2023

OPENING THE BALKANS

The Importance of the Regional Common Market in the Western Balkans

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Why is regional economic integration important?

Eventhough the political pledge of all governments in the region has been a swift entry of their respective economies to the European Union, due to their weak reforms record concerning the rule of law, democracy and functioning market economy - stipulated by Kopenhagen criteria as necessary prerequisites for EU accession - the Western Balkans remains far away from the EU common market.

In order to boost the reform agenda and bring those economies closer to the EU, the Berlin Process that was started in 2014 proposed the establishment of a regional common market, consisting of all 6 regional economies (Serbia, North Macedonia, Albania, Montenegro, Bosnia and Herzegovina and Kosovo*[1]). However, due to political disagreements regarding the political representation policy, this regional initiative did not make a significant move closer to the common regional market.

Therefore, a new inititive called Open Balkas was initiated by leaders of the three countries that were most willing to deepen regional economic cooperation: Serbia, Albania and the North Macedonia deepened their committment through this vehicle.

Eventhough economic theory provides strong arguments for economic integration of national economies, providing free movement of capital, people, goods and services, there is suprisingly few research endeavours regarding potential benefits of the regional economic integration in the Western Balkans. This study would like to fill in this gap and provide insights for important stakeholders and decision makers in this field.

[1] The legal status of Kosovo remains disputed in the international arena. This publication does not in any way want to go into this subject, Kosovo is therefore observed purely in economic terms, as one of economic spaces in the Western Balkans.

Berlin process vs Open Balkan

These two institutional approaches have the same goal – the leaders of Open Balkans countries have continuously stated that this initiative remains open to all other economies in the region willing to join. However, the main discourse currently visible is in contrasting these two instruments: one being supported and led by the European Union officials and the other being set up by local political players, as one of the rare grassroots initiatives in the region with local ownership.

These two approaches and deliberation which one is better are futile as they completely disregard the importance of lowering barriers in communication and movement of people, goods, services and capital across the existing borders. The futility of this approach is best depicted by quoting the Chinese communist leader Deng Xiaoping, who supported the market reforms in China in 1980-ies: ''It is not important if the cat is white of black, but if it cacthes the mice.''

On a technical note, the differences between these two instruments are strongly visible. The Berlin Process has created a lot of bureaucracies with several stand-alone agencies (regarding energy or transport communities, for example), involves – or at least tries to – business stakeholders throuhg regional chambers of commerce and even CSOs, and has a central secretariat, which is for the time being managed by the Regional Cooperation Council from Sarajevo.

The Open Balkans, on the other hand, is more like an open buffet where people choose their own meal, insteading of using a set menu. There are no official bureacratic institutions resposible for the implementation of this initiative, even though there is a consultative process of exchange of information with the business community and other stakeholders, this is done via informal channels. Each government has a liason officer responsible for the technical issues of cooperation within the initiative, but without technical secretariats or other institutions supporting the process. Both approaches have their own strong and weak points.

On a high politics note, the Berlin Process includes all 6 regional economies and is supported logistically and financially by the EU, while the Open Balkans includes just 3 of them and is supported only by local government resources. The 6+1 format of the Berlin Process enables smaller countries to feel that their voices are heard and not threatened by larger economies (such as Serbia) especially since there is is a disinterested party in the form of the EU that creates the rules and implememnts them. But since the decision making is done through concesus, it means that the regional integration will reach only the level of the least interested economy.

The Open Balkans does create a forum for those willing to opt for a deeper and closer regional integration, but it opens political fears that Serbia as the most populous country and the biggest economy, would be able to dictate rules of the game and promote its own political agenda that has little to do with economic integration and more with possible territorial aspirations. Eventhough these fears are not founded, they are understandable from the point of the still unresloved political issues in the region.

Prior research

The economic research conducted on the topic of regional economic integration in the Western Balkans agree that this policy would lead to welfare increases. However, the exact level of welfare gains, although significant, should not be overstated, bearing in mind the underlying positions and structure of respective economies. In the field of free flow of capital, the whole region has low (and een negative) savings rate, leading to a very strong importance of FDIs for development and growth.

WB economies also suffer from the low labour market activity rates and high unemployment – this has been somewhat improved in recent years and skilled labour shortages are becoming present, especially in industries such as ICT, construction and hospitality, but the region as a whole face a very similar situation regarding human capital and education policy. Therefore, similar trends exist in all economies decreasing possibility for labour movement within the region. This is further constrained by low wage premium between national labour markets, and a very high wage premium present compared to the EU which still attracts high numbers of skilled and young workers.

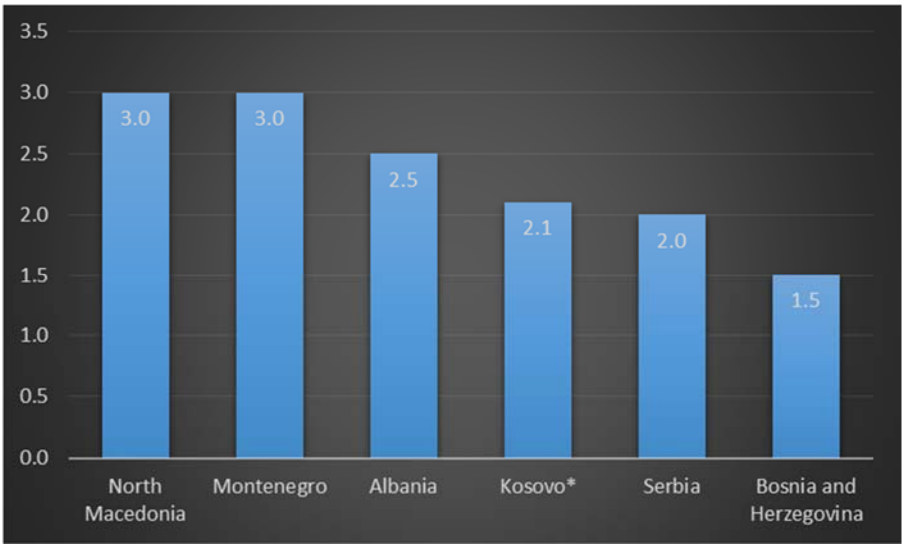
The trade in goods is already covered by the CEFTA agreement, which abolished trade tariffs and quotas in the region in 2006. Eventhough there is space for further trade facilitation, especially in services, possible gains are limited compared to the situation in which trade restrictions such as quotas or high tariffs remain in practice. Also, for all economies in the region, the common EU market remain the most important trade partner, with less than a third of the total trade volume being conducted with other Western Balkan economies.

Therefore, lifting the existing restrictions would not lead to a very significant flow of people, goods, services and capital across the borders overnight, thus limiting potential gains from the economic integration.

But this does not mean that there are no benefits from this policy of eliminating barriers in economic cooperation. Administrative trade restrictions still pose costs – the average time to cross the border between WB countries is still 3 hours longer than the average of OECD countries, according to a World Bank study.

Using trade gravity models, researchers have found statistically significant relation between these border costs and total trade volume: Toševska et al.[2] state that decrease of 10% in trade costs would lead to the same percentage of rise in exports between WB economies while 10% decrease in trade time would increase exports by 5.5%; Bjelić et al. also found statistically significant impact of administrative burden of border control on the total volume of exports[3] as well as Kaloyanchev et al.[4] with somewhat different coefficient values depending on the estimation approach.

Economic gains of trade facilitation policies, in % of GDP.



A recent study by the World Bank[5] using general eqilibrium model estimated welfare gains of 2-3% of GDP for the economies of the region if trade facillitation policies, such as common regional market, take place. Economic gains are larger

[2] Toševska-Trpčevska, K. and Tevdovski, D. (2014). Measuring the Effects of Customs and Administrative Procedures on Trade: Gravity Model for South-Eastern Europe. *Croatian Economic Survey* 16 (1), 109–127.
[3] Bjelić, P., Dragutinović, R. and Popović Petrović, I. (2015). *Administrative Barriers to Trade as Predominat Non-tariff Barriers in the Western Balkans Trade*.
[4] Kaloyanchev, P., Kusen, I. and Mouzakitis, A. (2018). Untapped Potential: Intra-Regional Trade in the Western Balkans. European Economy, Discussion Paper 080, European Commission.
[5] Gomez, M., Zarate, R. and Taglioni, D. (2023). The Economic Effects of Market Integration in the Western Balkans. Policy Research Working Paper 10491, World Bank.

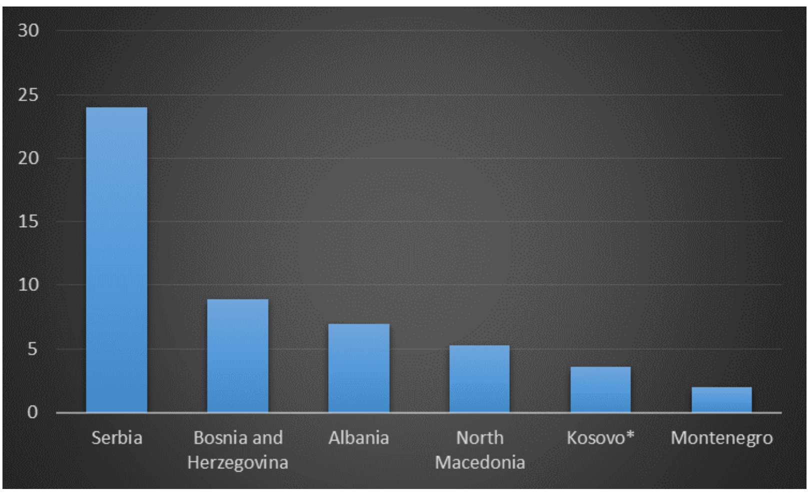
for small economies, those that trade more with the region in relative terms, and those whose goods need to cross more than one border to leave the region.

Freight cost reduction

Creation of a regional common market would lead to sigificant reduction in transport cost trhough elimination of waiting time at the border crossing. Our research estimates these savings to be at least 50 million USD (45 million EUR) on an annual basis for all economies combined.

According to a recent study on transporation costs by the World Bank[6], elimination of the existing border crossing where goods in transport need to be checked up would lead to a reduction in total transport costs of 4%. From the national account statistics we can extract the gross value added in the transportation sector in Serbia, standing at 3.4% of GDP. Having in mind that international freight transport (exports, imports and transit) makes up for 45% of the total road traffic, which is standing at 2.1% of GDP, we estimate that costs of transporting goods and services in Serbia across the borders reach 1% of GDP.

Savings in transportation costs with the regional common market, millions of USD.



[6] Atsushi, I. Estimating Road Freight Transport Costs in Easter Europe and Central Asia Using Large Shipping Data. World Bank. 2023.

Using standard cost model (SCM) from these numbers we estimate total savings in transport costs of 50 million USD annually, if the common regional market eliminating the border crossing is established. These savings are dispersed across the region, with more savings accruing to the largest economies and those whose international freight needs to cross more than one border in the region to reach is final destination.

FDI and the regional common market

Using panel regression, we estimate that creating a regional common market in the WB would attract new FDIs, since for every million USD rise in exports to the region would lead to rise in net FDI stock of 7.000 USD. The results are statistically significant at p 0,01 levels.

The importance of FDI for the Western Balkans economies cannot be overstated. Apart from the already established benefficial effects of FDI on economic growth and development, such as technology transfer, inclusion in global supply chains etc. the local context of WB countries emphasizes the importance of FDI.

The region has a very low savings rate, and therefore little resources for financing investments. Also, business environment plagued by bureacratic procedures and endemic corruption is not conducive to investments coming from SME sector, since they lack resources to tackle the red tape and associated transaction costs, which is not a problem for big multinational companies with their resources and even political backing by the executive government of the host country and diplomatic rerepresentatives of the country of origin.

Also, a whole decade of armed conflicts and mass violence made whole industries in the region fall behind their peers from other transition economies, due to disinvestment and physical infrastructure destruction. Recovery of these industries without high investments and new technology and associated know-how is impossible in practice.

However, FDI seem to go around the Western Balkans in a wide circle. Inded, in the literature it is even described as a ’’Balkan effect’’.[7] FDI stock in WB countries

[7] Estrin, S. and Uvalic, M. Foreign Direct Investment Into Transition Economies: Are the Balkans Different? *The Economics of Transition* 22 (2), 281-312.

is low compared to their transition peers, and only Serbia was able to attract significant FDI inflows in recent years. Creation of a common regional market, it is hoped, would be benefficial to attracting FDI to the region, since instead of providing 6 already small markets it would create a single economic space, creating more economic opportunities for supply chain inclusion.

In recent years, the region experienced an unprecedented fall in unemployment rates (due to high emmigration rate but also job creation in all economies) which means that big FDI project now struggle to find necessary skilled labour if restricted to the national labour market only. Eliminating border controls and establishing a single labour market could attract new investments to border regions, since they would be able to recruit skilled workers from both sides of the border.

This would probably have a stronger impact in areas where there are few language barriers, such as between Bosnia and Herzegovina, Serbia and Montenegro on one side, and Albania and Kosovo* on the other, while North Macedonia is poised to cooperate with both linguistic block, having in mind the large Albanian-speaking minority in the country and the closeness of the Macedonian language to the main South Slavic language areal.

It is important to note that associations of foreign companies operating in the region support the initiative of creating the common regional market, which can only be explained if these companies see clear benefits for themselves coming from that policy. Also, the local political elites in their statements supporting the regional common markets often describe their comittment to this project through their wish to attact more FDI and create new jobs via this instrument.

Furthermore, the recent trends in shortening of supply chains after the Covid19 pandemic increases the attractiveness of the Western Balkan region for FDI, due to its georgaphical location and proximity to the EU, increasingly improving quality of transport infrastructure, educated and skilled workforce and competitive wage levels. The countries in the region need to exploit this potential of nearshoring in order to transfrom and develop their economies.

This research would like to add to the existing debate by trying to identify if regional economic integration would lead to an increase in FDI. For that purpose, we conducted a panel regression analyses, using the OLS (ordinary least squares) method. In this regression model, we used:

$$FDI = a * Y + b * Ypc + c * Ins + d * Reg + e * Exports + u,$$

Where:

- FDI is total stock of FDI in USD since 2006. Because we could not find reliable Fdi stock data, we decided to turn to FDI net inflows and add them from year to year, starting with 2006. (World Bank)
- Y is the nominal GDP in USD, in millions of current USD (International Monetary Fund)
- Ypc is the nominal GDP per capita in USD (International Monetary Fund)
- Ins denotes quylity of institutions (Property Rights section of the Economic Freedom of the World)
- Reg is a proxy variable for the level of regional economic integration, measured by total exports to countries in the region, in millions USD (UN Comtrade)
- Exports is the total value of exports in million USD (UN Comtrade)
- u is the standard error of the model.

For this test, we used data 2006-2022 which is 17 years of observation, due to the lack of realiable data for WB countries before that. The model includes countries from the CEE and the WB, 13 in total.[8] Unfortunately, Kosovo* is omitted due to the lack of reliable data.[9] The data are taken from the Fraser Institute (Economic Freedom in the World), the UN Comtrade, the World Bank and the International Monetary Fund. In total we have 221 observations in the model.

The results of the regression are depicted in the table below. The model is statistically significant, describing approximately 62% of differences between FDI stocks in examined countries.

[8] From CEE, these countries are: Poland, Hungary, Slovakia, Slovenia, Czechia, Croatia, Romania and Bulgaria. From WB, these are: Serbia, Montenegro, Albania, North Macedonia and Bosnia and Herzegovina.

[9] The UN Comtrade from whose database the trade data were taken do not have data on Kosovo foreign trade. At the same time, Kosovo statistical service has very unreliable data especially in the trade section, where the discrepancies between the reported data on Kosovo* exports are sometimes two time lower that the cross-examined data from the trade partner at hand. Fraser Institute also does not cover Kosovo*.

Regression Statistics				
Multiple R	0.79			
R Square	0.62			
Adjusted R Square	0.61			
Standard Error	46.22			
Observations	221			
	Coefficients	*Standard Error*	*t Stat*	*P-value*
Intercept	-23.403	39.471	-0.593	0.554
Nominal GDP, in mil current USD	0.000	0.000	-6.204	0.000
GDP per capita	-0.002	0.001	-2.648	0.009
Quality of Governance	9.835	7.797	1.261	0.209
Regional exports, in mil USD	0.007	0.001	-6.534	0.000
Total exports, in mil USD	0.003	0.000	10.140	0.000

Coefficient value of nominal GDP is zero, and the value of the GDP per capita coefficient is even negative, which we explain that as countries develop economically they also start investing abroad. Since our variable is the stock of FDI, measured by adding net inflow of FDI annually, its value is decreased with investing abroad. The unexpected negative sign of the GDP per capita variable could also be explained this way. The Quality of Governance is the only variable not found staiststically significant (p value of 0,209), while all other variables are significant at 0,01 levels.

The regional trade variable is found to be statistically significant (p value 0,000) with the coefficient value of 0,007. This means that for every additional million USD in exports to the region, country at hand could expect a rise in its FDI net stock of approximately 7,000 USD.

We explain the comparatevily low coefficient value with the fact that in the absence of the regional common market there are still high transaction costs to intraregional trade, and with the relatively similar structure of individual national economies in the region.

But these results show that creating a regional common market would serve as a catalyst for encouraging stronger inflow of FDI in the region.

What else needs to be done in order to create the regional market?

The current processes of the region common market creation needs to be strenghtened and quickened. For example, even though the Berlin Process started in 2014, its results are relativelay modest, he most important ones being diploma and professional certification accreditation, and transport policy coordination, including trade facillitation towards third markets via ''green corridors''. These are all useful projects, but they fall short from creating a common regional market. With the current speed, the common regional market won't be established before the countries at hand become full members of the European Union.

The Open Balkan initiative, on the other hand, have pursued deeper integration, with the common labour market becoming active in July this year, mutual recognition of phytosanitary standards and with initiative to integrate border crossings management. Even this is still far below the target of creating a common regional market.

In order for the common regional market to be actually active, further activities need to be conducted, the most important being lifting capital controls, creation of a regional external trade policy, further recognition of technical standards and coordination in the state aid policy.

Capital controls between countries still exist. The most notable ones are present in Serbia, according to the IMF. These cross-border control make regional financial management practically impossible for the multinational companies with regional operations. Even when movement of capital across borders is possible, it is burdened with slow procedures making international payments a frustrating and costly process.

Trade policy is still conducted on the national level. Customs union in the region is not even discussed in high level meetings, and this is a prerequisite for a deeper economic integration. Since this would be a slow process with many vested interested groups battling for competing interests, it would be more efficient if the countries in the region would become mambers of the EU customs union. This would make the whole process of tariff coordination straightforward and clear, eliminating political economy considerations out of the picture. Turkey provides a good example, since its trade policy since 1995 mimmick the one of the EU, apart from the agriculture field.

A prerequisite for this is the EU support to take into its customs union economies of the region. This should not pose a significant problem, since the EU has already given preferential status to these countries via Stablilization and Association Agreements (SAA), dractically making any imports of industrial goods free of tariffs, quotas and other restrictions.

For the WB countries, it would mean a more open trade policy, since their tariffs protection level are still higher than those of the EU itself. It would also mean that current free trade agreement would become void, and in practice it would mean little changes in the trade rules concerning Turkey and EFTA. The only significant change in this regard would be concerning Serbia, whose preferential trade status on the market of the Eurasian Economic Union (EEU) would be forfeited. These losses would be well compensated with the benefits of entering the customs union with the EU and links between the common regional market and the European Economic Area (EEA).

On a political side, the political leadership of the EU has been trying to find some models of deeper economic integration with the candidate countries from the WB instead of providing them with a full membership, in order to first change its inner decision making structure and eliminate or decrease the number of cases where unanimity in decision making is required. This policy goes in line with allowing these countries further access to the Eurpean common market.[10]

Technical standards between countries still differ significantly. This problem should be addressed by common change towards EU standards – adoption of EU rules in this area is a prerequisite for the EU accession, and as in the case of the trade policy, such a clear benchmark would make this issue a technical, instead of a political one. This would also address the complaints that regional common market has negative consequences for those countries are closer to the EU accession (such as Montenegro or Serbia) and thus have started convergence of their technical standards towards those of the EU, which is a process some of other countries have yet to accelerate.

State aid policy is connected to efforts of attracting FDI. Across the region, all countries have their own individual schemes dedicated to attracting FDI, which

[10] The speech of the president of the European Commission, Urusla von der Leven, give at the end of May in Bratislava at the GLOBSEC forum, indicates that gradual inclusion in the EU common market for candidate countries would be a part of the new EU accession strategy.

include tax incentives, joint venture programs, and even budget subsidies. Resources dedicated to these programs can be quite high, and are usually non-transparent; their level are often linked to the level of investment and the number of job openings resulting from these projects. In that kind of environment with the zero sum game, national government have incentives to engage in ’’the race towards the bottom’’ with outbidding foreign investors wanting to come to the region, by providing them with more lavish incentive programs than their neighbours.

State aid policies modelled at the existing EU standards mostly exist in the region, but seldom are they implemented because of the strong political incentives not to do so, and weak oversight. Therefore, this area will be the one with the biggest political obstacles in implementing regional perspectives. However, the lack of skilled laour force in individual regional economies might lead to an increased cooperation in this area: by abolishing the borders, regional economies can hope to attarct more FDI in the border regions where these projects can rely on labour force from both sides of the border, which currently is not the case.