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Intra-regional cooperation in the Western Balkans:

Under which conditions does it foster economic progress?

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ABSTRACT The main motivation for regional cooperation in the Western Balkans is provided by the EU, formulating it as conditional for the countries' EU accession aspirations. Economically, this claim includes the establishment of regional free trade agreements (RTAs) whose direct economic effects are twofold and limited: Whereas inflows of FDI are likely to increase due to a bigger market, an increase of interregional trade will be moderate and might even stall microeconomic restructuring. To gain considerable profits from regional economic integration, transnational linkages on a microeconomic level as the emergence of cross-border alliances, joint efforts to conquer West European markets, or cooperation in R&D to enhance innovation are needed. Gains from a RTA thus will be of indirect nature: Long term profits result only from overcoming the aversions against regional partnerships and from the re-emergence of mutual trust.

1 Introduction

The European Union (EU) leaves no doubt that it expects the countries in South Eastern Europe to move together closer and to show their preparedness for regional cooperation. After the status of the region had been undefined for a longer time (Uvalić (2000)), the EU developed an instrument to establish peace in the region, and to set the appropriate conditions for an accelerating catching-up through the Stabilisation and Association process (SAp), targeting the five countries of the Western Balkans.[1]

The cornerstone of the SAp is set by the Stabilisation and Association Agreements (SAA). The conclusion of the SAA represents the signatories' commitment to complete over a transition period a formal association with the EU. As stabilisation and development are considered to be operatively determined by the intensification of regional integration, the implementation of the SAA is based on the gradual implementation of a free trade area and reforms designed to achieve the adoption of EU standards with the aim of moving closer to the EU. Regional cooperation, including the other South East European countries, has been formulated as a precondition for an EU accession of the countries in the Western Balkans.

Apart from establishing political and economic conditionality for the development of bilateral relations between the EU and the five countries, the SAp includes economic and financial assistance, budgetary assistance and balance of payment support, assistance for democratisation and civil society, humanitarian aid for refugees, returnees and other persons of concern, cooperation in justice and home affairs, and the development of a political dialogue.

Whereas the EU's instrument broadly refers to the creation of multiple ties and interactions linking people or institutions across the borders of the distinct states, the paper will take a narrower view and concentrate on the economic effects of the EU's approach, so that the effects of a free trade area (FTA) in South East Europe will be analysed. However, although taking economic analysis into focus and as a starting point, it will not be neglected that the process is in fact taking part on different levels of society - politically, socially, legally, historically, culturally etc. - that are reinforcing one another.

The paper will analyse the role of regional integration and the by this means facilitated cooperation in the Western Balkans and its effects on economic performance and interactions with the medium- to long-term perspective of an EU-accession. It will be assessed whether regional integration can foster economic growth of the small economies and in how far overcoming the under-developed markets and the creation of an integrated South East European market with improved labour division will attract additional foreign capital and stimulate trade. The economic analysis of the effects of a free trade area will be the fundament of discussion. Starting with a short overview on the theory of regional economic integration, its theoretical predictions will be applied to the special case of integration in the Western Balkans. Based on these evaluations, the paper finishes with a discussion of measures that could be taken to convert the regional cooperation that is often merely cheap talk into real economic outcomes.

2 The Effects of Regional Integration

2.1 The Theory of Regional Integration

Regional integration is the institutional unification of independent national economies to bigger economic entities. The term must be distinguished from regional cooperation which involves cooperative or collaborative efforts, common interests, or common issues that do not stop at the country border. In the terminology of the paper, regional integration will directly refer to the creation of a South East European free trade area, whereas cooperation as the broader concept denotes any form of joint efforts. Regional cooperation will often be facilitated by the creation of an economically integrated area, so that the success of regional cooperative efforts is to some degree dependent on the institutionalised unification in terms of integration.

Research on regional integration has mainly considered the conditions for an efficient use of resources on a regional basis. This includes the elimination of all barriers on mobility of goods and factors, but also the creation of efficient markets and institutions supporting the integration. Integration requires a reduction of national sovereignty, nevertheless, states submit to these restrictions in their political powers. Reasons are both political and economic aspects favouring regional integration (Robson (1998)). According to the classical and neoclassical trade theory respectively, whose most famous approach is the Heckscher-Ohlin-Theorem, countries are equipped with different production factors that are used by trade in the form of comparative advantages. In the context of international labour division, economies thus specialise on those products which can be created under comparative cost advantages. Through free trade, the factor costs for labour and capital adjust and the resources of different countries complement each other (Viner (1950), Robson (1998)). Returns to scale are constant, markets are perfect and complete, and transport costs do not exist. If polypolistic structures are paired with equal rates of investment and equal access to technological knowledge, the growth of an economy is only determined through population growth and technological progress. According to the neoclassic convergence hypothesis, relatively underdeveloped countries will then catch-up to higher developed countries. However, absolute convergence will only appear if the structural conditions of two countries are similar (Krugman and Obstfeld (2003)).

The traditional model according to Viner however suffers from important shortcomings, which have been taken into account and ruled out by the new trade theory that shows that profits can emerge independently of the existence of comparative advantages (Venables (1987)): For the neoclassic assumption to hold, the integration partners' trade structure is necessarily asymmetric. This assumption and the assumption of polypolistic markets are hurt in reality: The prevalence of intra-industry trade, i.e. trade in similar products, is difficult to explain in terms of comparative advantage, and product differentiation seems to be the driving force behind this kind of trade. This implies imperfect competition as each producer has market power in its own varieties. Competition is less likely to be based on prices than on innovation, as profits are generated from offering a differentiated bundle of goods. This specialisation enforced by trade tends to intensify (Krugman and Obstfeld (2003)).

The increasing importance of multinational corporations is another indication that imperfect competition matters, since a key explanation for the existence of such firms is that they have firm-specific advantages to bring to their hosts.

A third basic constraint on the validity of classical and neo-classical theories is the assumption of constant returns to scale and perfect competition (Walz (1999)). On a long term, however, dynamic more than static effects of factor allocation are inducing restructuring and growth. In reality, relative factor endowments and comparative advantages are not given, but in a state of permanent change. Moreover, they not only determine but are also over time determined by the pattern of international trade. Technology-intensive industries give strong incentives for innovation and opportunities for accumulation of physical and human capital, whereas an economy based on primary commodity production gives fewer possibilities for development.
These corrections of the neoclassic theory are especially valuable with regard to integration processes including less developed economies. In the aftermath of Viner, the theoretic literature on integration focused almost exclusively on industrialised countries. Only starting in the 60s, the question was asked whether the traditional theory of integration was applicable to emerging markets (Balassa (1965)). Especially concerning the relevance of static versus dynamic effects of integration and the weight of economic compared to political purposes, the validity of the neoclassic theory was questioned.

Taking the traditional analysis as a basis, i.e. the ideas of trade creation and trade diversion (Viner (1950)), North-South and South-South regional trade agreements operate in quite different ways. Trade creation increases the specialisation in production and thus welfare, whereas trade-diversion reduces welfare because it shifts production away from comparative advantage. Several studies showed that South-South integration is likely to create trade diversion. Early experiments of South-South integration in Africa and Latin America demonstrated a welfare reduction for the poorest members, trade diversion prevailing over trade creation in most cases. South-South integration tends to lead to divergence of member country incomes. In particular, countries with the highest comparative disadvantage within the area would suffer a welfare reduction (Venables, 2000). On the contrary, if the integration area includes relatively high income countries, it is the lower income country that experiences a welfare gain from trade creation. North-South integration, in contrast, would cause convergence, this creating an incentive for developing countries to establish trade links with industrial countries. Relying on an analysis in terms of trade creation versus trade diversion, north-south is better than South-South arrangements from the point of view of the participating Southern countries (World Bank, 2000).

However, South-South integration - on the theoretical basis of the new trade theory - can provide dynamic welfare effects including enhancing efficiency through mutual learning, increased competition between peers in development, enabling economies of scale and scope, increased attractiveness to FDI, and securing greater bargaining power.

Foremost among the assumed dynamic economic benefits of integration has been the ”training ground” effect. For many less developed countries, and particularly for those with very small domestic markets, regional economic integration may offer a valuable experience, helping the transition to a more balanced development and a more open economy (Robson (1998)). Within a regional setting, both quality and marketing techniques can improve and promote diversification and export production at a later stage. Integration will benefit customers in the integrated market as well as enhance export production.

However, the training-ground argument has the basic rationale behind infant industry protection and traditional import-substituting development strategies. Arguments in favour of import substitution view existing trade patterns as a source of dominance and exploitation. Extensive government intervention in the economy and protection in the form of tariffs and quotas are considered necessary to break out of the current world division of labour. One of the major problems with import substitution strategies is that the market size of a single country limits the degree of specialisation. Another problem are the distortions created by tariffs and other government interventions in the economy. Protection reduces the incentives to undertake quality and productivity improvements.

A second important argument for South-South integration is that the host country market size is one of the strongest determinants of where foreign firms invest. By reducing the trade barriers within a region, prospective investors can be offered a larger market, in combination with a harmonised investment climate and increased political and macroeconomic stability resulting from a successful integration process, this makes investments more profitable.[2]

Compared to North-South trade, it may thirdly be assumed that the goods of Southern countries are often suited to the needs of other countries on a similar level of development. Furthermore, in theory, commodity prices might be stabilised on a higher level through co-operation. Technology, infrastructure and information, i.e. the joint production of public goods, are also considered promising fields for co-operation. Although this is in most instances a matter of co-operation, possible without integration, a close relationship between integrated economies can make it easier for politicians to reach agreements, especially as one serious obstacle to South-South trade are transportation problems resulting from insufficient infrastructure. Also, corruption is a devastating problem in many emerging markets, can be more easily fought in a system of harmonised regulation (Shleifer and Vishny (1993)). Finally, shared marketing and distribution may in some industries make it possible to bring the commodities closer to the final customers, thereby increasing profit.

Finally, in addition to the improved access to large Northern markets and improved supply of intermediate goods due to lower tariffs, regional integration arrangements can speed up the adoption of new technologies by the least developed regions. Furthermore, it may give these members access to more advanced institutions and policy instruments. Although this may take place within South-South integration schemes, the potential for technology transfer is much bigger within integration schemes involving both developing and developed countries.

As a conclusion, it may be stated that the simultaneity of North-South and South-South integration appears as the most-promising strategy. Developing country participation in North-South and South-South arrangements makes it possible for integration to occur in various directions - within and between countries of both South and North.

2.2 Background and Economic Performance of the Western Balkans

Unlike in central Europe, where regional integration was a consequence rather than a precondition for EU integration, for the Balkans, for political and economic reasons, i.e. their tendency to national insularity and political instability, regional integration is a must.
Following its application in March 2003, and the Commission’s recommendation that the EU should open accession negotiations, Croatia as the first country of the Western Balkans was awarded candidate status on June, 18th. The European Council agreed that Croatia meets the political criteria, and moves from the status of applicant to candidate country for EU membership. ”The achievement of candidate status by Croatia should be an encouragement to the

other countries of the Western Balkans to pursue their reforms", the EU leaders stated, repeating their affirmation that "the future of the Western Balkans rests within the European Union".
Bridging the transitional period until this credible and concrete scenario becomes reality requires the political will and commitment of the regional leaders that will determine the success of both EU measures - the bilateral association process and regional integration. Since 1990, the region has been economically and politically disintegrated, although the common history, geography, and stage of development would be conducive to regional coordination, cooperation and economic integration. Thus, the conditionality imposed on the region would appear as a force to re-merge formerly integrated countries.

This only partly applies to the region as a whole since Albania had had a quite singular position among all East European transition economies. Even under the era of socialism it turned away from both economic blocks in East and West and followed a policy that was exclusively oriented on autarky and thus was not integrated into the division of labour within COMECON. Today, technology transfer via FDI is relatively low, with regard to the level of education and the potential to create a national innovation system, it is far behind other East and even South East European countries (Horn and Kušić (2001)). By far the most important trading partner is the EU, within it especially Italy and Greece, representing about 75 per cent of Albania's total imports and 90 per cent of its exports (European Economy. European Commission, Directorate-General for Economic and Financial Affairs (2004)).

The other four states, however, share the common heritage of SFR Yugoslavia, that economically and politically was quite a unique state under socialism as well.[3] A look at the data of inter-republic trade in SFRJ would thus imply that the re-integration of the region should be considered a step back to normality. Although there had been a rising regional autarky and fragmentation since the passing of the new constitution in 1974, the inter-republican trade always represented an important part of overall trade in the republics of SFRJ (Uvalić (2000)). The deepening fragmentation manifested itself in increasing domestic sales, the duplication of plants, barriers to the mobility of capital and labour and weak integration of enterprises, but in fact, the interdependence remained stronger than suggested on a political basis. Thus, in 1987, exports to the markets of other republics represented between 13.4 (Serbia including the provinces Vojvodina and Kosovo) and 25 per cent (Montenegro) of total gross material product (Uvalić (1993)).

Yet with the breakdown of the common market and as a consequence of the war, old trade patterns, distribution structures, existing networks and infrastructure were severely damaged or destroyed, hindering the re-emergence of close economic collaboration although the common history of the four states would strongly suggest increased cooperation on all economic levels.
How heavily the ethnical conflicts impacted not only on political, but also on economic stability, can be shown by a look at the Yugoslav successor state Slovenia, that – ethnically homogenous - survived the breakdown and the war quite unaffected. At the end of the 1980s, SFR Yugoslavia had more favouring starting conditions than many other transition countries, resulting from early reforms towards de-centralisation and orientation towards the Western markets, however, the breakdown of common market and state and the armed conflicts destroyed these advantages (Kušić (2002)).

In the last years, commonalities are mainly composed through economic backwardness relative to other transition countries and instability. Intra-regional trade declined significantly, and although one part of this decline could be compensated through unofficial and unregistered trade (smuggling, corruption), this will not contribute sustainingly to the strengthening of regional integration.

Moreover, factors that are conducive to regional integration would be geography and physical proximity, the common heritage of socialism, culture, partly language and social and economic cohesiveness, commonalities that have been partly offset by the experiences in the 1990s. Also economically, despite the relative backwardness, the region is far from being a homogeneous unit, which is also reflected in the main macroeconomic indicators that are presented for the whole South East European region in table 1.

Table 1: Macroeconomic Indicators, 2003

	p.c. GDP in US$	Real GDP growth	Consumer prices	Unem-ployment	Government balance	Current account	External debt
Al	1,764.9	6.0	3.6	15.8	-5.6	-8.4	23.2
BiH	1,857.3	3.5	0.1	40.6	0.3	-17.8	34.7
BG	2,504.9	4.5	5.6	18.2	0.0	-8.3	57.2
HR	6,408.6	4.5	1.8	14.8	-4.6	-6.8	83.5
MK	2,357.3	2.8	2.5	31.9	-1.6	-6.3	36.1
MD	450.7	6.3	15.8	7.4	0.2	-8.0	89.2
RO	2,519.6	4.9	14.1	8.2	-2.4	-6.1	35.7
SCG	2,506.6	2.0	7.7	28.9	-2.5	-11.6	68.5
CEB[4]	7,157.3	3.6	3.2	12.0	-3.3	-5.7	54.3
SEE	2,546.2	4.3	6.3	20.7	-2.0	-9.2	53.5
CIS[5]	1,106.3	7.6	9.1	4.7	-1.2	-2.0	52.7

Source: Sanfey, Falcetti, Taci, and Tepić (2004), p. 6.
Note: Data and estimations are those of the EBRD. National statistical sources present partly deviating data.

Croatia is at the upper end of the spectrum and has a GDP per capita that is more than ten times that of Moldova, which lies at the lower end. Croatia's economy in fact accounts for roughly half of the GDP of the Western Balkans. The other six countries in South Eastern Europe are bunched together more closely, averaging close to US$ 2,200 per capita. Inflation is broadly under control. Overall growth has been higher than in central Europe and the Baltics since three years. Yet it would take many years with these growth differentials to catch up. Unemployment remains a persistent problem in the region. Apart from Albania, Croatia has the highest consolidated general government benefit. Trade and current account deficits are typically high for the region.
The main economic incentives for regional cooperation are trade, the regional dimension of problems, investment, and EU integration (Uvalić (2000)). In fact, the common membership in international organisations or - in the case of the Western Balkans – the common goal to join them, the external pressures resulting hereof, and the need to create a stable and peaceful environment create the biggest incentive for cooperation behaviour. The main motivation for intra-regional cooperation is provided by the EU within the setup of compatible free trade arrangements. Whether the claim for their foundation can be justified based on an economic rationale, or whether it is just a means to create political stability will be assessed in the following paragraphs.

2.3 Potential Effects of a South East European FTA

Besides of ethnical conflicts, the region lacks economic cohesion that is mirrored in the trade patterns and in an insufficient common economic direction of the regional economies. Political inadequacies as flawed democratisation, nationalism, highly centralised or also week states may be interpreted as barriers to increased cooperation and the set up of free trade arrangements (Anastasakis and Bojicić-Dželilović (2002)). Partly, there are strong resentments against the EU's instrument that is used for the first time and exclusively for the Western Balkans. The hurting consequences of the war do not only weigh heavily on the political relations but tend to have social and psychological effects that partly offset the argument that the countries of the Western Balkans except for Albania have formed a homogenous economic area for decades and thus exhibit potential for increased trade.

Despite the quite significant regional differences on an economic level that are even revealed by a first look at the basic macroeconomic figures in table 1 and also reflected in the different stages of agreements with the EU, the integration in South Eastern Europe constitutes a case of South-South integration, whereas the bilateral agreements with the EU constitute a case of North-South integration. Thus, the direct gains from a South East European free trade area appear highly questionable, and will be examined below.

2.3.1 Trade patterns in the Western Balkans from a Neoclassic Perspective

The establishment of a South East European free trade area is well in progress. Except for Moldova, all countries have completed negotiations of bilateral free trade agreements (OECD (2003)). The Memorandum of Understanding on Trade Liberalisation and Facilitation was signed in 2001 by Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Macedonia, Romania, and Serbia and Montenegro, then Federal Republic of Yugoslavia (OECD (2002)). In addition to the intra-regional bilateral free trade agreements,[6] all countries of the Western Balkans have preferential free trade agreements with the EU.

The five countries have been benefiting from duty free access to the EU market for almost all goods, only limited by particular conditions for textile and agricultural products, via a set of autonomous trade measures unilaterally granted by the EU. The Stabilisation and Association Agreements (SAA) that have been signed between the EU and the FYR Macedonia and Croatia respectively furthermore provide the economies with progressive reciprocal free trade of goods. Negotiations with Albania to sign the SAA have started in 2003 and are under negotiation with Bosnia and Herzegovina and Serbia and Montenegro (von Hagen and Traistaru (2003)).

The look at the trade data for 2003 (table 2) yet points to the fact that the most important forms of trade barriers, i.e. those between the EU and the respective countries, have already been eliminated. The EU today has emerged as the most important trading partner.

Table 2: Trade figures in 2003 (in % of total)

Imports of:	AL	BiH	HR	MK	SCG	BG	RO	EU
from:								
AL		0,0	0,0	0,3	0,1	0,0	0,0	0,0
BiH	0,0		1,6	0,2	2,7	0,0	0,0	0,0
HR	1,6	22,2		3,4	2,5	0,3	0,1	0,1
MK	1,1	0,5	0,5		3,5	0,2	0,0	0,0
SCG	0,9	9,0	0,5	9,2		0,3	0,1	0,1
BG	1,9	0,3	0,3	7,2	2,9		0,7	0,1
RO	1,2	0,4	0,9	0,5	1,9	2,2		0,5
EU	73,1	35,9	56,0	50,7	49,7	56,4	62,7	
Total (USD bn)	1,8	4,4	14,1	2,3	7,7	10,0	24,2	2798,3

Exports of:	AL	BiH	HR	MK	SCG	BG	RO	EU
from:								
AL		0,1	0,4	1,5	0,6	0,7	0,2	0,0
BiH	0,0		14,2	1,8	15,9	0,2	0,1	0,1
HR	0,1	15,8		5,4	3,1	0,6	0,7	0,3
MK	1,5	0,4	1,1		8,9	2,2	0,1	0,0
SCG	2,3	15,7	3,1	22,1		3,0	0,8	0,1
BG	0,0	0,1	0,4	1,7	1,1		1,3	0,2
RO	0,0	0,0	0,3	0,1	1,1	2,8		0,5
EU	88,5	55,9	52,9	53,3	54,3	53,2	67,1	
Total (USD bn)	0,4	1,3	6,2	1,2	2,5	7,2	17,5	2841,2

Source: Own representation based on data provided in Gligorov (2004), pp. 73n.

Albania is the least regionally integrated country, and there have been no trends that this would change. Whereas the region seems to be an important export destination for all countries except Albania, it is a very modest source of imports, except for Bosnia and Herzegovina, although the overall trading of the country has been declining in the last years. In all countries over 50 per cent of the exports are destined to the EU, which is also the largest source of imports.

Given the low-level of intra-regional trade, some authors argue that the countries can in fact not be considered to form a region in economic terms (Gligorov (1998), Christie (2002)). The breakdown of the common market at the beginning of the 1990s terminated traditional trade links. Today, there is a revival of trade between Croatia and the Federation Bosnia and Herzegovina and between Serbia and the Republika Srpska.

Yet it should be noted that a high proportion of trade is likely not to be included in the statistics as it takes unofficial forms. A part of trade is thus illegal or takes the form of barter that is not reflected in the statistics. The data therefore probably underestimate the true level of intra-regional trade in the Western Balkans.

Nevertheless, there are good reasons to assume that although there are still some non-tariff trade barriers in South Eastern Europe, the main reason that keeps actual and potential trade rather low is related to similar trade structures and little complementarities. Experiences with CEFTA and existing trade and specialisation patterns suggest low level of potential intra-regional trade, especially given the small size of the regional market and similar competitive advantages (Vlahinić-Dizdarević and Kušić (2004)). To a large extend, the comparative advantages are therefore overlapping, as table 3 presents, showing the revealed comparative advantages of the region in 2002.[7]

Table3: Revealed Competitive Advantages in 2002

	AL	BiH	HR	MK
Basic manufactures	0,76	3,38	1,24	3,67
Transport equipment		0,06	1,12	0,14
Clothing	11,08	3,85	3	8,81
Leather products	24,03	8,35	2,8	2,46
Wood products	1,03	4,59	2,12	0,34
Non-electronic machinery	0,17	0,46	0,55	
Miscellaneous manufacturing	0,36	1,31	0,82	0,17
Fresh food	1,75	1,06	0,79	1,92
Minerals	0,28	0,64	0,93	0,2
Processed Food	0,24	0,79	2,07	2,55
Textiles		0,58	0,64	1,24
Electronic components		0,12	0,68	0,47
Chemicals		0,13	0,91	0,5
IT an consumer electronics			0,24	

Source: Calculations based on Comtrade of UNSD, ITC 2002.

The calculation of the indicator shows that there is a dominance of raw materials and labour-intensive products, pointing to little potential to develop sustainable competitiveness. The analysis indicates that the economies compete on the same external markets. Given the low elasticities of demand on these markets, implying low growth potential, development strategies should better focus on the upgrading of production structures and differentiated products (Kušić and Grupe (2004)).

In fact, labour-intensive products make up the largest part of exports for all countries, only Croatia has relatively high shares of capital intensive product exports. The trade structure reflects inter-industry specialisation patterns typical for developing countries in their exchanges with developing countries, as capital intensive products account for more than one-third of imports (von Hagen and Traistaru (2003)).

At the present stage, the Western Balkans compete on the basis of low costs in similar branches, the extend to which intra-regional trade may unfold is thus limited. Actually, empirical studies back this assumption. Christie (2002) was able to show a highly distorted pattern in terms of bilateral distribution of trade flows for the waning 1990s. Using a gravity approach, he re-estimated the trade potentials for the SEE-7[8] for 1999 without using any dummy variables affecting South Eastern Europe.[9] The actual level of trade between Serbia and Montenegro and

Croatia is then close to the base estimate, whereas trade between Bosnia and Herzegovina and both Croatia and Serbia and Montenegro is high above the estimate.

Integrating estimates with potential GDP and dummies for EU membership and regional integration (i.e. inclusion of a CEFTA dummy), there is scope for strongly increased trade between Croatia and Serbia and Montenegro. In contrast, even then the level of Bosnian imports in 1999 was in fact far higher than the estimate. Also, the trade of Serbia and Montenegro with Macedonia in 1999 was far above the calculated potential in all model specifications. However, it has to be taken into account that trade sanctions and the NATO's military intervention in 1999 strongly directed Serbia's trade towards selected neighbours and Russia, so that there is a large scope for significant redirection. In fact, Macedonia's trade is high above potential with all regional countries.

To conclude, Christie (2002) found that there was a strong overtrade between Bosnia and Herzegovina and both Croatia and Serbia, whereas the trade flow between Croatia and Serbia could increase dramatically in case of common integration. From the point of view of trade, SEE could not be considered a region due to very low trade flows given the geographic proximity, moreover, he expected the countries to elaborate their trade links with the EU.

The results have been confirmed by Kaminski and de la Rocha (2003) who calculated a gravity model for 2000. Again, trade between Serbia and Montenegro and Croatia stays 80 per cent below its potential. The overtrade between Croatia and Bosnia and Herzegovina of about 56 per cent is explained by the special relations between Croatia and the Federation, whereas distinct linkages between the Republika Srpska and Serbia and Montenegro also explain as the overtrade which exceeds the predicted level by 29 per cent.

Thus, except for bilateral trade between Croatia and Serbia and Montenegro there is not much room for increasing trade flows within the successor states of former SFRJ. The calculation of the gravity model changed dramatically when Albania was included, indicating that the potential for growth is 70 per cent. However, due to the autarchic policy Albania followed under socialism, there are still no transportation facilities or commercial linkages with the rest of the Western Balkans so that an expansion as big as predicted is unlikely to occur as long as there is no adequate infrastructure (Kaminski and de la Rocha (2003)).

To conclude, on the basis of these estimates of the effects of a FTA on trade in the region, thus the direct effects of the FTA, the economic justification of the EU's instrument appears porous. In addition, it has to be noted that the markets of the Western Balkans are rather small and thus the stimulus for further trade is smaller than that provided by the accession to the EU (Anastasakis and Bojicić-Dželilović (2002)). However, there might be indirect effects of the FTA to the degree that the increasing cooperation creates stability, thus attracts investors and makes room for cross-border alliances.

2.3.2 Potential Effects of a South East European FTA from the Perspective of the New Trade Theory

As the scale for intra-regional trade is limited, the focus of trade policies is on the markets of the EU. However, to benefit from the process of intra-regional integration and to stand the competitive pressures originating in the EU, the economies of the Western Balkans need to develop competitive production structures. Further reliance on low factor costs will not bring the desired catching up; instead to proceed, the enterprises of the distinct countries need to develop differentiated products, that find customers both in the increasing South East European market and in the single market of the EU and move up the skills and technology to sustain rising wages and permit greater economies of scale and scope in production (UNCTAD (2002)).

Whereas an application of the neoclassic trade theory has yielded the result that the scope of the effects through creation of a free trade area would be limited, we will now put the hypothesis of the new trade theory against the specific situation of the Western Balkans and access the extent to which effects of intra-regional integration as put forward by the new trade theory can help achieving the aim of increasing competitiveness.

2.3.2.1 The Training Ground Effect

In the context of South-South-integration, it is often argued and hoped for that this form of integration was more viable and effective than others devised to help developing countries enter the global economy, offering a useful training ground for countries to educate and prepare themselves before taking on more complex global economic endeavours. Governance, capacity-building, health, education, environment, science and technology, and trade and investment are fields often regarded as especially conducive for regional integration.

However, what makes a country competitive and thus successful on international markets are basically its enterprises. The mere institutional framework needs to provide the necessary general conditions (Kušić and Grupe (2004)).

The orientation towards regional and often familiar markets where the patterns of demand are less sophisticated appears yet unlikely to help overcome the lacking competitiveness. On one hand, it can be assumed that the re-orientation towards local customers is a means of evading the competitive pressure in western Europe and thus of delaying necessary steps of modernisation and restructuring.[10] The strong promotion of a FTA may thus even stall microeconomic restructuring. This is one reason that underlines the necessity of a simultaneous approach to the EU.

On the other hand, turning to regional markets may help preparing for increasingly competitive situations if it includes the establishment of networks and alliances. Due to the common heritage, local brands can be more easily distributed and sold than to markets of the EU, but probably also more easily than products coming from the West. In this respect, the regional setting may be a training ground, but only if this process is accompanied by a upgrading of general management skills that cover all aspects of marketing, distribution, after-sales service and continuous upgrading and innovation management.

Deficiencies in these areas are prevalent in enterprises of each country of the region, and setting a coherent and consistent framework may help to reduce them. Enterprises suffer from insufficient information regarding the legal framework, taxation, finance, and standards. Further difficulties are imposed on them by restrictive employment legislation and social barriers (Bartlett and Bukvič (2002)). In addition, many enterprises in the region suffer from liquidity problems and high liabilities, so that their capability for regional integration is a priori limited (Altmann (2002)). A harmonisation of certain conditions would help them find their way to regional domestic markets and thus strengthen themselves for the competition with the west. At present, market entry barriers, most notably in forms of inadequate mobility of capital and labour, exist and do thus not contribute to mutual interaction and support. For that purpose, formalities and procedures need to be simplified, laws and regulations must be harmonised, infrastructure be improved.

2.3.2.2 Economies of Scale and the Attraction of FDI

An economy's present and prospective trade flows are positively correlated with the size of its market. Markets in the Western Balkans, as a consequence of political disintegration, became increasingly smaller and less efficient during the last years, and were protected through newly created trade barriers. Decreasing incomes, record level unemployment, and worse standards of living in turn let decline the purchasing power of the region.

Economies of scale in the Western Balkans can only be achieved when the small states create a market of 25 million people that benefits producers and investors and erases all barriers to free movement of persons, goods, and capital.

Especially the capacity to attract foreign direct investment (FDI) is a crucial aspect of growth for the Western Balkans. FDI are not only an important source of financing of large trade and current account deficits, but are recognised as a source of positive spillover effects, ranging from the transfer of technology and know how to increased local competition and the creation of employment opportunities, and the provision of access to international markets for foreign producers (Dunning (1993)).

At a microeconomic level, direct technology transfer, contagion, and knowledge diffusion improve productivity and efficiency in local firms (Blomstrom and Kokko (1997)). Local suppliers, in addition, benefit from foreign investors' management skills and are forced to meet higher standards of quality, so that FDI enhance competition.

In the 1990s, the Balkans have gone through a series of security shocks inducing large political and economic shocks that were enforced by prevalent nationalism, creating a region that was averting investments rather than attracting them. FDI that are mainly of a market-seeking nature, will only flow to the Western Balkans if the market is sufficiently huge (Dunning (1993)). Whereas the effect of intra-regional integration on trade is estimated to be rather negligible, stability and the establishment of peace, together with a bigger integrated market, are likely to attract further FDI that will positively influence the catching up process through a pressure to modernisation and adaptation.

In the framework of the neoclassic model, it is often argued that the abolition of trade barriers decreases intra-regional FDI flows, as trade and capital flows are conceived to be substitutable modes of serving foreign markets. However, this negative effect is of minor importance in the Western Balkans: intra-regional FDI flows - apart from Croatian investments in Bosnia and Herzegovina - are not substantial at the moment.

Consequently, a large common market may make the region more attractive for outside foreign investors, especially countries that offer superior location advantages. These countries will be most likely Croatia and, depending on the progress of political and economic reforms, Serbia and

Montenegro. It is also possible that the establishment of a FTA generates various dynamic effects that affect FDI flows. An integration process can lead to significant efficiency benefits that may raise the growth rates of participating countries over the medium or long term (Kušić and Zakharov (2003)).

That there is potential for an upraise of FDI flows into the region has been shown empirically by Christie (2003). For Bosnia and Herzegovina, Croatia, and Macedonia,[11] he was able to show - using a gravity model that took into account data until 1998 - the region had abnormally low levels of FDI stock, in figures 46.88 per cent of potential inflows. In addition, he could find neither trade substitutability nor complementarity, so that from his study no implications can be drawn on the interplay between FDI and trade in the region.

In fact, a free trade area of 55 million people with access to the markets of the EU, should contribute to improving the image of the region for investors and lead to increased private investment within the region and also from outside the region (OECD (2003)).

Yet research has shown that a minimum level of absorptive capacity is necessary to benefit from such transfer (Borensztein and Lee (1998)). Although the Western Balkans may have been better endowed with human capital and skilled labour compared to other low and middle-income countries, this comparative advantage could have been eroded by the war and its consequences, most notably emigration and thus ”brain drain”. Therefore cooperation in the fields of research and development, human resource management and innovation appears increasingly necessary.

2.3.2.3 Infrastructure, Technology, Political Coherence

As South-South integration often is a priori limited by insufficient infrastructure and a lack of coherence in politics, also economic policy, these issues are generally considered promising fields for cooperation. Thus, it is argued that integration enforces cooperation in areas obliquely influencing economic performance. At present, integration may facilitate joint efforts to overcome deficiencies currently limiting the scope of development (Anastasakis and Bojicić-Dželilović (2002)). Many economic problems in the successor states of former SFRJ are regional in nature. Especially in the context of improving infrastructure, cross-national projects need to be promoted that aim at re-building railways, highways, and the communication network (Uvalić (2000)). The main areas of interest will be discussed briefly below.

Infrastructure and Environmental Protection. The energy supply is inadequate, resulting high costs for energy hamper economic recovery. The exclusive concentration on an expansion of energy production on a national level cannot be the solution to the problem. Moreover, intra-regional networks for the supply of power that take into account the extra-regional energy resources should be seriously planned and implemented. What is especially startling in this context are deficits in the environmental sector. Even before the eruption of war, the region suffered from exuberant pollution as a consequence of decades-long neglect of environmental problems. The conflicts during the nineties completely ousted the problem from the agendas and caused additional problems in the form of direct war damages (Altmann (2002)).

Economic Policy. But not only in the area of environmental economics, also in other areas of politics the developments are partly oppositional. What is attracting attention is the variety in currency issues, especially the side-by-side of EURO and Dinar in Montenegro, which, as a republic of Serbia and Montenegro, should accept the Dinar as the only legal tender. Different competencies for regulation in all the countries complicate the possibilities for cooperation and limit the free mobility of capital. In general, governmental as well as local authorities have proved to be weak in the past, financial possibilities are limited, corruption and a grey economy are widely spread. In due course, the abolition of trade barriers agreed upon on a state level is not always respected and imposes further barriers on cooperation (Altmann (2002)). In these fields, national policies have to take common measures and create multinational institutions to fight the problem.

Innovation. In addition, the region lags behind in terms of adaptation, application, and improvement of modern technology. Not only commercial structures in the enterprise sector have been disrupted, but also networks in the areas of research, education and innovation. Especially in research and development (R&D), there is huge potential for economies of scale. R&D is a costly input that should be used more efficiently. Today, linkages between universities are only slowly re-emerging, as well as those between research institutions that formerly connected the whole region.

3 The Future of Economic Cooperation in the Western Balkans: Chances and Obstacles

The approach of the EU towards the Western Balkans is based on two central assumptions:

1. Cooperation overcomes nationalism and
2. cooperation has economic advantages.

At present, the only form of cooperation that appears to be sufficiently promoted and that is perceived positively in most cases is integration into the EU. However, wide parts of the population are suffering from the disrupted markets. The free movement of labour has not been granted in the past. The prevailing visa-regimes that only have started vanishing lately not only limit the possibilities for travelling, but also impose restrictions on daily business life. Especially if we assume that a conciliation and cooperation can only be realised through a reanimation of personal contacts on an individual level. In addition, the movement of goods is still barred through formal and informal barriers[12] and slow border controls (Bieber (2002)).

Whereas formally trade barriers as tariffs and quotas will be eliminated, other barriers remain for the moment, most notably poor infrastructure, lengthy and costly payment procedures. Thus, what can be definitely concluded is that institutions and infrastructure should be re-built and developed commonly. In the context of railways, energy, and a reasonable use of existing capacities, especially in the small countries of the Western Balkans there should be given a strong impetus to regional cooperation (Holzner, Christie, and Gligorov (2004)).

From a mere economic viewpoint, it appears somewhat questionable if the EU’s approach to the Western Balkans can be justified any longer. The competitiveness of the region is low, so that regional orientation can be seen as an evasive manoeuvre and concluded that the demand for the establishment of a FTA does not promote increasingly competitive production structures.

Cooperation in the Balkans is mainly hindered by political barriers. After the consecutive wars in former SFRJ, a regional cooperation has been nearly unthinkable in the nineties. Thus, in this context, ethnic nationalism is commonly regarded as a main obstacle to cooperation in the

Balkans and it is frequently stated that the questions of borders and national identity are an impediment to regional cooperation. Contrarily, they should provide a main incentive to cooperation. Still, the undefined status of Kosovo and Montenegro and the fragile situation in Bosnia and Herzegovina constitute the major challenges both for the EU and towards regional institutions.

There is a present rhetoric in favour of cooperation, officially, representatives underline their willingness for trans-border cooperation, how ever, on-site conversations off records clearly reveal that there are aversions and resistance towards regional cooperation. Obviously, these provisos are the more obvious, the more north-west one moves. The further North the country, the stronger the ties with and the orientations towards the EU. However, plain talk is not enough. Signing agreements without implementation will not bring the desired results.

Contrarily, on an economic level, the necessity for regional cooperation and – more specifically integration - is seen, and talking to entrepreneurs in the region reveals that there is a will to cooperate and re-vive old distribution channels. Costs of adaptation to other markets are felt to be much lower, old sales channels can more easily be brushed up than new ones opened. Despite the fact that this might be a signal of lacking competitiveness, this also points to the awareness of businesses that old supply channels and capacities need to be enlivened to work efficiently. Enterprises throughout the region feel the pressure for growth and being profitable, so that the North-South incline in terms of readiness for integration that can be felt on a political level does not exist on an economic one (Grupe and Kušić (2004)).

Interestingly, the enterprises of one country that actually is not a part of the Western Balkans but was part of former SFRJ, i.e. Slovenia, are heavily engaged in the whole region, both in terms of trade and FDI. In 2002, Slovenian enterprises had been the second largest investor in Bosnia and Herzegovina (Gama, manufacturing sector)and the fifth largest investor in Serbia (Mercator, retail sector), otherwise only one intra-regional foreign direct investment ranks among the five highest in the respective countries; that was the investment of Finvest Co-Čabar (OECD (2003)); yet more positive tendencies show up.

Thus, will and preparedness for cooperation should strongly be promoted by economic policy. At present, the infrastructure in large parts of the region does not allow for increased exchange. Structures should be created that enable enterprises to turn their will to cooperate into real outcomes. Consequently, non-governmental cooperation in form of civil-society actions has had little effect on the overall climate and performance (Bieber (2002)).

Supporting autonomous initiatives on a business level is especially valuable as it is probable that the region will experience serious costs of delay. The countries of the Western Balkans should not confidently take for granted a repetition of the process in central eastern Europe. Costs of delay manifest themselves even today, and probably will become more and more perceptible if the desired FDI flows will bypass the countries and move further east - to the Asian markets. In addition, also the direct effects of EU integration in financial terms will vanish. EU Funds are successively diminished, and also, the allocation formula will change.

To actively promote these initiatives on a microeconomic level, the establishment of trust and confidence, relations in the business community at large such as membership in business associations, and relations between economic actors and the state are of major importance. Trust, taking an economic viewpoint, is an asset that promotes economic growth by means of lowering transaction costs. Lengthy and costly contracts can be avoided or reduced. Confidence, in contrast, refers to the generalised expectations of how systems operate in a given society. Confidence is thus related to the question of whether or not to enter economic transactions at all, trusts simplifies economic transactions. Whereas confidence is a systemic thing that appeals equally to all participants in the economy, trust is interpersonal, varying from partner to partner (Rus (2002)).

To increase trust among business partners, business associations, fairs, and other settings that generate opportunity for contact are helpful. To enhance trust in a country that has very recently experienced the disruption of former united state and was torn by war will be a long-term task, yet can be supported by a legislative environment that provides legal certainty and thus protection.

This will promote the establishment of enterprises that are prepared to face the competition with the EU and are willing to share their prospects and difficulties not only within enterprises from their countries, but also with their geographical neighbours. Thus, it may be concluded, cross-border cooperation is most effective when it takes place on a pragmatic and interest-driven level, which excludes national politics.

4 Concluding Remarks and Outlook

The analysis has shown that the scope of regional integration for fostering regional trade performance is limited due to similar patterns of specialisation and a dominance of labour-intensive production that offers little room for differentiation. Also an application of the predictions of the new trade theory creates little optimism based on regional integration in terms of the direct effects. Instead of providing a training ground, the alignment to regional markets is unlikely to promote competitiveness but stall microeconomic restructuring.

Yet the increased market size may attract FDI, yielding new knowledge and capital, and the institutional framework provided within the FTA may facilitate cooperation in areas of common interest that currently hamper economic progress. To be able to realise these advantages, the economic sphere needs to be supported by measures taken on a political level to ease economic transactions.

This however is only a credible scenario in the near future if further enforced by the EU, nurturing the conclusion that a successful approach to the EU has to be accompanied through intra-regional integration. The anchor for stability and security and for economic modernisation, however, lies outside the region. Modernisation requires an efficiently huge market and funds of finance. This is not feasible by solely using regional resources. In addition, the prospects for trade are highly dependent on the behaviour of external actors. Thus, the right sequencing of regional integration and EU-integration are important to create sustainable potential for development within the region.

The track record of regional cooperation in terms of the numbers of meetings, declarations, and initiatives is impressive, corruption and environmental pollution are often on the agendas, whereas obvious opportunities for collaboration as free trade, improvement of the infrastructure, and border and visa regulations are only insufficiently emphasised.

However, plain talk is not sufficient, what is needed is cooperation on a basic level between single enterprises and institutions. If trust and confidence will return to the region on all levels, and if this can be displayed credibly to the outside, the perception of the region may change sustainedly. Not only in terms of FDI attraction, but also to forward tourism, this changed perception could enforce economic progress. Local cross border cooperation as well as civil-society networking will eliminate ethnic prejudices and normalise relations.

What is stunning is the inconsistent approach of the European Union to the region: Whereas the EU on one hand makes regional integration a condition for EU accession, it somewhat boosts the lacking political orientation towards regional markets to the benefit of orientation towards the West: instead of integrating the region as a whole, the EU creates new divisions by granting candidate status to distinct countries while having no contracts with others. Then, the EU maintains its individual country approach when dealing with potential applicants. Through this two-sided approach, the region is included in the prospective process of European integration, but excluded form membership for a protracted area of time. The countries of the region fall in different categories of relations with the EU, what they share is that they are all excluded from the benefits of membership.

However, probably this is the only possible approach: The EU combines support with pressure to restructuring. To make the region succeed economically, it requires parallel North-South and South-South integration. Only through this proceeding, the danger of one-sided specialisation can be banned. If the EU would only take a regional approach, the effects of increased regional integration might even be negative in terms of microeconomic restructuring. In addition, simply waiting for the EU to approach them will not suffice the countries of the region. Moreover, independent restructuring and specialisation are required.

Today, European integration has become the shared ideal for individuals, communities, and states in the Western Balkans and thus unites the region. To achieve the aim, and to overcome structural deficits and recent legacies of war and conflict, a functioning of states and the demonstrated willingness for cooperation are a conditio sine qua non. Often, regional integration in the regional perception is understood as a sidetrack for the postponement of integration. However, regional integration goes beyond being a precondition for EU integration in unfolding its value for prosperity and stability.

Notes

[1] In accordance with the notation of the EU, the term Western Balkans in this paper will refer to Albania (AL), Bosnia and Herzegovina (BiH), Croatia (HR), Macedonia (MK), and Serbia and Montenegro (SCG). South East European (SEE) countries are the Western Balkans plus Bulgaria (BG), Moldova (MD), and Romania (RO).

[2] The experience of Mexico within NAFTA, and of Portugal and Spain within the EC, back this argument that integration can have a positive effect on investments (Baldwin and Venables, 1995).

[3] The cornerstones of these uniqueness were: 1. the relative independence of the Soviet Union since 1948, when Josip Broz broke with Stalin, 2. the slow approach to the West since then and 3. the special economic system of workers' self-management. The original self-management concept redesignated enterprises as work organisations of associated labour and divided them into smaller units at the level of factory departments. (See e.g. Roggemann (1970) and Stein1980 for details.) and since the 1950s and the foreign policy of nonalignment (app. 1956).

[4] Central Europe and the Baltics

[5] Commonwealth of Independent States

[6] For an overview see European Economy. European Commission, Directorate-General for Economic and Financial Affairs (2004).

[7] The theoretical foundation of the RCA is the Heckscher-Ohlin theorem according to which countries have comparative advantages in trading with goods with which it is suffciently endowed. See Balassa (1989), p. 43. The RCA is calculated as
$RCA = \ln [(x_i m_i) / (\sum x_i \sum m_i)]_i$
where x_i is the value of exports of the product group i and m_i is the value of imports of the product group i. Positive RCA-values indicate a comparative advantage, negative RCA-values a comparative disadvantage in the specific group. The higher the absolute value, the higher the advantage and disadvantage respectively.

[8] That are: Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Macedonia, Romania, and Serbia and Montenegro.

[9] Dummies specific to South Eastern Europe can be considered to correct for abnormal situations. Leaving out these corrections enables a comparison of potential flows with current flows. Christie (2002), p. 12.

[10] See Grupe and Kušić (2004) for a study on high-technology enterprises in Croatia that backs the assumption that the main problem in entering the EU was branding of domestic products. This is why most enterprises tended to orient themselves to regional markets, were the costs of adoption and of setting up sales channels are perceived to be significantly lower.

[11] Due to insufficient or unreliable data, he left out SCG and Albania.

[12] Passing the borders between Croatia and Republika Srpska may be a drastic example

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