Deeper Integration and Trade in Services in the Western Balkans

– Building Blocks for a Trade-Driven Growth Strategy –

(February 2007)

Abstract:
With the conclusion of the CEFTA 2006 free trade agreement among the Western Balkan countries and with trade of goods between them and the EU largely liberalized, regional integration has progressed significantly in recent years. As these countries seek to fulfil their European aspiration and to more effectively use trade a lever for domestic economic growth, attention is shifting towards behind-the-border policy reforms that are required to deepen regional integration and to permit the Western Balkan countries to successfully compete in the EU Single Market. On the one hand, this requires reforms in cross-sector policy areas such as public procurement, competition policy or rules of origin. On the other hand, it requires the liberalization of trade in services, including for sectors such as telecommunication, transport or financial services. Whereas this paper reviews the general policy issues associated with deeper integration and trade in services, two sector-specific papers on air transport and financial markets by the same author provide a more in-depth analysis of the type of reforms and integration dynamics that this will entail.
Trade-Driven Growth and Comparative Advantage

In most Western Balkan countries ‘transition-driven’ growth, based on the reallocation of resources, has run its course and needs to be replaced by new sources of growth. Trade could serve as such an engine for economic development. Countries that have successfully followed export-driven growth strategies include the Central and Eastern European countries, Chile, Malaysia and China. Given that the Western Balkans conducts the vast majority of its trade with Europe, trade liberalization and deeper integration with the EU should be the priority. Since the accession of Bulgaria and Romania in January 2007, the Western Balkans is surrounded by EU member states and forms a geographical enclave in its Single Market. The total population of Albania, Croatia, Bosnia and Herzegovina (BiH), Macedonia, Montenegro, Serbia and Kosovo is 21 million. This is equivalent to the population of the latest accession country Romania or less than 5 percent of the EU-27. Despite a large gap in per capita income, the small size of the region should facilitate its absorption into the EU economic structures.

Erosion of Trade Preferences: A combination of EU enlargement and global trade liberalization is eroding trade preferences that the EU has extended to the Western Balkans. In 2004 EU enlargement brought ten, mostly low-wage countries with 75 million inhabitants into the Single Market. With the accession of Bulgaria and Romania in January 2007, two South East European countries with a joint population of 30 million followed. This asymmetric reduction of trade barriers between the old and new EU countries reduces the relative attractiveness of the Western Balkan countries as trading partners and as a destination for FDI. At the same time, the EU has concluded dozens of free trade agreements (FTAs) with countries around the world, such as Chile, Mexico or South Africa. Hence, most trade concessions granted to the Western Balkans are not that preferential after all. To counter this significant erosion of trade preferences, the Western Balkan countries need to strengthen their own competitiveness and pursue deeper forms of integration with the European Union.

Triggering a ‘Supply Response’: Trade liberalization is a necessary, but not a sufficient condition for trade expansion – as the rather limited market response to past liberalization measures in the Western Balkans has demonstrated. Additional trade only occurs when export-oriented companies invest to expand their operations, when domestic firms win clients abroad and successfully integrate in global production networks or when foreign investors set up shop to serve export markets. To trigger such a ‘supply response’ a range of flanking measures have to accompany trade liberalization. These include a more conducive business environment (to foster private sector development), a more favorable investment climate (to attract FDI) and a removal of non-tariff barriers (to facilitate market access). Virtually all economic policies that are conducive for domestic economic development can also help trigger a supply response to trade liberalization – including a stable macro framework, labor and capital market reforms, privatization, judicial reforms, a reduced role of the state or infrastructure investments. The challenge, however, is to identify the binding constraints that currently prevent an adequate supply-response – and thus the associated policy levers for trade expansion.

Building Comparative Advantage: If the Western Balkan countries seek trade-driven growth, they need to harness new sources of comparative advantage. Arguably the most promising one would be their geographic proximity to EU markets. Translating proximity into trade, however, will require the broad-based removal of non-tariff barriers. In tourism and IT-enabled services, for instance, it

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1 Geographic distance (measured in kilometers) is only one determinant of economic distance (measured in time, cost and the reliability of economic transactions between two locations). Additional determinants of economic distance are factors like a common time-zone, linguistic and cultural proximity or similar legal systems.
helps to be geographically close to and in the same time zone as the client, but efficient transport and telecom services are also needed. In time-sensitive manufacturing – like just-in-time delivery of car parts or in-season replenishments in the garment industry – geographic proximity is also critical. But again, it is only a source of comparative advantage, if combined with state-of-the-art communications and logistics systems. Being surrounded by the EU Single Market markets creates opportunities, but for firms from the Western Balkans to effectively ‘plug into’ that market will require streamlined border controls, efficient backbone services and a favorable environment for foreign direct investment.

Box 1: Trade Agreements in the Western Balkans

The existing patchwork of 32 bilateral free trade agreements between the countries of South East Europe is being folded into the Central European Free Trade Area (CEFTA) agreement, which is expected to enter into force in the middle of 2007. Signatories to the agreement are all countries of the Western Balkans (including Kosovo/UNMIK) as well as Bulgaria, Romania and Moldova. The ‘CEFTA 2006’ agreement will not only simplify the regional trade regime, but will also considerably deepen regional integration by including provisions on trade in services, intellectual property rights, public procurement and investment.

While the CEFTA 2006 agreement liberalizes intra-regional trade in South East Europe, trade between the Western Balkans and the EU is governed by a series of Stabilization and Association Agreements (SAAs). SAAs have already entered into force with FYR Macedonia (in April 2004) and Croatia (in February 2005). An SAA with Albania was signed in June 2006 and has become partially effective through an Interim Agreement, before the full SAA enters into force upon ratification by all EU member states. SAA negotiations with Bosnia and Herzegovina, Serbia and Montenegro were all launched in November 2005, but have not yet been concluded. For these countries, the EU has already granted far-reaching trade concessions through ‘autonomous trade measures’.

In addition to the CEFTA and SAA agreement, there are two regional integration agreements for specific sectors. The Energy Community Treaty and the European Common Aviation Area (ECAA) agreement. In both cases, the signatories include not only the countries of South East Europe but also the European Community (this is not the case with CEFTA). The agreements oblige signatories to fully adopt sector-specific EU regulations by a given deadline (2015 for energy and 2010 for aviation) and will amount to a partial expansion of the EU Single Market to South East Europe. A similar agreement is now being discussed for the railway sector. The pursuit of deeper integration in individual sectors will significantly facilitate eventual EU membership.

Besides geographic proximity to the EU, the sources of comparative advantage considerably vary between countries. Croatia has an attractive coastline that constitutes a valuable asset for its tourism industry and a solid human capital endowment needed for more sophisticated manufacturing (e.g. in ship-building and pharmaceuticals). Serbia has a diverse industrial base, the largest city of the region with a substantial services cluster and fertile agricultural land in the Vojvodina. Kosovo and Bosnia and Herzegovina have mineral resources and traditional heavy industries. Montenegro seems small enough to primarily rely on its natural beauty to develop a thriving tourism sector. Albania is the only country in the region with a wage level low enough to attract labor-intensive manufacturing, such as textiles. Given their small size, most Western Balkan countries should be able to carve out a niche in the EU Single Market with relatively few sources of comparative advantage.

All these sources of comparative advantage, however, need to be actively preserved and developed through appropriate policies. The survival of Bosnia’s heavy industry, for instance, will largely depend on the ability to attract foreign investors in order to modernize a handful of large public enterprises as well as measures to foster backward linkages with local suppliers. The same holds for the lignite industry in Kosovo and its potential to generate electricity for export to neighboring countries. The long-term prospects of the tourism industry in Croatia, Montenegro and Albania will depend on the ability to develop a modern hotel infrastructure with the help of foreign investors, but
also on sustainable coastal zone management and the restoration of cultural heritage attractions. The
development of agricultural exports from Serbia or Macedonia will require not only efficient
transport links to EU markets, but also the development of a modern agricultural and food processing
industry that can comply with the strict sanitary and phytosanitary standards of the European Union.

For the Western Balkan countries to achieve continuous economic growth and to raise income levels,
they will also need to gradually move up along the ‘ladder of dynamic comparative advantage’ –
away from the export of raw materials and labor-intensive manufacturing towards higher value-
added activities. Increases in productivity, however, can only be achieved through investments in
human capital (e.g. education), flexible labor and capital markets (to reallocate resources to higher
value-added activities), a capacity to absorb technology (e.g. by attracting FDI) and the development
of modern services sectors. The countries of the Western Balkans are at different stages of
development. The appropriate policy mix thus depends both on a country’s sources of comparative
advantage and on its relative position on the ‘ladder of dynamic comparative advantage’. With regard
to human capital investments, for instance, Albania still needs to improve its primary and secondary
education, whereas Croatia’s main challenge is to render its universities more competitive.

The Central and Eastern European countries (CEECs) benefited from a large transfer of manufacturing
jobs from Western Europe in the years prior to their EU accession. More recently, however, they
have started to lose competitiveness as double-digit wage growth outpaced productivity gains and as
their currencies continue to appreciate against the euro (and the euro against the dollar). Combined
with the fact that investment opportunities in more mature CEEC markets are becoming scarcer, this
permits the Western Balkans to position itself as the ‘next frontier’ for foreign direct investment by
EU companies. In fact, the same set of EU players that have consolidated sectors such as financial
services, telecoms or energy in the CEECs have started to move on to South East Europe. When
positioning itself as the ‘next frontier’ for FDI, however, the Western Balkans competes with large
low-wage countries on the EU fringe, such as Romania, Turkey and Ukraine. With the exception of
Albania, relatively high wage levels will make it difficult to attract low value-added ‘nearshoring’
activities. Hence, the challenge will be to use the EU membership perspective and visible reform
momentum to redirect some investor attention from the CEECs towards the Western Balkans.

Given the small size of most Western Balkan countries, deeper intra-regional integration will also
enable them to more effectively participate in European and global markets. A larger ‘home market’
exposes domestic companies to the rigors of competition and permits them to exploit economies of
scale. This will render them more competitive in international markets. Intra-regional integration also
reduces investment costs in network industries such as electricity or railways. Moreover, economies
of scale can be reaped by developing cross-border institutions, including a regional stock exchange, a
regional air traffic control center or joint regulatory institutions in rail and electricity. Gains from
intra-regional integration can also arise in sectors where complex supply-chains or industry clusters
are important. Last but not least, a common Western Balkan market would put the region on the map
of international investors, who tend to prefer large markets. In summary, intra-regional integration
will also improve the competitiveness of Western Balkan countries in the global market place.

A final point that should be stressed on the issue of comparative advantage is that individual Western
Balkan countries not only need to define their comparative advantage relative to the EU, but also

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2 According to a study on the metal and electronics industries in the CEECs, carried out by the IFO-Institute in
Germany, wage growth between 2000 and 2004 averaged 12.8 percent per year, while wages grew by 13.5 percent
(Financial Times Deutschland, 12 July 2006).
relative to their immediate neighbors. An example for a welfare enhancing intra-regional division of labor is Montenegro, which ‘exports’ tourism services to visitors from Serbia and Kosovo. Kosovo in turn has the potential to become a supplier of electricity for neighboring countries, once it effectively exploits its lignite reserves. Thanks to its low wages, Albania is a natural location for the outsourcing of labor-intensive stages in regional supply-chains. Bosnia, endowed with natural resources and heavy industry, supplied metallurgical and chemical products to the rest of Yugoslavia and is making efforts to regain that function. Macedonia could capitalize on being a small country next to its large and more developed neighbor Greece. Croatia not only exports consumer products to its neighbors, but also helps to upgrade their food processing industry through the export of FDI and know-how.

Box 2: Intra-Regional FDI Flows

Even though the bulk of FDI to the Western Balkans continues to come from the EU, intra-regional investments are on the rise. Factors encouraging FDI between the countries of South East Europe include common languages and similar legal systems, border-spanning ethnic communities as well as historical business links dating back to Yugoslav times. Intra-regional FDI flows are mostly concentrated on a few sectors (e.g. banking, retail, energy) and the bulk originates from Slovenia and Croatia. Half of Slovenia’s FDI outflows between 2002 and 2004, for instance, went to other countries of former Yugoslavia. Nova Ljubljanska Banka, Slovenia’s largest bank, has subsidiaries in all countries of the Western Balkans. Slovenia’s largest retailer Mercator has opened supermarkets and grocery stores in Croatia, BiH and Serbia and plans further expansion across the region. Slovenia’s oil and gas company Petrol maintains a network of gas stations that stretches across Slovenia, Croatia and BiH. Agrokor, a leading Croatian food processing company has made a series of investments in Serbia and BiH, while its branded products are being sold throughout the region. In December 2006, Serbia’s Telekom Srbija paid € 646 million for Telekom Srpske in a privatization tender. Another important source for FDI is Hungary. Magyar Telecom (majority owned by Deutsche Telekom) bought telecom operators in Montenegro and Macedonia, while Hungary’s OTP Bank has recently acquired banks in Croatia, Serbia and Montenegro. Even though there have been a number of cases where political sensitivities led to the obstruction of cross-border investments, intra-regional FDI flows are fostering deeper integration between the economies of South East Europe. As cross-border retail networks, consumer brands and supply-chains become common features of the economic landscape, the anxieties and prejudices they provoke should gradually fade.

3 The examples from this text-box were taken from Economist Intelligence Unit, Croatia Country Profile 2006, the respective company websites and Financial Times Deutschland (6 December 2006).
Deeper Regional Integration

Economic integration between countries is a continuum that leads from shallow forms of integration to deeper forms of integration. Shallow integration normally focuses on trade liberalization for goods, while deeper forms of integration involve a liberalization of trade in services, the removal of non-tariff barriers, regulatory harmonization and physical infrastructure linkages. The challenge for the Western Balkan countries is to gradually move towards deeper economic integration and the conclusion of the CEFTA 2006 agreement represents a significant step forward in that regard (see box 1). The end-point of the process is also in sight. Eventual EU membership will lead to the deepest possible form of integration both within the region and vis-à-vis the rest of Europe. For most countries, however, this point is still a decade or so away and broad economic reforms still have to be implemented to gradually deepen integration between the Western Balkans and the European Union.

While classical trade liberalization focuses on the removal of tariffs and quotas, a multitude of non-tariff barriers (NTBs) obstruct trade and resource flows between national economies. They can arise, inter alia, from cumbersome border-controls, differences in the legal and regulatory framework or insufficient backbone services such as transport or telecoms. Deeper integration between economies ultimately takes place at the company-level through phenomena such as cross-border supply-chains, retail networks or foreign direct investment. For economies to ‘mesh’ at the company-level, however, reforms at the policy-level are needed to remove non-tariff barriers. Deeper integration can be pursued both through sector-specific policies (e.g. in financial markets or manufacturing) and through horizontal policies (e.g. competition policy or investment rules conducive to FDI).

As is the case with classical trade liberalization, the economic gains from deeper integration arise from enhanced specialization according to comparative advantage, economies of scale, import competition, knowledge spillovers and FDI flows. Since deeper forms of integration remove a wider range of cross-border distortions, they tend to yield larger benefits. But deeper integration also involves more complex behind-the-border reforms and thus entails substantial negotiation, transition and compliance costs. Therefore, deeper integration is normally best pursued in a selective manner. Governments should identify priority sectors and policy areas and gradually deepen integration over time. This and the following chapter will explore a possible sequencing and prioritization of deeper integration measures for the Western Balkans – both within the region and vis-à-vis the EU.

Geographic and cultural proximity generally facilitates deeper integration. The Western Balkans has some specific characteristics that make it particularly well suited for regional integration. First, most countries used to be part of one national economy (Yugoslavia) and significant economic gains can be reaped from reintegrating fragments of former regional systems such as power grids, rail networks or supply-chains. Second, the Western Balkans comprises mostly small economies, which would benefit disproportionally from participation in a larger regional market. Montenegro’s independence in mid-2006 and the imminent conclusion of Kosovo’s final status negotiations further add to the number of small economies. Third, geographic and ethnic factors increase the interdependency between these countries – including a common language, ethnic minorities or the crescent-shape geography of Croatia, which wraps around BiH. Fourth, all Western Balkans countries strive for EU membership and are thus converging towards the same regulatory framework.

4 With 660,000 inhabitants and a fraction of the EU’s income level, the size of Montenegro’s economy is equivalent to that of a Western European town of about 150,000 people. The joint GNI of all Western Balkan countries (21 million inhabitants) is a quarter of that of Austria (8 million inhabitants). (World Development Indicators 2005)
While all this makes the Western Balkans a ‘natural’ region for the pursuit of deeper integration, the actual patterns of integration do not follow strict geographic boundaries. Depending on the sector, companies from individual EU neighbors tend to be particularly active in the region – for example, Austrian banks, Italian textile manufactures or Greek energy companies. There are also significant intra-regional FDI flows from the more developed countries of former Yugoslavia like Slovenia (an EU member) and Croatia (an EU candidate) to their less developed peers. Moreover, some Western Balkan countries have developed particular links to specific EU countries. Albania, for instance, has a particularly close relationship with Italy and Greece. Geographic proximity fosters trade between Macedonia and Greece. And Croatia has close links with Austria and Germany. These patterns are the result of migration, geographic, economic and historical factors.

**Box 3: Regulatory Convergence and Acquis Compliance**

A prerequisite for EU membership is the full adoption of the *acquis communautaire*. This body of EU law comprises an estimated 80,000 pages of text and the process of regulatory harmonization is therefore complex, time-consuming and costly – especially for the smaller countries of the Western Balkans. If rushed, it could put a significant burden on the economy, while distracting policy makers from more pressing reform challenges. The process of regulatory convergence should thus be gradual, carefully sequenced and tailored to the specific needs of transition economies with low income levels and weak administrative capacity. The two accession candidates Croatia (where negotiations already started in October 2005) and FYR Macedonia (which was granted candidate status in December 2005) will be obliged to transpose the entire acquis. However, more complex policy areas (‘chapters’) are left for later stages of the negotiations and for parts of the acquis where compliance is particularly difficult or expensive (e.g. the environment) temporary derogations may be granted.

In that context it should be noted that the economic essence of the EU Single Market is not the acquis as such, but the *four freedoms* for the movement of goods, services, capital and people. The quickest way to achieve those freedoms is not through a wholesale adoption of the acquis but rather a targeted removal of barriers that currently obstruct these freedoms. Moreover, acquis compliance not only requires legislative approximation but also effective enforcement of these rules. This, however, remains a major problem throughout the Western Balkans. Hence, a main priority for most countries in the region will be to strengthen administrative capacity and build functioning market institutions. In fact, premature acquis adoption – i.e. legislative approximation that outpaces the capacity to actually enforce the new laws – threatens to undermine the rule of law.

Governments would be well advised to first adopt those elements of the acquis (i) that are conducive to growth and foreign direct investment, (ii) that help remove obstacles to regional integration and (iii) for which the economic benefits outweigh associated adoption, transition and compliance costs. In many cases, the acquis only defines general principles, whose transposition into national law leaves scope for adoption to country-specific circumstances. The optimal sequencing and transposition modalities need to be determined on a sector-by-sector and policy-by-policy basis. In financial services, for instance, the first priority should probably be the banking acquis, whereas the complex rules for sophisticated capital markets (which do not yet exist in the region) should follow at a later stage. In air transport, full compliance with the sector acquis by 2010 is a requirement of the ECAA agreement, but implementation will take place in three pre-defined stages.

**Cross-Border Supply Chains and Regional Production Networks**

A major company-level conduit for regional trade and the participation of Western Balkan countries in EU markets are cross-border supply chains (also referred to as ‘value chains’). As a result of business trends such as outsourcing and supply chain management, individual production stages in manufacturing are becoming increasingly fragmented. At the same time, production is being dispersed geographically thanks to trade liberalization, reduced costs of transport and advances in information technology. The consequence is that value chains are increasingly ‘sliced’ between firms...
and that individual production stages are moved to foreign countries (‘offshoring’) with corresponding comparative advantages (e.g. countries with low labor costs for labor-intensive tasks).

Such a division of labor between firms or subsidiaries of multinational companies generates outward processing trade (OPT), or ‘production sharing’ between countries. As an OECD report on the linkages between trade and development stressed, this type of trade tends to generate broader economic gains. According to the report the “spillover effects of production sharing processes include the diffusion and absorption of new and improved production technologies, management and labor skills and information about world markets.” OPT therefore permits “a catching-up with best practice in the world economy”, while “strengthening know-how and skills of both firms and labor.” Equally important are the effects on FDI flows, as “the globalization of production structures takes place through investment abroad, which in turn stimulates trade. It is thus unsurprising to find that the same non-OECD countries that were able to attract the bulk of FDI were the ones that participated most vigorously in production sharing.”

While ‘offshoring’ is conducted at a global scale, geographic proximity facilitates the maintenance of complex supply chains. ‘Nearshoring’ is particularly common in those industries, where just-in-time production is important. Examples are car manufacturing or segments of the garment industry where short-term replenishing orders are needed. South East Europe is close enough to the EU to permit for such tight integration of Western Balkan companies into pan-European production networks. While geographic proximity to the EU Single Market thus constitutes an important source of comparative advantage for South East Europe, the region is competing with other emerging economies in the EU’s periphery – such as Turkey, Ukraine or North Africa. To attract nearshoring activities, Western Balkan countries need to raise productivity and offer an attractive business environment.

But there is another important precondition for effective participation in pan-European production networks. OPT is a type of trade that is particularly sensitive to delays and disruptions between individual stages of the supply-chain. The reasons is that ‘production blocks’ in the sliced value chains have to be connected by ‘service links’, which allow different companies or subsidiaries to effectively coordinate their activities. A range of trade-related services are thus needed for cross-border supply chains to function properly. These include transport, telecommunications, financial, distribution and business services. For Western Balkan companies to participate in regional production networks, they need access to efficient ‘backbone services’.

Analogous to the fragmentation of the production chain in manufacturing, an increasing number of back-office services are also being outsourced. Such business process outsourcing (BPO) is no longer confined to basic services like accounting or call center work. More specialized activities like frequent flyer programs or medical transcriptions are also increasingly subject to BPO. It has been estimated that BPO transactions account for $ 200 billion annually worldwide and they continue to grow rapidly. Thanks to advances in communications technology, many of these services have also become tradable (‘IT-enabled services’) and can be offshored to economies with lower wages.

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6 ‘Backbone services’ can be defined in two ways. In the narrow sense of the term it relates to infrastructure services that are provided on the basis of physical infrastructure networks (e.g. electricity grids, oil and gas pipelines, road and rail connections). In the broader sense of the term, backbone services are all those services that facilitate economic transactions and resource flows across borders and thus act as connectors between economies. This would also include financial services, business services or distribution services.
7 Information from Dun & Bradstreet cited in The Economist (5 May 2001).
study of the consultancy Gartner estimated that up to a quarter of traditional IT jobs will be relocated from developed to developing countries by 2010. Approximately one third of leading European businesses already include outsourcing of IT services to foreign countries in their business plans.

The experience of the CEECs illustrates how trade liberalization, economic reforms and foreign direct investment can help integrate transition economies on the former EU periphery into European production networks. A World Bank study found that several years prior to EU accession, many manufacturing companies in the CEECs had already “become part of the intra-product division of labor around the EU.” Trade in the office and telecom equipment, furniture and car industries – important sectors for manufacturing trade – in these countries increased from $ 6 billion in 1993 to $ 28 billion five years later. “In 1989 not a single CEEC had a revealed comparative advantage in assembling [...] Czech Republic, Hungary, Slovakia and Slovenia already acquired it in 1993 and by 1997 Poland and Estonia had also become specialized in assembly operations”. Thanks to large-scale FDI inflows into car manufacturing, industry output in the automotive industry rose by 27 percent in the CEECs between 2000 and 2005, while it remained flat in Western Europe.

Box 4: The Privatization of Zenica Steel Mill and its Impact on Regional Supply Chains

In 2004, a 51 percent share of the Zenica steel plant in the Bosnian Muslim-Croat Federation was privatized. The stake was bought by the global player Mittal Steel in what was the country’s largest foreign investment to date. The new owner paid $ 80 million and committed itself to invest a further $ 200 million within a decade. According to Mittal, production is meant to increase from 120,000 tons in 2004 to 2.2 million by 2007/8, while the head-count should rise from 2,900 in early 2006 to 4,600. The mill had lain idle for several years following the war in 1992. In a complementary investment, Mittal entered into a joint venture to operate and modernize the iron ore mines near Ljubija, which are located across the inter-entity border in Republica Srpska and had been cut off from the mill for political reasons. These large-scale commitments of Mittal are also encouraging investments in related companies. In mid-2005, for instance, Slovenia’s Livar bought the Jelsingrad steel foundry from the government of Republica Srpska. Most of the production of the Zenica plant is earmarked for clients abroad and should give a boost to Bosnia’s exports. Since the main target markets are in South East and Eastern Europe, this will also give a boost to intra-regional production networks. In fact, part of the output will be shipped for additional processing in Mittal’s recently-acquired plant in Montenegro’s capital Skopje. The reconstruction of war-damaged transport infrastructure was an important precondition for the company to regain access to suppliers and customers across the region. Zenica not only illustrates the importance of FDI for the development of exports and cross-border supply chains, but also the productivity increases associated with the transfer of FDI-related know-how. Mittal operates a sophisticated knowledge-management and staff-exchange program on 25 different technical and organizational themes to help spread best practice between its plants around the world. As part of that scheme, experts from subsidiaries in Germany and South Africa were seconded to help improve the performance of Zenica’s electric arc furnace, while employees from Bosnia were in turn sent to provide assistance on the handling of iron ore to their colleagues in Algeria.

Much of the potential for ‘nearshoring’ between the EU and South East Europe remains unexploited. A recent study by the World Bank Group analyzed the strengths and weaknesses of Western Balkan countries as investment locations for selected manufacturing sectors – namely car parts, food processing and leather and shoe production. The findings are not only meant to help governments

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8 Financial Times (17 March 2004).
11 Information on the Mittal Steel case study was taken from: Financial Times (15 September and 9 August 2005), EBRD Feature Story “Mittal’s Bosnia deal signals confidence” (January 2006), EBRD Project Summary Document “Mittal Steel Zenica” (July 2005) and Economist Intelligence Unit. BiH Country Profile 2005.
improve the business environment and national investment promotion agencies to better target foreign investors but they will also feed into efforts of the European Investor Outreach Program (EIOP) to attract sector-specific FDI to these countries. According to that analysis, for instance, Croatia and Serbia have potential for FDI in the automotive component industry; Serbia is well positioned to export berries and greenhouse fruit/vegetables while Albania has a competitive edge in fish products as well as shoe and leather manufacturing (where Italian investors already play a key role). Another example for a donor-funded initiative to foster regional supply-chains in a specific sector is an automotive cluster project for South East Europe by Germany’s GTZ.

**Policy Measures to Foster Deeper Integration**

Economic reforms in a range of policy areas can encourage trade and deeper regional integration in the Western Balkans. A selection of those policy areas is discussed below.

**Rules of Origin:** If imports from one party of a preferential trade agreement are to qualify for tariff exemptions in another, these goods have to ‘originate’ from the exporting country. Rules of origin (ROOs) define the conditions that a good has to meet to obtain that status, such as a minimum content of domestic value added or specific processing steps performed in the exporting country. In complex supply chains, goods tend to cross multiple borders as they are being processed from raw material to final product. Depending on the sequence of trades this entails, different ROOs apply. Within regional trade blocks, it is important to allow for a ‘cumulation’ of origin; processing steps performed in trading partner A, and incorporated in intermediate products imported by country B for further processing should be treated as originating from country B, if the resulting products are later exported to third member of the trade block. Given the small size of the Western Balkan countries, sophisticated production networks can only be developed at the regional level. Hence, ROOs that do not permit for cumulation constitute an impediment to deeper integration and the expansion of trade.

The CEFTA 2006 agreement among the countries of South East Europe includes provisions on rules of origin in article 14, in annex 4 as well as in annex 5 (on customs). The signatories agree to apply the ‘pan-European’ ROOs between each other. These were originally developed by the EU to permit for cumulation and harmonization of ROOs between the Community and its trading partners in the European Economic Area (EEA) and in the Euro-Mediterranean free trade area. While this will permit for cumulation among CEFTA members, it does not yet extend to trade with the EU. If Serbia exports products to the EU, for instance, that contain inputs from Bosnia, it does not benefit from duty exemptions. Even though the EU has in principle agreed to permit for cumulation in its trade with the Western Balkans, the SAAs do not yet contain such provisions. Before this important missing link for regional cumulation can added, the institutional capacity of customs administrations in Western Balkan countries will need to be strengthened. Unless the full integrity of certificates of origin can be ensured, a system allowing for cumulation would be open to considerable abuse.

**Border Controls:** Customs and other border-related controls impose costs on traders and induce considerable frictions into cross-border supply chains. Wide-spread problems in the region include administrative red tape, corrupt practices, a multitude of border controls by different agencies and a

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lack of cooperation between authorities on both sides of common borders. This is being amplified by
the fact that a relatively small region with a population equivalent to that of Romania is divided into
eight countries and entities, all of whom maintain their own external borders and border-crossing
regimes. A freight truck, for instance, that is driving between Salzburg and Thessaloniki has to cross
five different borders – each with controls on both sides. At these borders, it is subject to customs
and other freight-related controls, such as sanitary and phytosanitary controls in the case of
agricultural products. In addition, the driver will have to present his visa and driving permit, while
the truck may be checked for compliance with vehicle standards, insurance etc.

To address these problems, the multi-donor Trade and Transport Facilitation Program for Southeast
Europe (TTFSE), managed by the World Bank, has provided assistance to customs reforms, the
removal of physical bottlenecks at border crossings and better coordination between border control
agencies. Launched in 2001 and largely completed by 2006, the 120 million dollar initiative helped
improve the efficiency of trade flows, while reducing border-related corruption, smuggling and
human trafficking. In the planned second phase (TTFSE II) the scope of the project is to be extended
to cover additional border crossings and border-related agencies and to fund infrastructure
investments along the main regional corridors. Other initiatives to increase the efficiency of border-
related controls are the European Commission’s assistance to customs authorities throughout the
region and the Ohrid Process on Border Security and Management under the auspices of the Stability
Pact. Despite progress made through these and other initiatives, many border-related controls in the
Western Balkans remain cumbersome and a key impediment for deeper regional integration.

Public Procurement: The procurement of goods and services by the governments and public entities
can account for 10 percent of a country’s GDP. Fair and transparent cross-border competition for
public contracts is an important building block of a truly integrated regional market. Across the
Western Balkans, however, discrimination in favor of national companies remains widespread. This
can take the form of local content rules or residency requirements as well as more subtle forms such
as biased product specifications, non-competitive contract awards or rigged tenders. These types of
discrimination in not only constitute important non-tariff-barriers, but also impose significant costs to
the government budget. An analysis of OECD countries found the ‘margin of preference’ (i.e. the
premium paid by governments to favor domestic suppliers) to range between 13 and 50 percent.
Moreover, non-transparent procurement practices create a fertile breeding ground for corruption –
which constitutes a major impediment for economic development in the Western Balkans.

The two accession candidates Croatia and Macedonia started to open their procurement markets by
introducing the principle of non-discrimination between domestic and foreign suppliers in their
procurement laws, in compliance with the respective EU acquis. In most Western Balkan countries,
however, non-transparent practices and discrimination between domestic and foreign suppliers
remain wide-spread. The CEFTA agreement contains provisions on public procurement in articles 34
to 36. While it introduces the principle of non-discrimination, a relatively long transition period until
May 2010 will apply. The CEFTA provisions go beyond WTO rules and contain an evolutionary
clause with a review mechanism. As with most other policies that are of relevance for deeper
integration, however, the challenge for the Western Balkan countries is not to make de jure
adjustments in line with international norms, but to de facto enforce these new rules. The annual
progress reports of the Commission contain procurement chapters and monitor progress in this regard.

Competition and State Aid Policy: Anti-competitive behavior by firms not only reduces economic
efficiency at the national level, but can also be an important barrier to market access and thus trade
between countries. Small markets like those in the Western Balkans are particularly prone to cartels,
restrictive practices or the abuse of market power. The pivotal importance of competition for the process of deeper integration is reflected in the fact that the EU’s strict competition and state aid rules constitute a central pillar of the Single Market and are enforced both by the European Commission and by national antitrust authorities. Whereas pro-competitive regulation in the network industries tends to be targeted at well-defined incidences of market failure (e.g. vertical unbundling in electricity, network access in railways, slot allocation at airports), cross-sector competition rules are a flexible instrument to counter anti-competitive behavior on a case-by-case basis. This, however, requires a high degree of institutional capacity and technical skills of antitrust authorities.

Most Western Balkan countries have adopted competition laws in compliance with EU rules and several have established independent competition authorities. The laws as such, however, are only a fraction of the relevant acquis, which mainly consists of a vast body of case law. The poor enforcement track-record in terms of cases investigated and volumes of fines collected indicates that significant capacity building for anti-trust authorities in the Western Balkans will be needed. Given the small size of these countries, it might be useful to contemplate the establishment of multi-regulators or certain regional-level regulatory structures. As far as state aid is concerned, compliance with EU rules is a long way off and even reliable data on the flows and magnitude of state aid is hard to come by. Both the CEFTA 2006 agreement (in articles 20 and 21) and the SAAs between the EU and the Western Balkan countries contain some general provisions on these issues. Most importantly, perhaps, the annual progress reports by the European Commission contain chapters on competition and state aid and are a useful instrument to monitor and encourage the gradual convergence towards EU practices.

**Investment Climate:** Attracting FDI in trade-related industries is one of the most powerful policy levers for trade expansion. The associated policy issues for specific services sectors are discussed in the following section, but there are also important cross-sector policies that need to be addressed in order to create a favorable investment climate. The main initiative to improve the investment climate in the region is the Investment Compact for South East Europe, which is being coordinated by the Stability pact and the OECD. It provides a framework for assessments and peer reviews on investment-related policies and it provides technical assistance for associated reforms. The CEFTA agreement also contains some investment-related provisions, providing for non-discrimination, national treatment and most-favored nation (MFN) treatment. One most effective instruments to attract FDI, however, is actually the privatization of government-owned companies. Ideally, privatization transactions should not only be structured in view of maximizing privatization revenues, but also broader economic gains. These include subsequent investments by the buyer and an integration of the privatized companies into international production networks. The benefits of such privatizations is illustrated in the case studies in text-boxes 4 and 7.

A general discussion of the various cross-sector policy areas of relevance for deeper integration is beyond the scope of this paper, but some additional ones should be briefly flagged here. An important non-tariff barrier for trade in goods are norms and standards and their harmonization is a natural priority also for the Western Balkans. This includes sanitary and phytosanitary standards, which are one of the most significant constraints for increased trade in agricultural products in the region. The broader business environment is another determinant of trade expansion and includes policy areas as judicial reform, accounting and auditing reform, the establishment of cadastres (to provide for land-titles) or the fight against corruption.

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14 Investment Compact (www.oecd.org/pages/0,2966,en_35424885_35425063_1,1,1,1,00.html).

15 For information on the business environment, see EBRD-World BEEPS results for South East Europe: (http://siteresources.worldbank.org/INTECAREGTOPANTCOR/Resources/BAAGREY20060208SEE.pdf)
The Liberalization of Trade in Services

Trade in services liberalization could become a powerful driver for growth in the Western Balkans for several reasons. First, services sectors account for the bulk of economic activity in the Western Balkans – between 53 percent of GDP in Albania and 62 percent in Croatia. They even account for over two thirds of GDP in the European Union. Second, many of these sectors have traditionally been government controlled and shielded from competition. Hence, a liberalization of services trade should induce substantial efficiency gains. Third, services are an important input in other economic activities – accounting for an estimated 10 to 20 percent of production costs in manufacturing – and a liberalization of trade in goods without a liberalization of trade in services would increase effective rates of protection for the former. Fourth, most trade barriers for services come in the form of behind-the-border policies and thus the liberalization of services trade involves broad domestic reforms. Fifth, most trade in services takes place through commercial presence and thus entails significant FDI flows and knowledge spillovers. Not surprisingly, the gains from liberalization in services trade usually exceed the gains from liberalization in merchandise trade.

Trade in services differs fundamentally from trade in goods. Since services tend to be intangible and non-storable, their trade often requires a direct interaction between buyer and seller. As a result, there are four different modes of supply: (1) Cross-border supply, where consumers and producers do not interact (e.g. financial services transacted online). (2) Consumption abroad, whereby the consumer moves to the producer (e.g. tourism or port services). (3) Commercial presence, whereby the producer comes to the consumer (e.g. bank branches or retail outlets). (4) Presence of natural persons (e.g. short-term assignments of architects or consultants). The relative importance of the four modes differs between sectors and liberalization should ideally cut across modes. Nevertheless, commercial presence tends to be the dominant mode. Consumption abroad is mainly relevant for tourism while technological progress is making cross-border supply a feasible mode for an increasing number of services (e.g. IT-enabled services). Due to its peculiar nature, services trade entails substantial flows of capital, labor, intellectual property rights and knowledge spillovers between jurisdictions.

Whereas the main barriers to trade in goods are tariffs and quotas enforced at national borders, barriers to trade in services mostly come in the form of behind-the-border administrative barriers or regulations, targeted at services suppliers. If cross-border trade in services is to be liberalized, a wide range of domestic policies need to be reformed. These include rights of establishment (e.g. for foreign retailers or hotel chains), rules for market access (e.g. network access for telecom operators or electricity generators), licensing regimes (e.g. for accountants or medical staff), investment rules (e.g. restrictions to foreign ownership or the repatriation of profits), visa regimes and competition rules. Policy measures to liberalize trade in services can be of a cross-sector nature or sector-specific. Many of the reforms needed for a liberalization of services trade are similar to those required for structural adjustment. The reason is that obstacles to market entry by foreign firms also undermine competition, private sector development and economic efficiency at the national level. Examples are legal exclusivity rights, state-owned monopolies, anticompetitive behavior or red tape.

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19 Such restrictions do not generate fiscal revenues (as tariffs do) and thus entail a deadweight loss to the economy.
Box 5: Migration and the Temporary Movement of Workers

The movement of natural persons tends to be the most contentious of the four modes of services trade. The boundary with migrations is somewhat blurred and in fact the two are often being confused. In contrast to migration, however, the movement of natural persons is of a temporary nature and linked to the delivery of a specific service. Examples are company employees sent abroad to establish commercial presence, auditors or consultants providing advisory services or engineers working on construction projects. In global trade negotiations, many developing countries (endowed with a surplus of cheap labor) have long been eager to liberalize mode four, while developed countries (who fear ‘wage dumping’ and unemployment) are reluctant to make such commitments. A possible compromise is to trade off concessions across different modes and sectors. Other options are to limit mode four to labor market segments where wage differentials are less pronounced (e.g. for highly qualified staff) or to use transition periods (as between the EU-15 and the new member states).

Migration is a cross-border issue by definition and the Western Balkans has seen some large-scale migration flows – including negative side-effects like illegal migration and human trafficking. About two million Bosnians have left their country while one million Albanians (mostly in Greece and Italy) and one million Croats (mainly in Germany) are estimated to live abroad.20 Kosovo also has a large diaspora relative to its population. Moreover, the series of wars and civil conflicts led to the displacement of ethnic minorities within the region. An economic consequence of these migration flows are workers’ remittances: Albania receives $0.9 billion worth of remittances per year, Bosnia and Herzegovina $1.8 billion, Croatia $1.2 billion, Macedonia $170 million and Serbia and Montenegro $1.4 billion.21 For Albania, where almost a third of the population lives abroad, the International Organization for Migration calculated that remittances account for 14 percent of GDP in 2005 and finance 63 percent of the country’s trade deficit. Money sent home by migrants not only support relatives left behind, but are also being invested in real estate and small scale businesses.

But there are other reasons, why migrants and temporary workers act as catalysts for deeper integration; they establish border-spanning personal networks that facilitate the flow of ideas and business contacts. Returning migrants bring back skills, set up firms or work for the subsidiaries of foreign companies in their home countries. Having experienced life in more developed countries, they can act as change agents in the process of socio-economic modernization. The challenge for the Western Balkans is to more systematically harness the resources of its migrant communities. Programs to support return migration or channel remittances into more productive investments could be launched. As examples from other countries show, the internet can be an important tool to build ‘virtual’ exile communities and reconnect the émigrés with their countries of origin through the exchange of information, jobs postings and business opportunities. Other important instruments to foster people-to-people contacts are the planned visa facilitation as well as the inclusion of Western Balkan countries in EU-internal exchange programs for students and researchers.

At the multilateral level, the General Agreement on Trade in Services (GATS) under the auspices of the World Trade Organization (WTO) is the main vehicle for services trade liberalization. Trade between WTO members is governed by a number of principles like the most-favored nation principle (no discrimination between trading partners), the national treatment principle (no discrimination between domestic and foreign firms), the transparency principle (all remaining trade barriers need to be explicit) and institutionalized dispute settlement (to enforce compliance with WTO rules). As far as services are concerned, each WTO member can select sectors for which it is willing to subject itself to GATS disciplines. For each of these ‘bound’ sectors, all remaining trade restrictions have to be explicitly listed in a country’s schedule of commitments (‘negative listing’). Schedules are divided into horizontal commitments (e.g. general rights of establishment) and sector-specific commitments. For each of the various sectors and sub-sectors, commitments can then be made for the four modes of supply (which yields a ‘matrix’ of commitments). Among Western Balkan countries Albania, Croatia

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20 Economist Intelligence Unit. *Country Profile Albania 2005.*

Daniel Müller-Jentsch

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EC-WB Office for South East Europe
and Macedonia are already WTO members, while Bosnia and Herzegovina, Serbia and Montenegro are negotiating accession.\footnote{Albania joined in September 2000, Croatia in November of the same year and FYR Macedonia became WTO member in April 2003. The accession negotiations are in their final stages for Bosnia and Herzegovina, well advanced for Serbia and at an earlier stage for Montenegro.} Their GATS commitments or offers are generally rather comprehensive.

With all of the EU and most of the Western Balkans members of the WTO, trade between them is also subject to WTO rules. Nonetheless, a separate regional agreement could help deepen cross-border integration in the services sectors in two general ways. On the one hand, it could include more far-reaching commitments (more sub-sectors, additional modes, more liberal provisions). On the other hand, it could incorporate elements of the acquis communautaire in order to achieve regulatory convergence in selected areas. Even though the CEFTA 2006 agreement addresses services trade in articles 29 to 29, it does not yet contain any binding commitments but just a declaration of intent regarding a gradual liberalization of services trade. This could either be achieved through separate services negotiations to amend CEFTA or through unilateral liberalization measures. If the parties opt for a services agreement, they would be well advised to adopt a ‘negative list’ approach, in which case only trade barriers that are explicitly listed may be maintained. This would considerably enhance the transparency of the trade regime.

**Trade in Specific Services Sectors**

The liberalization of trade in services in the Western Balkans is well advanced, but progress varies between sectors. In financial services and tourism most market access restrictions have already been removed. The regional agreements on air transport and energy will gradually remove most remaining barriers in those two markets. The telecom sector has seen an influx of FDI (mode three) and planned reforms should lead to a further expansion of trade (e.g. liberalization of fixed-wire services, privatization of state-owned operators, issuing of additional mobile licenses). Distribution and construction services are also relatively open to cross-border trade, even though some restrictions continue to exist. For professional services, a lack of mutual recognition significantly restricts trade. State-ownership remains an obstacle for trade via mode 3 for several services sectors (e.g. transport, energy and environmental services). In some cases where formal market access restrictions have been removed, anti-competitive behavior by incumbents still constitutes a barrier to trade.

Despite the tangible nature of infrastructure networks, telecommunication, electricity and transport are treated as services sectors for trade purposes. The reason is that the physical infrastructure only serves as a basis for the delivery of intangible infrastructure services.\footnote{Only the cross-border transport of physical infrastructure equipment (e.g. telephone switching stations, power stations, airport equipment, electricity and telephone cables) involves the trade in goods.} The following section mainly focuses on backbone services and other services with significant trade potential. Sectors in which the Western Balkan countries seem to have potential to expand their services exports include tourism, IT-enabled services and construction services. In contrast, potential for increased imports seems to exist across the board, especially via the dominant mode three. As mentioned above, such imports via commercial presence involve substantial FDI inflows as well as the employment of local staff by foreign services providers. Hence, the net economic benefits for the importing country in terms of domestic value added, capital formation and employment are even higher than in the case of goods imports. In other words, even from a ‘mercantalist’ point of view, services imports are highly desirable.
Transport: Efficient transport is a catalyst both for economic development and for deeper regional integration. It facilitates the cross-border flow of goods, tourists and business travelers and it connects the region to its large emigrant communities. But regional integration is also taking place within the transport sector itself. Other than in telecommunications, however, where regional integration at the sector level is primarily driven by cross-border investments, the main conduit of integration in the transport sector is regulatory harmonization and coordination between authorities. The policy issues, reform challenges and investment needs vary between transport modes (air, rail, road, maritime, inland waterways) and are discussed in more detail in the following paragraphs. One of the most important sources of transport frictions in the region, however, are border crossings. Hence, the Trade and Transport Facilitation in Southeast Europe Program (TTFSE), discussed in chapter 3, is also an important initiative to foster regional integration in the transport sector.

An ambitious integration scheme has been launched in the air transport sector. In June 2006 the EU and the countries of South East Europe signed an agreement to establish the European Common Aviation Area (ECAA).24 It commits all signatories to fully liberalize air traffic and to adopt the entire aviation-related acquis by 2010. This will effectively extend the EU’s single market for air transport to the Western Balkans. Implementing this ambitious agenda will require a revision of national aviation codes, the liberalization of cross-border traffic rights, capacity building for civil aviation authorities (CAAs) and improvements in the safety and security regimes. A particular challenge will be the restructuring and consolidation of the many small national airlines to ensure they survive the onset of competition. All six Western Balkan flag-carriers together carried 3.2 million passengers in 2005 – about one third the figure of Austrian Airlines. Much closer regional cooperation will also be needed in air traffic management (ATM), given the fact that planes on some routes cross five different countries in the course of an hour. Most of the investment needs in air transport can be mobilized from the private sector, once appropriate policies are in place, as successful cost-recovery in ATM, the concession for Tirana airport and public private partnerships at Belgrade airport illustrate.

The case for deeper regional integration in rail transport is equally compelling. Railways constitutes a network industry with substantial economies of scale and the break-up of the former Yugoslavian railways created several small systems that are barely viable on their own. Macedonia, for instance, has a mere 200 km of track. In freight traffic, rail only tends to be competitive on for bulk cargo and on long-distance routes beyond 500 km. The fact that less than five percent of traffic between the EU and Turkey are carried on this mode illustrates that Western Balkan rail companies are missing out on potential transit traffic, as a consequence of low efficiency and border-related disruptions of rail traffic. Reform challenges throughout the region include overstaffing, high costs and a lack of modern management. The requirements of the EU acquis will also require far-reaching adjustments, such as open network access or a separation of infrastructure from services provision. The World Bank published a regional study on railway reform in the Western Balkans in December 2005 and has proposed a regional rail initiative, in close cooperation with the European Commission.25 This would entail an agreement between governments on a set of common objectives as well as a series of complementary technical assistance and investment loans at the national level. Despite the general endorsement of the concept by governments and donors at a regional rail conference in Rome in May 2006, the details are still to be decided and implementation of the initiative will take several years.

A third priority for regional integration in the transport sector is closer coordination of infrastructure investments and facilitation measures along land corridors. In fact the vast majority of cross-border

transport flows among Western Balkan countries and vis-à-vis the EU moves along a limited number of road and rail corridors. In June 2004, governments signed an MoU on the development of the South East Europe Core Regional Transport Network.\textsuperscript{26} Based on the analysis conducted under two technical studies in 2002 and 2003 (the TIRS and REBIS studies), the core network consists of a backbone system of roads and rail lines plus the main ports and airports of the region. At the heart of this multimodal system lie the Pan-European Corridors V, VII, VIII and X which traverse the region. A Steering Committee of government representatives, supported by a South East Europe Transport Observatory (SEETO), was established to oversee the implementation of the MoU. The focus of the discussions to date has been on possible priorities for infrastructure investments (‘hard measures’) along the core network. While some missing links have been constructed (e.g. several hundred kilometers of motorways in Croatia) or are under construction, the challenge will be to better coordinate the less costly but more complex regulatory and institutional reforms (‘soft measures’) that are needed to render transport flows more efficient. Theses include a streamlining of border crossing procedures, more effective maintenance of existing infrastructure, the privatization of state-owned transport companies, road pricing and cost recovery schemes, more efficient modal interfaces and measures to improve road safety. Another challenge will be to identify parts of the core network for which private investments could be mobilized (e.g. ports and airports) and to put in place the necessary regulations.

**Telecommunications:** Telecom services are not only an important connector between economies, but also constitute a large sector in their own right. The process of telecom liberalization and privatization in the Western Balkans still lags behind the rest of Europe, but has gathered momentum in recent years. Cross-border investments by a handful of European companies are driving both infrastructure modernization and the process of regional integration. Hungary’s Magyar Telekom, majority owned by Deutsche Telecom, acquired controlling stakes in the fixed-wire operators of Macedonia and Montenegro. Deutsche Telecom itself bought a 51 percent share of Croatia’s main telecom company H-HT from the government. Greece’s OTE controls the largest mobile provider in Albania, the second largest in Macedonia and a 20 percent stake in Serbia’s fixed-wire operator Telecom Srbija. Telecom Austria owns the second-largest mobile operators in Slovenia and Croatia, the mobile market leader in Bulgaria and it acquired Serbia’s and Macedonia’s third mobile license respectively. It might also bid for a stake in OTE that the Greek government intends to sell in 2007. UK-based Vodafone has mobile operations in Albania and Greece. In a rare case of intra-regional FDI, Serbia’s Srbija Telekom won the tender for Telekom Srpske in Bosnia’s Republika Srpska in late 2006.

The foreign players have brought large-scale privatization receipts and infrastructure investments to the region. In August 2006, for instance, the Serbian government sold the country’s leading mobile operator to Norway’s Telenor for € 1.5 billion. A few months later Telecom Austria, paid $ 427 million for Serbia’s third mobile license and plans to invest a further $ 333 in the roll-out of the network. The impact of investments and competition has been particularly pronounced in mobile telephony and in several countries subscriber rates for mobile telephony have surpassed those for fixed wire services. With a population of 2 million, for example, Macedonia had 1.3 million mobile subscribers in mid-2006, while the mobile market penetration in Montenegro is over 80 percent. Moreover, modern management and competition has led to the improvement of services and a substantial fall in prices across the board. These unfolding market dynamics are a reflection of substantial policy reforms. In the last few years, most Western Balkan governments have introduced modern telecom laws in line with EU rules, established independent telecom regulators and liberalized market access for new services providers.

\textsuperscript{26} Memorandum of Understanding on the Development of the South East European Core Regional Transport Network. June 2004.
Nonetheless, significant reforms remain to be implemented before the Western Balkans will catch up with the level of sector development in the EU. The governments of Croatia and Montenegro plan to sell further stakes of their partially privatized telecom companies in 2007. After unsuccessful privatization attempts, Serbia and Albania are yet to sell majority stakes in their national telecom companies. The operators of Bosnia’s Croat-Muslim Federation and Kosovo also remain publicly owned. Even though network digitalization is well advanced across the region, substantial investments will be required to increase the availability of broadband and UTMS services. While Slovenia, Croatia, Serbia and FYR Macedonia already issued third mobile licenses, such a move is now being prepared by Montenegro and Kosovo/UNMIK. While some countries started to liberalize fixed-wire services (e.g. Croatia, Serbia), the development of effective competition will require a strengthening of the independence and institutional capacity of telecom regulators across the region.

Box 6: National Sovereignty and Cross-Border Institutions

If the Western Balkan countries are to develop modern market economies and comply with the EU acquis, they will have to establish a wide range of specialized institutions: (i) Market institutions in the more narrow sense such as stock markets and power pools. (ii) Technical institutions required for certain markets to function properly like air traffic control centers, network managers for railways and transmission system operators for electricity. (iii) Regulatory institutions to tackle incidences of market failure such as competition authorities, telecom and energy regulators, civil aviation authorities and financial sector regulators. Many of these institutions tend to be seen as being quintessentially ‘national’ – either because they execute government functions or because they relate to ‘strategic’ assets (e.g. domestic airspace, energy supply). In many cases, however, economic institutions that have historically been regarded as symbols of national sovereignty are better organized at the cross-border level. This holds particularly in the case of small countries, such as those of the Western Balkans. A radical example for a country ceding national sovereignty in economic policy is Montenegro, which unilaterally adopted the euro and thus gave up its ability to conduct monetary policy.

The transfer of regulatory functions to trans-national institutions is a defining feature of the European Single Market. In fact, the EU has been a global pioneer in the development of cross-border market institutions. The European Commission, for instance, acts as the central antitrust authority enforcing the EU’s strict competition and state aid rules. In aviation, the European Aviation Safety Agency (EASA) has central oversight functions with regard to safety and security, while Eurocontrol and regional air traffic control centers manage air traffic at the cross-border level. Several EU ‘flag-carriers’ – traditionally seen as a symbol of national sovereignty – have been taken over by foreign competitors. An interesting model is provided by three Nordic countries, who established the ‘tri-national’ flag carrier Scandinavian Airlines System (SAS) five decades ago. In financial services, cross-border stock markets such as Euronext and OMX have emerged and further consolidation is underway. In electricity, the Union for the Coordination of the Transmission of Electricity (UCTE) is responsible for the technical integrity of the European grid, the European Transmission System Operators (ETSO) coordinate economic aspects of interconnection and the Council of European Energy Regulators (CEER) ensures regulatory cooperation. As these examples illustrate, regional markets need regional institutions.

The Western Balkan countries are gradually become part of these European structures. They have all joined Eurocontrol and the UCTE. With the implementation of the Energy Community Treaty they will also join ETSO and CEER. As part of the establishment of the European Common Aviation Area, they will become members of EASA and discussions about a regional control center for air traffic management are taking place. Despite such progress, the countries in the region would probably be well advised to also join forces in other areas, if they want to successfully compete in the EU Single Market. Regional airlines and stock markets will have to team up if they want to gain minimum efficient scale. Another case in point is railways, where the EU acquis obliges all countries to separate rail infrastructure from operations, establish a rail regulatory authority, a rail licensing body, a rail safety authority, an accident investigation authority and a notified body. Given the dire financial situation and the small size of railway operations in most Western Balkan countries, innovative solutions for cross-border institutions should be explored. But there are also other cases where small market size and weak administrative capacity calls for the development of regional institutional structures.
Trade in telecom services mainly takes place via mode 3 and as outlined above, FDI in the sector is already wide-spread. It should receive a further boost through planned privatizations and the issuing of additional licenses. With trade in telecom services mostly liberalized, the main outstanding challenge for deeper integration in the sector is regulatory convergence through the adoption of EU rules. Whereas the accession candidates Croatia and FYR Macedonia will have to transpose the full telecom acquis, less advanced countries in the region would probably be well advised not to immediately go for the current telecom acquis (the ‘2002 package’ of legislation) but for the previous ‘1998 package’ that is geared to earlier stages of the liberalization process. In any case, the main challenge will not be legislative approximation, but the effective enforcement of EU rules through independent and competent sector regulators.

**Energy:** One of the sectors where regional integration is most advanced is the energy sector. Based on two previous MoUs on electricity and gas (the ‘Athens Memoranda’) the Commission and nine SEE partners signed the Energy Community Treaty for South East Europe in 2005. A Vienna-based Energy Community Secretariat has been established to oversee the implementation of the treaty. The agreement commits all signatories to gradually transpose the energy acquis by 2015 and it will lead to the full integration of the Western Balkans into the EU-internal energy market. The acquis package on which the agreement is based includes the entire acquis for electricity and gas as well as sector-related regulations on competition policy and the environment. According to an estimate by the World Bank and the European Commission investments in the order of 15 to 20 billion euro will be required to bring the energy infrastructure of the region up to EU standards.

In the electricity sub-sector, the acquis obliges all members of the Energy Community to unbundle generation, transmission and distribution, while establishing independent sector regulators and transmission system operators (TSOs). Especially for ‘small systems’ – such as those of the Western Balkans – the benefits of regional integration stem from cross-border competition, the ability to reduce expensive reserve capacity and to trade electricity with neighbors that have different energy endowments (e.g. hydro-power, lignite). To help unlock those synergies, the World Bank with funding from the European Commission prepared a South East Europe Generation Investment Study in 2004. Based on a demand forecast, it maps out a least-cost generation expansion plan for the region as well as a strategy for regional energy trade. Based on this analytical work and the Energy Community Treaty, the World Bank prepared a $1 billion horizontal Adaptable Programmatic Loan (APL). Under this APL, it is implementing a series of complementary projects at the national level, which will support sector restructuring through technical assistance and investment lending.

Forging a regional energy market requires close cooperation between national regulators and hence the policy framework for the EU Single Market in electricity not only has a regulatory but also a strong regional institutional dimension. As discussed in text-box 6, the UCTE ensures technical cooperation and thus the stability of the interconnected grid. ETSO facilitates cross-border network access and electricity flows. The CEER ensures the compatibility of economic regulation between countries. The countries of the Western Balkans were reconnected to the continental European grid in October 2004 (they had been cut off in 1991 in the wake of the war) and have become full members of UCTE. In due course, transmission system operators and sector regulators from the region should also join ETSO and CEER. Few sectors are as prone to the abuse of market power and

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27 Website of the Energy Community ([www.energy-community.org](http://www.energy-community.org)).
other forms of anti-competitive behaviour as the electricity sector. Hence, significant capacity building for national regulators will be needed to ensure market access.

Trade in electricity services can take place via mode one (cross-border supply) or mode three (commercial presence). The former requires sufficient interconnection capacity and a regulatory regime that permits for cross-border trade. The latter requires the ability of international investors to acquire electricity sector assets. In the oil and gas sub-sectors FDI also plays an important role, but since oil and gas are energy goods and not energy services, trade mainly takes place through cross border transport (often via pipelines). Even though the region is well endowed with coal deposits and hydro power, it remains a net energy importer. In oil and gas, the security of supply and cross-border pipelines are important themes for regional cooperation. In fact, the EU has a strategic interest to diversify its oil and gas supplies towards the Caspian region and Iran via pipelines crossing South East Europe. The gas sub-sector is also covered by the Energy Community Treaty, but both the level of sector development and the process of regional integration are less advanced than in electricity. The World Bank plans to prepare a horizontal APL for the gas sector that would be modeled on the APL for electricity. Preparation is ongoing and the tentative target for board approval is late 2007.

The energy sector in the region has already attracted significant amounts of FDI. The Croatian government, for instance, sold a 25 percent stake in the oil and gas company INA to Hungary’s MOL in 2003. INA owns two large refineries, a network of 400 petrol stations and a 38 percent stake of the Adriatic oil Pipeline (Janaf) which starts at an oil terminal on the island of Krk and is linked to a pipeline system extending to Hungary, Serbia and Slovakia.30 In 1999 Hellenic Petroleum of Greece bought a majority stake in Macedonia’s Okta refinery in a controversial privatization deal and subsequently built a 220-km oil pipeline from the port of Thessaloniki to Okta. In December 2006, Czech power company CEZ agreed with the government of Republika Srbska to invest $1.5 billion into a joint venture with the Serbian group ERS into a coal-fired power plant and the development of a coal mine to supply it.31 A peculiar case of cross-border cooperation is the co-ownership between Croatia and Slovenia of the Yugoslav-era nuclear power plant at Krsko in Slovenia. FDI-inflows into the sector are expected to continue as state-owned energy assets are being privatized, and as a reformed sector framework opens creates new opportunities for green-field investments.

Financial Services: The financial sector in the Western Balkans has seen dramatic improvements in recent years – thanks to comprehensive reforms by governments and the help of international financial institutions like the IMF, the World Bank and the EBRD. The turbulences associated with banking crises, hyperinflation and pyramid savings schemes have been left behind. Regulatory frameworks have been modernized and financial supervision has been strengthened. The share of bad loans has been reduced dramatically. Privatization reduced state-ownership in banking down to less than 20 percent in most countries and it has attracted foreign banks into the market. Branch networks are being expanded and a range of new financial products, such as mortgages and leasing, are being introduced. Thanks to these developments, financial intermediation is growing at double-digit rates and central banks have even been forced to introduce measures to control the side-effects of growth, such as a rapid expansion of consumer credit and foreign exchange exposure of the financial system.

Despite these positive developments, financial markets in the Western Balkans remain small, fragmented and at an early stage of their development. In most countries of the region, banks account for over 90 percent of financial sector assets, with the capital markets and insurance sub-sectors only playing a marginal role. All banks of the Western Balkans taken together had €57 billion worth of 

30 Economist Intelligence Unit. Country Profile Croatia 2006.
31 Financial Times (5 December 2006).
assets in 2005, which was comparable to that of a single mid-sized bank in the EU. The total market capitalization of the nine stock exchanges of the region amounted to € 54 billion in 2006 and was merely a third of the already small Vienna Stock Exchange. As far as market turnover as an indicator of liquidity is concerned, the gap was even larger. Financial intermediation in most Western Balkan countries, measured by banking assets as a share of GDP, is still only equivalent to 40 to 70 percent. The notable exception is Croatia, where the figure was 114 percent.

Box 7: The Knock-on Effects of Erste Bank’s Entry into the Serbian Market

As part of its privatization program, the Serbian government sold a 83 percent stake in Novosadska Banka to Austria’s Erste Bank for € 73 million in 2004. Novosadska is the second largest bank in the northern Vojvodina region, but with 71 branches it only ranks number 13 in the country as a whole. However, it is in direct proximity to Erste’s existing branch networks in neighboring Hungary and Croatia and the bank intends to use it as a launching pad for expansion across Serbia. As one of the first measures, Novosadska was renamed Erste Bank Serbia. An ambitious restructuring program was launched soon after the takeover. It focuses on organizational reform and the replacement of key managers as well as the upgrading of risk management and accounting procedures to standards of the parent institution. Erste is also redesigning existing financial products and introducing a host of new ones. Two specific initiatives are geared at developing the mortgage business and financing programs for SMEs. Investments are made into staff training, branch refurbishing and the modernization of the IT infrastructure. As restructuring of the existing operation progresses, Erste has ambitions to increase its Serbian market share from 2 to 10 percent (measured in banking assets). It plans to open 15 new branches in 2006 and 20 additional ones in each of the two following years.

In many respects, Erste Bank’s entry into the Serbian market is typical for the activities of foreign banks in the Western Balkans. It treats the region as a common market and it builds a border-spanning branch network and consumer brand. It transfers extensive know-how through the secondment of experts, the development of local staff and the implementation of its standard business practices. At the same time, it brings considerable amounts of FDI to the country as it recapitalizes its new subsidiary, modernizes the physical infrastructure and expands the branch network. This comes on top of the privatization receipts and taxes that go to the government budget. Other beneficial effects that foreign investors like Erste Bank bring are new financial products, an impetus to banking competition, a deepening of financial markets and increased confidence in the banking sector. In the longer term, FDI by international banks generates positive spillovers, such as the movement of trained employees to other firms, backward linkages with local suppliers and demonstration effect of using new technology and management techniques. Last but not least, many foreign banks are also active in the insurance sector and key players in the emerging capital markets of the Western Balkans.

With sector efficiency largely a function of depth and liquidity, the economic gains of regional integration in financial markets can be substantial, especially for small countries like those of the Western Balkans. Fortunately, financial markets have actually been an impressive success story of regional integration. The main driver of cross-border linkages has been foreign direct investment by EU banks. In all Western Balkan countries, financial sector restructuring and bank privatization has brought the market share of EU banks to 50-80 percent of banking assets. A handful of EU banks have established a presence throughout the region, including Unicredito and Intesa from Italy, Raiffeisen and Erste Bank from Austria or National Bank of Greece. Similar developments are now underway in the insurance sub-sector. The market entry of EU banks has not only brought privatization receipts, investments into branch networks, better management and new financial products (see box 7). As the subsidiaries of foreign banks are supervised by the home regulators of their parent institutions, FDI by EU banks has also allowed the Western Balkan countries to ‘import’ modern regulation.

While the main driving forces of regional integration have thus been company-level dynamics, complementary efforts at the policy level are needed to complete the integration process. Closer cooperation between financial sector regulators is required to supervise the activities of international financial groups. The harmonization of regulatory frameworks through the adoption EU rules is also needed. However, much of the financial sector acquis relates to developed capital markets, which most Western Balkan countries do not yet have. Another priority for regional integration would be closer cooperation and if possible even mergers between stock exchanges. In fact, Vienna Stock Exchange has already launched efforts to forge closer links with other bourses across South East Europe. In the longer term, the extension of the Euro Payment Area to the Western Balkan countries would be another building block for the development of truly regional market.33

**Distribution Services:** As the final stage of the supply-chain, distribution constitutes a ‘backbone’ service that facilitates deeper integration in goods markets. Without access to wholesale and retail distribution networks, foreign companies will have difficulties to sell their wares to potential clients and thus inefficiencies in that market can constitute an important non-tariff barrier. Distribution is also an important sector in its own right. Trade in distribution services is mainly conducted via mode 3 (commercial presence) and to a lesser extent via mode 1 (cross-border supply). Barriers to trade include restrictions to the right of establishment, zoning laws for the construction of retail outlets, limitations to the acquisition of real estate by foreigners or restrictive rules on the distribution of certain products. Due to significant scale economies, distribution tends to be highly concentrated and competitive in industrialized countries. Across much of the Western Balkans, however, the retail sector remains fragmented and poorly developed. The EU is home to important global players in the distribution sector, such as Carrefour, Metro, Safeway, Ahold, IKEA or H&M. In the past decade, many of them have expanded their retail networks deep into Eastern Europe and some are now turning their attention to the Western Balkans. The complex logistics networks needed by these retailers creates an economic rationale for regional integration at the company level. Given the nature of the industry, the market entry of foreign suppliers tends to significantly enhance competition and is associated with significant investments in infrastructure and the training of local staff.

**Other Services:** While an analysis of all services sectors is beyond the scope of this paper, a number of other services seem to offer potential for trade and regional integration. **Tourism**, including visits from migrants abroad, already accounts for a major part of services trade in the region and additional growth potential remains to be exploited. **IT-Enabled Services** are a rapidly expanding segment of international trade and Eastern Europe has recently seen a substantial influx of FDI by EU companies in this sector. Some Western Balkan countries might also be able to tap into this market by attracting outsourced back-office processes, such as accounting or call centers. A modern and competitive telecom sector, however, is one of the preconditions for such trade. **Construction and engineering services** could be another important service category where Western Balkan companies might be able to supply foreign clients. In contrast, there is probably less export potential for **business services**, but the availability and quality of these services is an important component of a country’s business environment and the region could benefit from the transfer of know-how that would be associated with imports of these services via mode three (commercial presence). These are just some examples that illustrate how expanded services trade could become an important driver of growth and development in the Western Balkans.

33 For an overview over the sector, see: Müller-Jentsch, Daniel. 2007. “Financial Sector Restructuring and Regional Integration in the Western Balkans.” World Bank-European Commission Office for South East Europe.
Suggestions for Further Work

Further Work on the Section on Deeper Integration:

- Insert examples and conclusions from the value-chain analysis in the CEM for BiH as well as the respective chapter in the ECA trade report. Insert data on import/export of parts and components, intra-industry trade and patterns of FDI flows into the supply-chain section.
- In section on border controls: include table with TTFSE statistics and additional information on the EC customs assistance, the Ohrid Process and CEFTA annex 5.
- In section on public procurement: include (i) data on procurement as share of GDP by country, (ii) info on procurement problems in the region, reform initiatives and donor assistance, (iii) info on EU acquis and SAA provisions on the subject.
- Include text-box with overview of privatization programs (already requested from Sanjay) with the following information: (i) progress of privatization programs by country, (ii) privatization receipts and FDI mobilized to date, (iii) distribution by sectors, (iv) evidence on which types of privatization are best to attract FDI and to raise productivity (e.g. sale to strategic investors, IPOs or sale to employees), (v) what remains to be done and how should it be done?
- In section on competition policy: get data on staff numbers and case load (e.g. cases concluded and fines paid) of competition authorities in all countries.

Further Work on the Section on Trade in Services:

- At the beginning of Chapter 4, cite evidence for the benefits of trade in services from the literature review of Bernard Hoekman.
- For box on migration, get 2005 EBRD report on remittances and 2006 ECA report on migration. Include table with exact data on migration and remittances.
- Add box on mutual recognition: a key remaining barrier and one where intra-regional liberalization would be easier to achieve than EU-integration.
- Trade data: Present and analyze statistics on trade in services. Since these might not be very reliable, it should be complemented by figures on FDI in key services sectors and other complementary data for specific services (such as tourism arrivals and tourism receipts).
- Telecoms: (i) Check EC telecom regulatory reviews for Western Balkans. (ii) Include table with telecom statistics (incl. benchmark countries Slovenia, Slovakia, Bulgaria): fixed/mobile/internet penetration, cost of services (e.g. Ardo’s data on Skype costs). (iii) Add table with reform status by country: fixed competition, 3rd mobile license, regulator independence, % state ownership.
- Transport: Insert a map of the regional core transport network.
- Energy: Include regional map with oil and gas pipelines (from FTD, 9 June 2006).
- Distribution: more actual facts and figures from the region

Other Issues for the Regional Trade Report:

- Discuss low levels of intra-regional trade, decline in trade following break-up of Yugoslavia (what is now intra-regional trade used to take place within a common country).
- Discuss direction and composition of trade and its policy implications.
- Make the point that Albania is the only Western Balkan country that was not part of former Yugoslavia and that it has problems with connectivity vis-à-vis its neighbors in various sectors.
Analyze in which areas the region has not used its trade preferences in the past (e.g. agricultural trade) and why there has not been a sufficient supply-response.

Discuss capital stock of these countries (in the context of resource endowments): in some areas too large, too depreciated (issue of maintenance and destruction due to wars) or too little.

Too much investment in physical infrastructure and too little in human capital? Ireland grew because of the former and this could be a key recommendation of the report. Flag problem that education and health not part of the acquis and therefore blind spots in the pre-accession process.

Keep in mind that the value added of a regional study is to focus the analysis on the truly regional issues that need to be tackled at the regional level (e.g. network industries).

Use benchmarking among Western Balkan countries (and with Slovenia) throughout the report (take data from OECD benchmarking analysis on SEE that has just came out).

At the end of the report, there should be a section discussing for each country what niches they could carve out in the EU Single Market over the next 10-15 years, what sources of comparative advantages they need to achieve that aim and what type of policy reforms this implies.

Include series of maps in the report to visualize the geographic patterns of regional integration: (i) core transport network, (ii) pipelines (from FTD), (iii) power grid, (iv) ECAA route network 2000 and 2005, (v) other (biodiversity corridor, network of protected areas or tourist routes)

**Trade and FDI Patterns to be Analyzed:**

- total imports and exports of the region (graph with time-series for 2000-2005)
- imports and exports by country (table with data for 2000 and for 2005)
- trade/exports as share of GDP (with Slovakia, Slovenia and Chile as benchmarks)
- direction of trade (percentage to/from the EU and share of intra-regional trade)
- composition of trade (imports and exports by country and for whole region for 2000 and 2005) (show degree of export diversification as well as share of high-value added exports)
- revealed comparative advantage of individual Western Balkan countries (in 2000 and 2005)
- dynamics of trade (what are the fastest-growing components of the export/import bundle)
- parts and components of exports and imports (for 2000 and 2005): in absolute terms and as share of manufacturing exports/imports (Slovakia, Slovenia and Malaysia as benchmarks)
- stock of FDI (2005) and annual flow (2000-2005) of FDI per country in the Western Balkans, stock of FDI per capita (with Slovenia, Slovakia and Chile as benchmarks), percentage of FDI stock coming from the EU and percentage that is intra-regional
- if possible, sectoral breakdown of FDI and/or list of main FDI transactions (to show which sectors account for the bulk of FDI and that privatization and infrastructure are main drivers)
- try to come up with a quantitative measure to quantify the erosion of trade preferences from EU need data to quantify and compare resource endowments of the various countries
- table with # of migrants of Western Balkan countries and percentage of them living in the EU
- possible comparators (for all indicators): Slovenia, Slovakia, Chile, Turkey, Tunisia
- seek quantitative measures of resource endowments
- try to measure effect of bilateral agreements on trade flows (most of them came into effect very recently) and come up with estimate of CEFTA benefits compared to deeper integration benefits (according to Mary, data on these issues would be interesting to have)
- include table with population, GDP, PPP/capita