶ World Development Indicators, available at <http://povertydata.worldbank.org/poverty/region/ECA>.



Source: World Development Indicators (Figure 3) and IMF World Economic Outlook, April 2014 (Figure 4)

Figure 3: Incidence of poverty in the Western Balkans, Percentage of population (2013)

Figure 4: Gross Domestic Product, Current prices (2013), Values in US \$

Western Balkans, with about 60 percent of the people surveyed by EBRD reporting that the crisis has affected them significantly, deteriorating their living standards.⁷

If data are read carefully, they also prominently portray very high levels of income inequality in the region, as the countries of the Western Balkans mainly have similar patterns of income per capita, but very different levels of poverty (cf. Figures 3 and 4).

Hopes of high growth rates and the eventual convergence of living standards with the more prosperous West are put at risk. Economic convergence is fading. The stall of GDP growth in the region is alarming for these weak, emerging economies. Little growth spurts followed by stagnation simply lower the average growth and prolong the process of catching up with the advanced economies.

Countries of the Western Balkans are middle-income economies.⁸ Research shows that when countries arrive at similar levels of growth, they usually enter “the middle-income trap,” while factors that have enabled them to catch up diminish and growth begins to slow down. The explanation is that markets become structured and the industries that drove growth in earlier periods become uncompetitive due to rising wages and the cost of living.

⁷ European Bank for Reconstruction and Development (EBRD), *Life in Transition: Impact of the Global Economic Crisis* (EBRD, 2011), available at <http://www.ebrd.com/downloads/research/surveys/LiTS2eb.pdf>.

⁸ According to the World Bank, countries are considered middle-income when GDP per capita ranges from 5,000 to 10,000 US dollars.

Old Economic Model

The economic model in the Western Balkans is highly challenged. Former socialist countries began implementing the neoliberal transition model based on the postulations of the Washington consensus, with quick liberalization and deregulation of markets, prices and foreign trade, rapid privatization, and deregulation of economic flows. The hope was to replicate the successful model applied in many Central European countries with a quick transition phase into well-established market economies. Instead, the same model manifested many weaknesses in the Western Balkans. Neo-liberal reforms and privatization processes have not been effective, but have instead favored insiders and increased corruption.

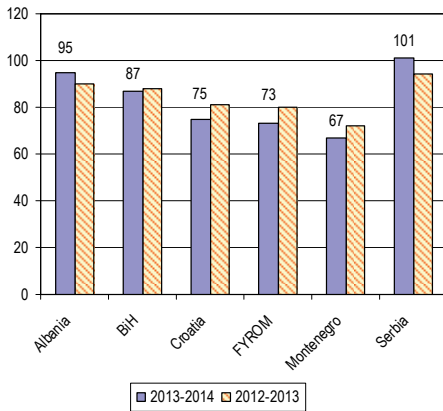
Among other problems discussed later in this paper, the Western Balkan countries were encumbered by their unfavorable starting position – with low incomes and high unemployment in the early nineties. The situation further deteriorated due to military conflicts and regional disputes in the second half of the nineties, destroying the hardly-existent industrial capacity, disrupting trade among countries and worsening the economic situation. At the same time, governments were distracted from applying and implementing much-needed structural reforms.⁹ Lagging behind other transitioning countries, the Western Balkans began deep economic reforms after the year 2000, striding in their transformation process and slowly catching up with other European economies.

However, development in the last decade was driven by the accumulation of physical and financial capital, which has fueled the sovereign debt of the countries over time. From a growth theory perspective, the relatively high growth was based on domestic, demand-led expansion, made possible by large capital inflows chiefly through the huge privatization process of state-owned companies, large credit growth and private transfers. One of the negative consequences of the large credit capital inflows was their misallocation towards consumption, not properly feeding productive investment activities. All of the above hindered the competitive upgrade of these economies.

Economic indicators show a significant performance lag in the improvement of the enterprise sector and creation of strong competitive markets. With very low productivity, growth so far has been based on increased efficiency,¹⁰ and the competitiveness of the region is highly unsatisfactory. The Western Balkan countries also rank very poorly in the Global Competitiveness Report 2013-2014, particularly when it comes to innovation and business sophistication. With the exception of Croatia—which is a member of the group of the countries transitioning between efficiency and innovation-driven economies—all other countries have reached the second stage of economic development based on efficiency, according to World Economic Forum indicators. As figures 5 and 6 show, the lowest rank is held by Serbia in 101st place, and the highest is held by Montenegro in

⁹ Valbona Zeneli, “Economic Security in Southeast Europe,” *Per Concordiam: Journal of European Security and Defense Issues* 4:4 (2014): 10–16.

¹⁰ “The Pre-Accession Economies in the Global Crisis: From Exogenous to Endogenous Growth?” *Occasional Papers* (European Commission Directorate for Economic and Financial Affairs, 2012).



Source: Global Competitiveness Index, World Economic Forum database. Kosovo is not included in the data.

Figure 5: Competitiveness in the Western Balkans, Ranking based on 148 countries researched

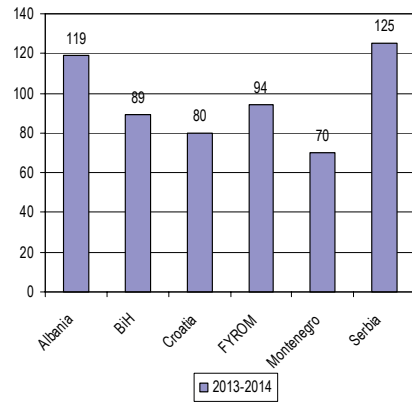
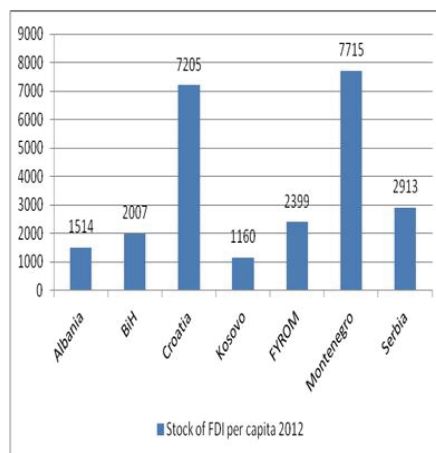
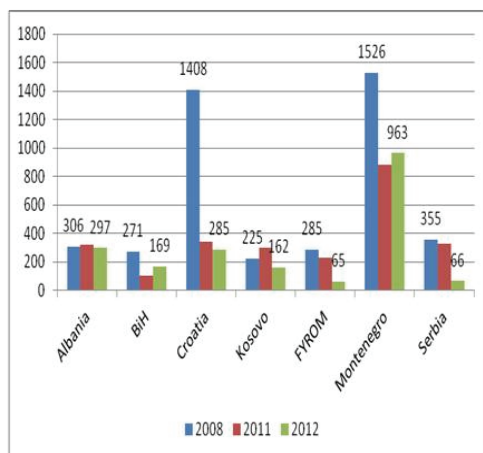


Figure 6: Innovation and Sophistication factors, Ranking based on 148 countries researched

67th place out of 148 countries taken into consideration.¹¹ The average rank for the region would be 99, whereas the EU 27's average score would rank at 35.

Combined with the unfriendly business environment characterized by weak institutions and rule of law, the extremely limited role of innovation in the economy is another big challenge. The region has the lowest levels of spending in R&D in Europe, significantly contributing to its low competitiveness. Because of weak domestic demand and small markets, domestic companies are unable to generate sufficient profits, furthering the weak interest in modernization and innovation. The ranking of some countries in the GCI with regard to innovation and sophistication factors is even worse (Figure 6), while total productivity can only increase through innovation and technological progress. However, innovation is costly and the poor economies of the Western Balkans do not have the financial and human capacities to invest in it. Technology and knowledge can be imported from advanced economies to the Western Balkans solely through trade and foreign direct investments. Fortunately, the region is within proximity to one of the biggest powerhouses of technology and research in the world, the European Union.

¹¹ Klaus Schwab, ed., *The Global Competitiveness Report 2013–2014* (World Economic Forum, 2013), available at http://www3.weforum.org/docs/WEF_GlobalCompetitivenessReport_2013-14.pdf.



Source: UNCTAD database. For Kosovo, author's calculations based on World Bank data.

Figure 7: Inflows of FDI pc in the Western Balkans, Values in \$

Figure 8: Stock of FDI pc in the Western Balkans, Values in \$

The Western Balkans, offering unique opportunities in terms of strategic positioning, a proximity to western markets, natural resources, and relatively cheap labor costs, still attract very few investments. Montenegro had the highest level of FDI stock per capita in the region in 2012 with \$7,715, while Albania and Kosovo had the lowest, at only \$1,514 and around \$1,160, respectively.¹² Throughout the region, with the exception of Albania and Kosovo, countries experienced the sharpest decline in FDI of any other emerging market after the beginning of the global economic crisis in 2009. This was followed by another decline in 2012, as is shown in Figures 7 and 8. The unique situation in Kosovo and Albania is related to the existing low number of investments and the privatization process.

Such a decreased level of FDI does not depend entirely on the lack of global financial resources, particularly considering that contraction in the Western Balkans in 2009 was almost 30 percent compared with only 8 percent globally. Rather, it is a crisis of confidence. No important investment will take place without solid knowledge of the political-social and economic environment of the host country.

Foreign investments in the region are mainly market seeking, related mostly to the privatization process, services and financial sectors, retail trade and, very rarely, export.

¹² Data on FDI are taken from *UNCTAD (United Nations Conference on Trade and Development) Statistics*, p. 5, available at http://unctadstat.unctad.org/ReportFolders/reportFolders.aspx?sRF_ActivePath=p,5&sRF_Expanded=. For Kosovo, the author's calculations are based on World Bank data, available at <http://data.worldbank.org/indicator/BX.KLT.DINV.CD.WD>.

The absence of Greenfield investments¹³ and lack of investment in the manufacturing industry did not stimulate real industrial growth or development in the market through positive spillover effects.

Foreign investors are reluctant to commit seriously in the Western Balkans for various political and economic reasons, including economic structural problems, pervasive corruption and governance issues, political risks, inefficient rule of law, weak growth rates and skill deficiencies. Statistical research has proven that the quality and performance of the institutions and a business environment free of corruption are the main factors that foreign investors consider before entering this region.¹⁴ In terms of attracting foreign investors and based on the VC/PE Country Attractiveness index 2013, of 118 countries taken in consideration, the most attractive country in the Western Balkans is Croatia, ranking 65th in the list, followed by Bosnia and Herzegovina in 73rd place, FYROM in 80th, Serbia 82nd, Montenegro in 86th, and finally Albania in 108th position.¹⁵

Few countries in Europe have higher levels of corruption than the Western Balkans, varying by country. Research has shown a direct negative relationship between high levels of corruption and income per capita, which is statistically confirmed in the region. According to the Transparency International's corruption perception index 2013, Albania ranks worst in 116th place out of 177 countries, followed by Kosovo in 110th position. The best performer in controlling corruption in the region is Croatia ranking 57th.¹⁶ Red tape, overregulation, corruption, lack of transparency, the inability to create a business-friendly economic environment and weak institutions all hurt the competitiveness of the region.

Revising the Economic Model in the Western Balkans: The Economy of the Future

The Western Balkan countries are struggling to regain their economic stride despite facing the double challenge of structural changes under financial austerity pressure. The old extractive, import-led and financial-sector-driven growth model needs to be reevaluated. The current structure of the Balkans' economies, which accounts for more than 50 percent, is dominated by services, trade and real estate. The production of goods remains at the lower end of the value chain, based on cheap and unskilled labor. The com-

¹³ Greenfield investment involves establishing a new plant with its own production abroad. There are different definitions of FDI given by different scholars, in this case the definition of OECD is considered: FDI is generally defined as an investment by a firm from one (home) country in another (host) country, where the foreign investor owns at least 10% of the company in which the investment is made (OECD 1996).

¹⁴ Valbona Zeneli, *The Determinants for the Attraction of FDI in Southeast European Countries: The Role of Institutions*, Ph.D. dissertation (University of Bari, 2011).

¹⁵ The Venture Capital and Private Equity Country Attractiveness Index 2013, available at <http://blog.iesee.edu/vcpeindex/files/2013/08/VCPE-Index-2013-Annual-HD.pdf>.

¹⁶ Ranking of the Western Balkan countries in the Corruption Perception Index 2013: Croatia 57th, Montenegro 67th, FYROM 67th, Serbia 72nd, Kosovo 111th and Albania 116th, cf. <http://cpi.transparency.org/cpi2013/results/>.

petitive advantage in the past has been the relatively cheap labor, which is not sustainable anymore with increased wages.

The present situation looks gloomy for the region, but longtime prospects have the potential to be bright, as the Western Balkans have plenty of catching up to do with the rest of Europe. To accomplish these hopes, there is a strong need to change the drivers of growth by shifting patterns toward a more export-oriented and foreign direct investment-driven growth, which would be more competitive and productive. The future economy of the Western Balkans should be envisioned as socially just, sustainable and innovation-based.

Growth needs to be driven by investment, productivity, competitiveness and economic integration. Attracting FDI will be crucial to accelerating the trend, while learning important lessons from the economic history of other Central European countries, which single out FDI as one of the main promoters of economic growth and successful integration into the EU.

FDI is even more important for the Western Balkans especially when considering the very low savings rates and the anemic domestic investment. Data shows that the Western Balkans are not very attractive to foreign investors. The starting point for each of the seven countries considered in this paper would necessitate the recognition that they are too small and weak to generate the sufficient scale and capacity to attract productive foreign investment. Each country lacks the required numbers of skilled workers, local financial capacity and the ability to sustain economic clusters. Remodeling the economies of the Western Balkans will not be possible without creating a favorable business environment while simultaneously exploring effective cross-border linkages.¹⁷

Regional Integrated Growth

Regional integrated growth is imperative. By strengthening regional trade and investment cooperation, regional economic integration would help to collectively achieve more on the international stage and bring a multitude of positive effects for each country.

Although there has been considerable progress in trade exchanges and the reduction of barriers, trade levels remain low, below 10 percent of total trade.¹⁸ This low level of cross border activity cannot be explained by the lack of access to each other's markets. A good existing framework is already in place: the Central European Free Trade Agreement (CEFTA), which has substantially lowered the tariffs and eased administrative procedures. However, this framework is still very poorly implemented, with the

¹⁷ Valbona Zeneli, "Growth and the Future of Southeast Europe," *Turkish Policy Quarterly* 2 (Summer 2013): 145-55, available at www.turkishpolicy.com/dosyalar/files/vol_12-no_2-zeneli.pdf.

¹⁸ Peter Sanfey and Simone Zeh, "Making sense of competitiveness indicators in South-eastern Europe," EBRD Working paper No. 145 (EBRD, 2012), <http://www.ebrd.com/downloads/research/economics/workingpapers/wp0145.pdf>.

most problematic issues lying in the non-tariff barriers: lengthy procedures, extensive corruption and absence of political will for cooperation.

First, regional economic integration through lower tariffs and, better still, complete trade liberalization, the removal of the non-tariff barriers, and the liberalization of trade in services, would increase intra-regional trade and enhance consumer choices in the Western Balkans. Producers would benefit from the increased market size and consumers would benefit from greater competition, receiving higher quality and better prices. It would mean new opportunities in terms of resource exploitation, new markets and new trade partners.

Second, exporting within an integrated region would serve as a first step towards an expansion of international exports, taking advantage of low tariffs within the region, building export capacity and achieving a competitive advantage in the long term. Countries can also build cross-border production chains by leveraging each other's comparative advantages and subsequently export the finished products outside the area.

Third, the EU integration agenda, which all countries have as a strategic objective, helps better regional cooperation through the harmonization of custom and trade regulations in the process of adapting to European standards. The idea of regional integration itself has been pushed and supported by the European Council, and aims to serve as a preparation step for the region before it joins the common market.

Fourth, it is necessary for the Western Balkans to collectively promote and develop a friendly environment for the attraction and targeting of "qualitative" FDI towards sectors that augment domestic investment, foster exports and lead to sustainable economic growth. Countries should cooperate with regard to a "pooled" competition for FDI.¹⁹ Creating a regional strategy for investment promotion and developing a single capital market would help improve the region's global competitiveness. Regional links through FDI typically play a prominent role, just as they did in the 1990s when Central European countries became integrated in the European production chains. Increased foreign investment in the region along with the direct positive effects for economic growth, employment and higher incomes would be a source for economic modernization, improvement of skills and overall productivity.

Fifth, public and private capacity building should be one of the main priorities, including critical elements such as human resources and skill development, technology, know-how, infrastructure development and enterprise development. This task is also in line with the EU 2020 growth strategy, which discusses smart growth built on knowledge, education, and innovation.²⁰ With austerity continuing unabated, it is not an easy task. Future growth could be achieved only by operating regionally. Individually, no country has the potential to succeed.

¹⁹ Ibid., 18.

²⁰ *Europe 2020: A Strategy for Smart, Sustainable and Inclusive Growth* (European Commission, March 2010), available at <http://ec.europa.eu/eu2020/pdf/COMPLET%20EN%20BARROSO%20%20%20007%20-%20Europe%202020%20-%20EN%20version.pdf>.

Finally, regional integration can help the countries strengthen economic and political institutions. Working with the EU in the integration process has been of crucial importance in building institutional capacity. In the future, however, the region should support itself and carry out reforms for its own sake without too much reliance on external actors.

International institutions frame the region poorly from a business environment perspective, with corruption being one of the main challenges to doing business. One key issue with regard to creating a favorable investment environment is the urgent need to strengthen political and economic institutions. Investment policies should ensure the fair treatment of foreign and domestic companies, a friendly business environment and institutional support for private competitiveness by supporting small and medium enterprises in particular. All countries rank very poorly in World Economic Forum indicators when it comes to the effectiveness of the anti-monopoly strategy, with Bosnia & Herzegovina ranking best in the region at 68th position out of 148 countries, and Serbia as the worst in 141st position.²¹

Real reforms and bold efforts devoted to the fight against corruption are imperative for creating a friendly business environment and carrying out growth strategies that can support productivity growth, increased competitiveness, job creation and facilitate income convergence. Implementing a more effective privatization strategy, and cutting bureaucratic red tape and bribery would unleash the creative destruction necessary for economic growth in the region.

Smart Growth

Many of the socio-economic problems affecting the western Balkans cannot be solved or alleviated unless robust economic growth returns to the region. In line with the SEE 2020²² growth and development strategy following the European perspective of the region's future, the drivers of growth should be based on innovation, skills and trade integration.

Cheap labor, which has been a competitive advantage of the region in the recent two decades, is vanishing. Qualitative human capital based on a skilled labor force is the main source of productivity and innovation, and a factor for growth and job security in this century. The Western Balkans should promote an innovation- and knowledge-based economy.

The World Bank's Knowledge Economy Index (KEI) 2012 measures the countries' potential to generate growth, taking into consideration four important pillars for development (economic incentives and institutional regimes, innovation and technology, education and training and ICT infrastructure).²³ The countries of the Western Balkans rank

²¹ "Effectiveness of Anti-monopoly Policy," in *The Global Competitiveness Report 2013-2014*, 472.

²² *South East Europe 2020: Jobs and Prosperity in a European Perspective* (Regional Cooperation Council, August 2013).

²³ World Bank, Knowledge Economy Index (KEI) 2012 Rankings, available at <http://siteresources.worldbank.org/INTUNIKAM/Resources/2012.pdf>.

varyingly. Out of 146 countries researched, the best performer in the region was Croatia in 39th place, followed by Serbia at 49th, Macedonia at 57th, Bosnia and Herzegovina at 70th and Albania in the 82nd position.

Statistics show that knowledge-based development is possible only if there is qualitative human capital. The latter is grounded in modern education and solid skills.²⁴ International institutions raise issues about the lack of skills in the workforce in the region, which depend both on the quantity and quality of education. According to World Bank reports in 2012, tertiary education attainment rates were very low (although enrollment rates are much higher) – 15 percent on average in comparison to 36 percent of the EU countries.²⁵ On the other hand, when it comes to the quality of education and the local availability of specialized research and training services, the World Bank lists countries out of 148 as follows: Croatia in 74th, followed by Macedonia in 78th, Montenegro in 99th, Bosnia and Herzegovina in 100th, Albania in 113th and Serbia in 121st.²⁶

Following the logic of the statistics, the task for the upcoming years is to increase the quality of education, particularly focusing on tertiary education.

Even in the regional perspective, infrastructural projects alone are not enough; regional cooperation needs to be placed in a much wider development context, aiming the advancement of human capital by strengthening regional value chains and supporting the creation of transnational clusters and business networks. A larger, more integrated market facilitates innovation. The promotion of linkages between academia, industry and policy makers is important for encouraging the free flow of talent throughout the region, stimulating brain gain, supporting private and public sector investment in R&D, and regionally coordinating policies that would enhance innovation and promote the knowledge economy.

In the global economy, even countries with a limited geographic area and inadequate resources can strengthen their economies and increase national strength by fully engaging in the international marketing. In this century, the choice is no longer between being a “big” or “small” state, but being a “smart” or “laggard” state. A “smart state,” with inclusive institutions is capable of correcting problems, providing the right policy guidance, creating favorable conditions for successful private entrepreneurship and promoting innovation through greater inclusion of all talent in the society.

The international economy enables countries that are stable, secure and open to learn rapidly from those in vanguard of economic performance under two conditions: the host countries should invest in education and inclusive economic institutions.

²⁴ Ibid., 23.

²⁵ Educational Data from World Development Indicators and UNICEF – TransMonEE, www.Transmonee.org.

²⁶ *Global Competitiveness Report 2013–2014*.

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