



Funded by the 3rd Call of the Key-Action: "Improving the Socio-Economic Knowledge Base" of the European Commission, DG Research under Theme 3: Citizenship, governance, and the dynamics of European integration and enlargement. IBEU was coordinated by ELIAMEP (Athens) and involved the LSE (London), IECOB (Forlì), WIIW (Vienna), CLS (Sofia), IME (Sofia) and SAR (Bucharest).

## **INTEGRATING THE BALKANS IN THE EUROPEAN UNION: FUNCTIONAL BORDERS AND SUSTAINABLE SECURITY**

### **IBEU Work Package 4: Regional Co-operation**

#### **Summary**

Historical and geographical borders play a significant role in shaping economic developments in the Balkans that continue to be marked by high unemployment rates, significant macroeconomic imbalances, pervasive corruption and criminality. Nothing is more urgent than sustained growth, and, in the past few years, growth rates throughout the region have been high while pockets of recession, mainly around areas of latent conflicts have been shrinking to a degree. In this environment, investment in this region is crucial, and it has to come from abroad. At the same time, regional co-operation, in spite of current obstacles, has to be further pursued not necessarily for its economic value, but mainly for its political implications. In this, the role of the EU as a regional anchor and a promoter of regional co-operation is indispensable. IBEU has been working on the hypothesis that the EU and the SEE have a 'hub-and-spoke' relationship. Trade and investment patterns as well as infrastructure developments suggest that SEE is much better connected with the EU than with itself; as a consequence, regional co-operation mostly goes via co-operation with the EU. For this reason, our research has concentrated on the opportunities for regional co-operation in trade, transportation infrastructure, and on the banking sector.

*Trade.* The current and foreseeable trends for trade to, from and within the region are quite positive. After a decade of setbacks, regional cooperation has finally picked up again, notably through the conclusion of a set of bilateral trade agreements. Of course a multilateral route would have been preferable (faster, more efficient), but the bilateral route is better than nothing, at least for the moment, as it does result in the lowering of trade barriers all over the region. In the medium run (2007-2008) many of these bilateral agreements will lapse thanks to the EU accession of Romania, Bulgaria and, increasingly likely, of Croatia. However trade will remain very free, as the EU has unilaterally granted wide-ranging trade concessions to the Western Balkan countries. By that time the other bilateral agreements will be in the final stages of their tariff phasing-out calendars, implying that trade in goods will be "almost free" within the region and between the region and the EU. On issues of transaction costs and market access (in the physical sense) there have been real improvements in terms of trade facilitation, for example in terms of border waiting and clearance times, both within the region and between the region and the main EU markets, a process which is also helped by the May 2004 accessions of Slovenia and Hungary. Transport infrastructure is also expected to improve over the next few years, thanks in good part to a coordinated effort by the main international players in financing and overseeing infrastructure investments. Improvements in this area should prove helpful not only for goods trade, but also for services trade. There is

still untapped potential, notably with respect to tourism, and the already significant success of Croatia is an indicator of what could develop elsewhere in the region.

The main unresolved issues concern the right policy mix in the run-up to the foreseeable EU accessions of the core countries of the region which will be left over after the 2007 (2008) enlargement. In terms of trade policy there is a case for the left-over countries to join in a customs union with the EU. This policy option should be given serious consideration. More generally, the region's export commodity structures still compare rather unfavourably with those found in the more advanced Central European countries. Here the implications are not in terms of trade policy, but rather in terms of private sector development, including the need for more foreign direct investment.

*Banking.* During the past few years, the banking sectors in SEE have been transformed in line with international practices in this field; foreign capital, know how and expertise have been injected into the region's financial services. Government reform policies have radically changed the ownership structure of the banking systems across all countries and have improved performance indicators. The extent of foreign ownership – in their overwhelming majority EU – in numerous Balkan countries exceeds 75%. Once again, this highlights the extent of the hub-and-spoke connections that characterises EU-SEE relations. The 'development' and 'convergence' of the banking sector, signal a shift in the transition process from reconstruction to institution-building, however, much is still needed with respect to developing the SME sector, improving transparency in economic transactions, and implementing the regulatory and supervisory frameworks that are necessary for a functioning and growth-enducing banking and financial sector.

*Infrastructure.* Southeast Europe is characterised by poor rail and road transport infrastructure and with low levels of efficiency; its inherited infrastructure is distorted because of the history of political disintegration. The central question is whether the Southeast European countries have enough infrastructure capacity (given their current stage of economic development), and whether the poor level of transport infrastructure is a constraint for further economic growth, particularly at the regional level. Looking at the maps, one sees that most of the Balkan countries have better transport connections to the EU than with the other countries of the region. However, in this post-conflict region of small countries characterised by tense neighbourly relations in the political sphere, development is sapped to the extent that 'hard' territorial borders impede large infrastructure projects. The Stability Pact's experience in effect testifies that these borders are 'hard' to cross for public agencies pursuing regional initiatives. The challenge is clearly for all sides to perceive cross-border infrastructure development as beneficial to them. Only then will infrastructure investments be able to be pursued further with beneficial effects on regional security and on the rationalisation of the behaviour of local public agents, i.e. states and other political entities. In principle, investments in infrastructure lead to significant cross-border co-operation and nurture conditions for increased economic growth and political integration. This is even more the case with a transit region such as Southeast Europe, where "big push" effects could be expected to exist because, by assumption, lack of adequate infrastructure leads to the existence of unexploited opportunities for trade, investment and production of goods and services.

Most of the factors that hinder inter-state co-operation may be found at the national level. For instance, cross-border investments may have significant impact on the

budgets: not only may some direct sources of public revenues be lost – e.g., tariffs – but the reallocation of businesses may present various budget centres with a changing tax base. This may be temporary, but still important enough to make it difficult, if not impossible, for local public authorities to co-operate on common projects. For that reason, the public failure is perhaps more difficult to deal with than the market one, because there is, by assumption, no market solution to this problem. In these circumstances, an outside agent, either private or public, could play a useful role in moving the various local governments to co-operate on common infrastructure projects. The same logic would work for the outside push for faster and more comprehensive reform in the sector of infrastructure services. It is indeed in this sector that public and private partnership (P&PP) play such a crucial role if that partnership is well organised and carried out.

### **Policy implications of IBEU research**

Bringing down borders, both official and invisible, through cross-border co-operation on infrastructure or trade related issues, has a very significant soft-security aspect. Even though this would not necessarily provide for an immediate boost to the regional economy, the relaxing of borders with the EU in particular would have major economic impact and would contribute significantly to sustainable regional stability.

1. The EU should speed up and strengthen the accession process of the Balkans. Rendering candidate status tangible makes the prospect of eventual membership more realistic, more constraining and more of a catalyst for the much needed reform and co-operation throughout the region. Left to itself, the region will revert to 'Balkanisation', however, short-sighted and harmful this may be.
2. It is important for the EU to recognise that aid and budget support are neither sufficient nor paramount in triggering growth and co-operation in the region.
3. Multilateralisation of the bilateral FTAs may be the most that can be achieved at present; however, we cannot expect the added advantages to be spectacular.
4. To improve investment opportunities, each country has to engage in further institutional reforms and gradually participate in the international financial markets.
5. Intra-regional trade would be facilitated by an indirect exchange rate co-ordination – a version of the ERM – tied to the euro.
6. Co-ordination of the fiscal sector is paramount so as to lower tariffs and support trade liberalisation, to decrease distortion and rent-seeking behaviour on behalf of firms in the region, and to bring in the informal sector.
7. EU banking groups own most of the Balkans' banking and financial sector; the EU should encourage these groups to spur foreign investment in the region.
8. The positive experiences of the CEEC in regional co-operation in the fields of trade, investment and policy co-ordination (and given certain similarities in their post-communist transition), should serve as guidelines for SEE (rather than the more orthodox policy approaches of the IMF and the World Bank that have had limited success in the region). Knowledge-sharing from the new EU member states must be encouraged.
9. P&PP are based on the rationale that public interest should be applied to the investment in the public good while private interest should be relied on to efficiently supply the private goods. For this partnership to work across the region's borders, it is important that proper procedures for competition are put in place: it is necessary to liberalise the services sector in the whole region and to make it evident to all sides involve that they stand to gain from specific collaborations. The role of the EU is

central in inducing the local public agents to co-operate not only in infrastructure projects but also in the liberalisation of the services sector across borders.

10. Thus, liberalisation and political co-operation are the instruments of soft security that could contribute significantly to the decrease of illegal trading and smuggling. Those measures come under the heading of rewards rather than punishments. Of course, the increase of efficiency at the official borders is more than necessary but, the key cause of illegal trade and the resulting security problems come from the proliferation of borders and tariff and non-tariff barriers rather than from the lack of security services.

**For more information, workpackage papers and contact details:**

This research is the result of the collaboration between the Vienna Institute for International Economic Studies (WIIW) and the Hellenic Foundation for European and Foreign Policy (ELIAMEP).

For further information on the scope of research undertaken by the IBEU team on the informal sector, please contact the lead of WP3 **Prof. Vladimir Gligorov**, Vienna Institute for International Economic Studies (WIIW) Email: [gligorov@wiiw.ac.at](mailto:gligorov@wiiw.ac.at)

**The following papers will be available after the Final Conference in Brussels, 18 November 2004 and can be downloaded from the IBEU Website**

[www.eliamep.gr/3/4/wp.asp?projectid=1&wpid=6](http://www.eliamep.gr/3/4/wp.asp?projectid=1&wpid=6)

- o Gligorov V., *"Southeast Europe: Regional Co-operation with Multiple Equilibria,"*
- o Christie E., Gligorov V. & Holzner M., *"Infrastructural needs and economic development in SEE: The case of Rail and Road Transport Infrastructure,"*
- o Christie E., *"Trade flows in SEE"*
- o Stubos G. & Tsikripis I., *"Regional Integration Challenges in SEE: Banking sector trends"*