The Deepening Crisis in the European Super-periphery

Will Bartlett (London School of Economics and Political Science)\(^1\)
Ivana Prica (Faculty of Economics, Belgrade)

ABSTRACT

We argue that the Western Balkans form part of a ‘super-periphery’ of Europe, being highly vulnerable to the effects of the Eurozone crisis yet lacking support from the EU bailout funds and policy instruments that are available to ease the crisis impact on the ‘peripheral’ EU Member States. The crisis has been transmitted through several channels including exports, remittances, foreign investment and bank credit flows. The paper investigates the impact of the Eurozone crisis on the region in a comparative perspective, considering the crisis effects in six countries (Albania, Bosnia and Herzegovina, Croatia, Macedonia, Montenegro, Serbia). It questions whether the EU accession process continues to offer hope of economic prosperity in the future or whether the countries of the super-periphery should rely more on their own resources, new alliances, and regional cooperation to support future economic growth.

\(^1\) Corresponding author: Will Bartlett, w.j.bartlett@lse.ac.uk
1. Introduction

Since early in 2010, the global economic crisis that began in 2007 has transformed itself into a specific crisis of the eurozone. In this paper we investigate the impact of the eurozone crisis on the transition economies of the Western Balkans, a set of countries that form part of the European ‘super-periphery’. This set includes countries of the Western Balkans and EU eastern neighbourhood countries that are not EU members. All of them have achieved some degree of EU integration and most are candidate or potential candidate countries for EU membership. The economies in these countries are characterised by a high degree of euroisation that has made them highly vulnerable to all the negative effects of the eurozone crisis, yet without the support from the various EU bail-out funds, the European Central Bank (ECB) and other policy instruments that are available to ease the impact of the crisis on the ‘peripheral’ EU Member States such as Greece, Ireland, Spain, Portugal and Italy. While the eurozone crisis has had a damaging effect on its weaker members in the EU periphery it has not been widely recognised that it has had an even more damaging effect on countries outside the zone especially those in the volatile European ‘super-periphery’. In several of these countries (Bosnia, Macedonia, Serbia) unemployment currently exceeds 25% - a position worse than in Greece or Spain. Countries in the super-periphery are especially vulnerable to the effects of the eurozone crisis due the effects of euroisation, which is particularly pronounced in the Western Balkan countries. In Serbia, for example, more than 80% of all private sector loans are denominated in a foreign currency, while in Montenegro the Euro is officially legal tender. Euroisation makes it hard for countries in the super-periphery to achieve a real devaluation, and so internal devaluation through domestic recession and reduction of unit labour costs is the only way to restore international competitiveness. In doing so however, these countries must manage without the support of the EU for debt reduction and so must impose even harsher austerity programmes than those attempted in Greece. They must also design their own programmes to ensure structural reforms that could

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3 Montenegro and Kosovo have adopted the Euro as legal tender without the approval of the European Central Bank, Bosnia has a currency board which ties its currency to the Euro. Other countries in the region have little room for manoeuvre as a large proportion of domestic liabilities are denominated in Euro. Croatia and Macedonia therefore have fixed pegs to the Euro. Only Serbia and Albania have flexible exchange rates.

4 Martin Brown and Ralph De Haas, “Foreign banks and foreign currency lending in emerging Europe”, Economic Policy, January 2012
underpin renewed economic growth, which is the only way to escape the vicious circle of debt, austerity and recession.

The first effects of the financial crisis on the Western Balkans countries came with a significant lag and were generally not very significant until 2009\(^5\). The intensification of the eurozone crisis throughout 2011 and 2012 and has had a predictable impact on the Western Balkan economies. Already weakened by the effects of the global financial crisis on external trade, FDI inflows and remittances, they have been hit again by the renewed slowdown in the EU, which has exacerbated the economic volatility of the region. For example, Serbian real GDP fell by 1.7% in 2012\(^6\), heralding renewed recession at a time when unemployment is already above 25%. Croatia, the newest member state of the EU, experienced its fourth year of recession in 2012 with a fall in real GDP of 2.0%.\(^7\)

2. Domestic economic performance: growth and unemployment

**GDP growth**

Economic growth in the Western Balkans underperformed earlier expectations in 2012 due to the bigger than expected slowdown in the eurozone. In April 2012 the IMF published a revised forecast predicting a contraction of 0.3% GDP for the eurozone in 2012\(^8\). This contraction has quickly spilt over into the Western Balkans where growth forecasts of major international institutions such as the EBRD have been downgraded accordingly (Figure 1).

\(^5\)Marko Ba and See Ivana Prica eković, detneser repap ,”snaklaB eht ni ytilibatS dna noitasilarebiL laichaniF“


\(^7\)Eurostat online data, variable code [tec00115].

\(^8\)April 2012, World Economic Outlookonal Monetary Fund, “Growth resuming, dangers remain”, Internati
The latest quarterly economic data indeed reveal that in major economies in the Western Balkans the prolonged effect of the slowdown as well as the renewed recession in the eurozone have had a deepening impact in the Western Balkans which entered recession in the first quarter of 2012 (see Figure 2).

Croatia, already struggling, saw its GDP plunge once again with a year-on-year contraction of 1.3% in the first quarter of 2012, mainly due to a fall in exports which fell by 3.5%; the largest falls in output took place in the industrial and construction sectors. In Serbia, the central bank forecasts a contraction of 0.5% of GDP for the year as a whole. In Macedonia, GDP contracted by 1.4% in the first quarter of 2012, compared to the first quarter of 2011.
Unemployment

The situation in the labour markets in Western Balkans has also deteriorated. Data from Labour Force Surveys (LFS) show increased rates of unemployment in all countries in the region. From 2010 to 2012 unemployment fell only in Macedonia, which nevertheless still had by far the highest rate of unemployment at 32% in the latter year (see Figure 3). Even there, unemployment has begun to increase again. Unemployment in Bosnia and Herzegovina is approaching similar levels, having breached the 30% level in the first half of 2012. Unemployment has also shown dramatic increases in Serbia (from 19.2% in 2010 to 25.5% in 2012) and in Croatia from 11.8% to 17% over the same period.

Figure 3: Unemployment rates (%)

Source: National Statistical Offices, Labour Force Survey data

These data reveal that unemployment has reached far worse proportions in the Western Balkans than even in those countries of the EU periphery that have been worst affected by the eurozone crisis. In the eurozone as a whole, the unemployment rate reached 10.5% in 2012. In Greece the unemployment rate reached 24.3%; in Spain, the rate of unemployment was 25.0%, the worst in the eurozone. These extremes were exceeded in Bosnia and Herzegovina (30.7%), Macedonia (31.6%) and Serbia (25.5%), providing further evidence of the dire position of the Western Balkan countries in the European super-periphery.

Youth unemployment has increased to even more dramatic levels. The unemployment rate of those aged 15-24 in Bosnia and Herzegovina was 63.1% in 2012, in Montenegro it was

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9 Eurostat, online data, variable code [tsdec450]
41% in 2012,\textsuperscript{11} and in Croatia it was 45.2% in Q1 2012.\textsuperscript{12} In Serbia the unemployment rate of 20-24 year olds in 2012 was 48.4%.\textsuperscript{13} In comparison, in the eurozone the youth unemployment among under-25s was 22.8%.\textsuperscript{14} The situation, however, reached astronomic proportions in Greece and in Spain, where in 2012 youth unemployment reached 55.3% and 53.2%, respectively, even higher than in the Western Balkan countries (with the exception of Bosnia and Herzegovina).

3. External economic performance: exports, FDI, and debt

Exports to the euro area as a whole fell in most countries in the region between the first quarter of 2011 and the first quarter of 2012. The most seriously affected countries have been Montenegro and Serbia whose exports to the euro area fell by 26% and 16% respectively over that period. The exception to this contraction of trade has been Albania, whose exports to the euro area have increased in that period. Albania’s exports are very small so there may be low base effects appearing here. In addition almost all Albania’s exports go to Italy and there may be specific factors that have affected Albanian exports to this country (such as inelasticity of particular exports).

Figure 4: Exports to the Euro Area (% change, 2012q1/2011q1, euros)

![Figure 4: Exports to the Euro Area](image)

Source: IMF Direction of Trade Statistics (DOTS), adjusted for end of quarter exchange rates.

\textsuperscript{11}No. 83, 29 March 2013 ReleaseMontenegro Statistical Office "Labour Force Survey 2012",
\textsuperscript{12}No. 9.2.7/1, 19 July 2012 First Release Force Survey", Croatian Bureau of Statistics, “Labour
\textsuperscript{13}Statistical Office of the Republic of Serbia, “Labour Force Survey 2012”, Table 2.1
\textsuperscript{14} Eurostat online data, June 2013, [tsdec460]
Remittances from migrant workers abroad to their home countries have also made a significant contribution to the current account balance on international payments. In several countries this reaches significant levels such as in Kosovo where remittances accounted for 18% of GDP in 2011, Bosnia and Herzegovina (11%), Albania (9%) and Serbia (7%). Between 2010 and 2011 remittances held up well and even increased in absolute terms in every country except in Croatia. However, the inflows of remittances fell in all these countries in 2012 as the eurozone entered recession since many migrant workers are employed in the eurozone countries (for example, Albanian migrants are increasingly loosing their jobs in Greece). Remittances fell by 16% in Serbia, 11% in Albania, 9% in Kosovo, 5% in Bosnia and Herzegovina.\(^\text{15}\)

*Current account deficits*

Current account deficits have continued to increase in 2012 (see Figure 5) despite the fact that they are in crisis, mostly due to high government spending and political inability to curb it. Since FDI has been falling in most countries (but not all) the increased deficits were more often than not financed by the additional government borrowing, which has led to an increase in external debt to sometimes prohibitively high levels (especially during the crisis), as we discuss in the next section.

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\(^{15}\) World Bank, migration and remittances data, online June 2013
The high levels of the current account deficits in Montenegro and Albania have been sustained by a continuing inflow of FDI into those countries, albeit at a lower level than before the onset of the crisis. In Croatia and Macedonia current account deficits fell to relatively low levels in relation to GDP, which was in line with the lower levels of FDI inflows into those two countries. The high current account deficits in Bosnia and Herzegovina and in Serbia were partly financed by IMF loans supplemented by funds from the World Bank and the EU.

Foreign direct investment

One of the main consequences of the global financial crisis of 2008-09 was the collapse of international capital flows and a sharp reduction in global FDI flows\(^\text{16}\). This was reflected in the Western Balkans with a reduction in FDI inflows in these years\(^\text{17}\). The contraction in FDI inflows continued in Albania and Montenegro in later years, while other countries that had

\(^\text{16}\) eht gnirud sIolf Iatipac lanoitnternti :tnemheerter taeq ehT“ ,Ferreti and Cédric Tille-esiMil Maria-Gian April 2011 ,Economic Policy,global financial crisis”,

\(^\text{17}\) and Ivana Prica For accounts of the early effects of the global economic crisis in the Western Balkans see repap, ”eporuE nretsae htuoS dna lartneC no sisirc cimonone labolg eht fo tcapmi ehT“ ,Milica Uvalič Will ,2009 September 27-Belgrade, 25 ,Economic Policy and Global Recession presented to the conference on South Eastern Europe After the Crisis: A New Dawn or Back to ,is (eds)Vassilis Monastiriot and Bartlett Ivana and School of Economics and Political Science, 2010; Will Bartlett London ,LSEE ,”Business as Usual Vol. LVI, ,Economics Annals ”,eporuE tsaE htuoS ni sisirc cimonone labolg eht fo tcapmi elbairav ehT“ ,Prica No. 191, 2011
been hit harder by the initial bout of the global financial crisis saw some recovery in FDI inflows in relation to GDP between 2010-11. Altogether, the levels of FDI in all countries were far lower than in the pre-crisis period.

**Figure 6: Foreign Direct Investment, 2010-11 (% GDP)**

![Figure 6: Foreign Direct Investment, 2010-11 (% GDP)](image)

*Source: Candidate and Pre-Accession Countries Economic Quarterly, 2012 Quarter 2, European Commission ECFIN Unit D-1, 6th July 2012.*

**International debt**

The external debt position of countries in the Western Balkans is quite varied ranging from almost 95% of GDP in Croatia and Montenegro to just 37% of GDP in Albania. The largest external debt was that of Croatia whose public and private sector external debt had reached an astonishing €47.4 billion by the end of April 2012, which is an increase of 4% since the end of 2011 and which is due to new central government borrowing.\(^{18}\) As seen in the Figure 7, critically high external debt positions are found also in Montenegro and Serbia and with both of these countries having continuously large trade and current account deficits these are alarming figures indeed. Macedonia and Albania are fast approaching these dangerous levels as well.

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\(^{18}\) Croatian National Bank Bulletin No 183, 2012
Despite its high level of external debt, Croatia has the highest sovereign investment rating as defined by Standard & Poor, although the rating is the lowest rank of investment grade and is on a negative watch. All the other countries in our pool are still in the speculative grade, with Bosnia and Herzegovina at the bottom of the list.

4. The financial sector in the Western Balkans

The concentration of bank ownership by foreign banks is extremely high in all Western Balkan countries and this gives a very negative outlook for their economic development in the current situation\textsuperscript{19}. The share of bank assets owned by foreign banks is above 90\% in Albania, Bosnia and Herzegovina, Croatia, and Macedonia, almost 85\% in Montenegro and 75\% in Serbia\textsuperscript{20}. Concern has been expressed in various quarters about the vulnerabilities this poses to the economies in case the support of parent banks through continued refinancing of foreign currency loans to domestic affiliates should be significantly reduced\textsuperscript{21}. The Vienna Initiative agreement in 2009 and the Vienna Plus agreement in early 2012 were designed to

\textsuperscript{19}According to EBRD online data

persuade parent banks, mainly based in Italy, Austria and Greece to remain engaged in the region. Most reports of international organisations such as the IMF and the EBRD insist that local banks are well capitalised and liquid, with high levels of provisioning against potential losses and that the foreign banks operations in the region are highly profitable due to the high interest rates charged of domestic loans and their virtual monopoly (oligopoly) position on the market. Nevertheless, the incidence of non-performing loans (NPLs) is increasing sharply throughout the region and concerns are no longer so easy to gloss over. In a recent IMF statement on Croatia, following a visit of the IMF mission to the country these concerns have become visible:

“The sizable dependence of banks on external financing exposes them to the risk of contagion from the euro area (interest and rollover risks), especially if concerns about the sovereign debt adversely affect the euro area parents of Croatian banks. Potential difficulties in obtaining refinancing at affordable interest rates could lead to excessive or disorderly deleveraging, complicating macroeconomic recovery. In the context of weak growth prospects, the risk of further deterioration in asset quality also remains material.”

During the global financial crisis credit collapsed in the developed countries and this spilled over into the Western Balkan region. As most of these banks are based in the eurozone, the credit contraction has continued with the progression of the eurozone crisis and the continuing difficulties faced by the eurozone parent banks has inhibited the resurgence of credit up to the present date. As illustrated in Figure 8, by 2011 the rate of credit growth had fallen to single digit figures in all countries except Albania where credit growth reached almost 12% and Montenegro where credit continued to actually contract as it had done also in 2010. According to a World Bank assessment “credit growth is likely to remain weak, and the financial sector, increasingly dependent on local deposits as deleveraging of European banks continues, will have at the same time to deal with elevated NPL levels.”

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22February 2012 3. Croatia: Concluding statement of IMF staff visit, International Monetary Fund
22012 June 5. South East Europe: Regular Economic Report, World Bank
Non-performing loans have risen rapidly as the effects of the economic crisis have worsened and both companies and households have experienced increasing difficulties in paying back their loans (see Figure 9). The share of NPLs in total loans reached 13.8% in BiH in Q1 2013, 13.6% in Croatia in Q4 2012, and 10.1% in Macedonia in Q4 2012. A range of legal, judicial and regulatory obstacles reflecting lack of protection for creditors has led to significant delays in NPL resolution. The rise in NPLs has put strain on the balance sheets of banks and has inhibited them from increasing the rate of credit growth, which has shrunk to low levels as already shown. This means that in the affected countries, small businesses are finding it hard to obtain credit to finance expansion and growth, or simply to stay in business. This in turn places another break on economic growth in the region. The issue does not yet seem to be causing critical problems for banks operating in these countries, which have built up large capital buffers on the basis of their highly profitable operations in the region. In Croatia, 20% of corporate loans were non-performing in September 2011, while only 8.5% of household loans were non-performing. However, within the category of household loans, mortgage loans were badly affected by the sharp drop in the house prices of around 20% from

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24 IMF Financial Soundness Indicators database.
25 Working group on NPLs in Central, Eastern and European Bank Coordination “Vienna” Initiative 2012 March, Southeastern Europe
26 January 2012, p. 44, Financial Stability Report, Croatian National Bank
the peak in 2007 amounting to the bursting of a property bubble. The real estate property prices have, due to the crisis, dropped in all these countries while mortgage holders who had indexed their loans in foreign currency were the most vulnerable. This was especially the case earlier on for mortgages that were indexed in Swiss Francs and that, albeit for a brief time, appreciated sharply against the domestic currencies, causing a panic amongst the debtors and their governments that had to introduce emergency measures to deal with this issue – until the value of the Swiss Franc was fixed against the Euro.

Figure 9: Non-performing loans as % of total loans, 2010 and latest data for 2012

Source: IMF Regional Economic outlook, October 2011 and EBRD Regional Economic prospects, July 2012. Note: data for 2012 refer to latest available data

A significant new factor in relation to the developing eurozone crisis is the phenomenon of deleveraging by eurozone parent banks that operate in the Western Balkans (see Figure 10). According to the IMF “Central and Eastern Europe are the most exposed to the euro area and could suffer disproportionately from an accelerated withdrawal of bank funding or portfolio capital”27. Deleveraging can come about through reductions in cross border flows of interbank funding, nonbank private credit including trade finance and also through reduced public sector lending28. The incentives on parent banks to pursue this strategy are varied. Firstly, market funding has become more costly due to adverse feedback loops between the sovereign debt crisis and banks. The rising costs of raising funds from wholesale money

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27 World Economic Outlooks, further policy action needed”, International Monetary Fund 2012 July , Update
28 Economic Premise , ”seirtnoq tekram gnigreme rof snoitacilpmi:gnigareveled knab naeporuE“, World Bank 2012 April , No. 79
markets have therefore become less attractive as a source of funds compared to local deposits than in the past. Secondly, eurozone banks are relatively undercapitalised and are required by more stringent regulations to raise their capital reserves to meet the Basel III requirement of 9% Tier 1 capital ratios, which limits their ability, or attractiveness to provide loans to cross-border affiliates. Thirdly, as bank equity values have fallen it has been more difficult for them to raise funds on private markets to build capital buffers against potential sovereign defaults. Furthermore, weakening economic performance leading to possible sovereign downgrades in the Western Balkans could increase country risk factors in decisions to of parent banks to remain engaged in the region.

Figure 10: Deleveraging in all sectors of BIS reporting banks (change in external net assets, 2009-2011)

Source: Bank for International Settlements (BIS) online data. Note: data refer to gross assets minus gross liabilities

An example of the tightening of conditions due to the eurozone crisis comes from actions taken by the Austrian National Bank, which in mid-November 2011 imposed tight curbs on home banks’ ability to lend in CSEE, instructing Erste Bank, Raiffeisen Bank International and Bank Austria (a subsidiary of Unicredit) to boost capital reserves and limit cross-border loans in the CSEE region\(^\text{29}\). The regulation requires that Austrian bank subsidiaries in emerging Europe must limit ratio of new loans to deposits to no more than 110%. Cross-border credit was expected to fall by up to one fifth as a result. In short, generally the deleveraging of EU banks in order to conform with the new EU capital adequacy requirements (Basel 2.5 and III) as well as due to the current market conditions, will

\(^{29}\)November 2011, The Financial Times
necessarily result in significant lowering of their exposure to the Western Balkan countries, which will, in turn, further reflect negatively on the price and availability of capital in these countries, regardless of the Western Balkan daughter banks’ capitalisation and/or their profitability. The extent of deleveraging in 2009-11 is illustrated in Figure 10. During this period the volume of external funding by parent banks fell by more than 20% in Albania, Bosnia and Herzegovina, Montenegro and Serbia. In the first quarter of 2012 the pace of deleveraging slowed down due to the policy measures introduced by the European Central Bank in December 2011 in the form of LTRO funding of the eurozone banking system through provision of €1 trillion of low-cost three year loans (the LTRO programme). Some of this funding found its way into the banking systems in the Western Balkans, providing a temporary respite. Nevertheless, the pace of deleveraging picked up again in the second quarter of 2012.

A worsening of the eurozone crisis would exacerbate these trends. According to the latest EBRD Regional Economic Prospects report, if the eurozone crisis is not contained and spreads to large eurozone countries (such as Spain and Italy) it could render “several large European banks insolvent. Major parent banks would accelerate deleveraging in the region, triggering a credit crunch and recession in emerging Europe… A negative Eurozone crisis scenario would affect CEB and SEE countries …[through] … depressed exports and financing inflows.”

5. Conclusions

As the data presented above unambiguously show, the eurozone crisis has hit the Western Balkan countries of the EU super-periphery extremely hard, with record falls in GDP growth rates compared to the rest of Europe, combined with extremely high and increasing unemployment levels. Furthermore, should the crisis in the EU be no worse than it is now, the prospects are that the economic performance is likely to deteriorate further so that the situation in Greece and Spain would pale in comparison.

Lacking the domestic political will and know-how to deal effectively with the crisis and without recourse to the EU stabilisation mechanisms (neither to the bail out funds nor to low-cost refinancing from the ECB) these highly euroised economies are bearing the full brunt of
the eurozone crisis unprepared. Furthermore, they lack any substantial internal buffers, which were used up during the prolonged exposure of these small open economies to the first phase of the global financial crisis (for example, debt has already increased to unsustainable heights in several countries). Dependency on the EU at this time of crisis also brings dangers in terms of increased vulnerabilities to downturns in the eurozone, which is especially problematic for the countries in the region, as the negative effects of EU monetary integration seem to have particularly amplified effects in the European super-periphery. In the absence of significant additional external aid we can expect social unrest and political upheavals the likes of which we have not seen in Europe in recent years.31

What are the possible ways out? The only rational approach that we can see, in the absence of significant and substantial EU assistance on the scale provided to countries such as Ireland, Portugal and Spain, would be that the countries of the Western Balkans, and of SEE as a whole including Greece, should consider ways in which they can work together to boost regional growth.32 Regional cooperation in this part of Europe could be an alternative to the dependence of each individual country on the EU. Undoubtedly there are political obstacles to such cooperation, but the benefits may be sufficient to overcome them, at least on the basis of practical economic programmes such as regional infrastructure investments, creation of a regional labour market, sharing of research capacity, creation of an integrated regional educational and training capacity. The aim would be to combine the considerable resources of the region in such a way to achieve economies of scale and promote externalities at a regional level in order to boost economic growth. However, once we move away from economic

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31 In June 2013 demonstrators in Sarajevo surrounded the parliament building keeping politicians and government officials as virtual prisoners until the early hours of the morning over a dispute about ID cards and child health services; in Banja Luka students demonstrated over cuts to education services; in March 2013 demonstrations against corruption and poverty were held in the centre of Pristina; in Skopje, Macedonia protestors clashed with police over an essentially ethnic issue with many injuries demonstrating the fragile nature of social peace in the country.

32 The idea of regional cooperation is not new, and has been actively promoted by the EU through its accession strategy for the region since at least the Thessaloniki declaration of 2003, and also through the instrument of the Regional Cooperation Council based in -wolph-f owned-Stability Pact and its ‘locally Sarajevo. The most successful achievement of this approach has been the formation of the CEFTA 2006 y got beyond the phase regional free trade agreement, although other regional cooperation initiatives have hardl of declaratory statements of intent. The EU has also supported the Western Balkans Investment Fund to finance infrastructure projects at a regional level. However, the strategy of regional cooperation has not been icient funds from the EU or by sufficient political willingness and initiative by the countries accompanied by suff of the region themselves. In part this is due to their adherence to the competing policy paradigm of national gainst another on the international market place. The economic ‘competitiveness’ that sets one country a paradigm of economic competitiveness is promoted by numerous international organisations including the regional OECD, the World Bank and not least by the EU itself in partial contradiction to its own strategy of cooperation.

33 Building further on and deepening the work of the Regional Cooperation Council and the Western Balkans Investment Fund
reasoning and bring in the political constraints, we are aware that it is unlikely that the rational approach would be accepted, as the individual political interests of each small country in the Western Balkans seem to often work only to their own detriment. And that is not a surprise - after all, a similar situation seems to prevail in the eurozone, with national political interests frequently trumping collectively rational solutions.
AUTHORS

Will Bartlett is Senior Research Fellow in the Political Economy of South East Europe at the European Institute, London School of Economics and Political Science, Houghton Street, London, WC2A 2AE, Tel: 07941399730, Email: w.j.bartlett@lse.ac.uk & will.bartlett2@gmail.com

Ivana Prica is Associate Professor at the Faculty of Economics, University of Belgrade, Kamneička 6, 11000 Belgrade, Serbia, Email: ivanapopov.prica@gmail.com