

CHAPTER 3

Deepening Integration

Introduction

For small countries such as those in the Western Balkans, sustainable growth should be export-led, but this process has fallen short of its potential. Small countries gain more than larger ones from trade-induced expansion in market size, which makes the effect of trade on per capita income and rate of growth on small countries much larger.¹ In the Balkans, there is little doubt that the key response to the challenges of improving and sustaining growth should involve a sustained increase in exports. Yet, the region has been undertrading relative to its potential, as chapter 2 discusses.

This chapter suggests that deeper integration in the world economy may help and is typically more easily achieved in the proximity of the country and region. The term “deep integration” goes beyond merchandise trade liberalization, as it also includes government actions to reduce the market-segmenting effect of domestic regulatory policies. Such integration is happening, to different degrees, at the levels of the region (SEE), the EU, and the world. Typically, owing to both physical and cultural proximity, such integration usually occurs or starts at a regional level. In SEE, the conclusion of CEFTA 2006 represents a major step forward in this regard.

The benefits of deep integration go beyond those of merchandise trade. The benefits arise from the objective of creating a single economic space, and include greater contestability, a larger market, greater economies of scale, and so on. Benefits would manifest, for example, in intraregional supply chains and higher FDI. These benefits would be magnified by an increase in the efficiency of those services sectors that supply crucial backbone services. Deeper integration would also enhance intraregional trade to a greater extent than a pure trade focus would.

In the next two sections, this chapter will briefly discuss developments in, and benefits of, deepening integration at the world and EU levels, including SEE regional integration and policy measures needed to foster deeper integration. Note that some of the integration agenda is discussed elsewhere in the report. Chapter 2 discusses trade integration (at world, EU, and regional levels), as well as supply-chain integration, and chapter 4 discusses integration in services, largely at the EU and regional levels. Note also that the geographical dimensions are not exclusive. For example, if trade logistics were to improve for intra-SEE trade, it would also lead to better trade linkages with the rest of the world. In services, chapter 4 argues that in fact liberalization is best done on an MFN basis, and will have benefits at world, EU, and regional levels.

Accession to the WTO and MFN Tariffs

The multilateral trade regime remains very attractive to existing and prospective members. New candidates, including countries from SEE, are in the fray. The WTO provides a set of rules, safeguards, and redressal mechanisms for the conduct of international trade in goods and services. It is even more useful for small countries, for which multilateral, rule-bound negotiations would be much preferable to bilateral negotiations in which bigger countries would have the upper hand. Bosnia and Herzegovina, Serbia, and Montenegro are negotiating WTO accession, but currently have only observer status.

Countries gain by accessing markets and anchoring their own commitments to the rules of the WTO. Countries completing their WTO accession process, such as Bosnia and Herzegovina, Serbia, and Montenegro, can use the process to reduce further existing trade controls, both in terms of nontariff barriers, and, where needed, further tariff liberalization. WTO accession will provide these countries with an anchor for the conduct of trade and tariff policy and will contribute to the removal of quantitative barriers and restrictions not acceptable under the GATT. The practice of binding tariffs to an upper bound greatly reduces the risk of any policy

reversal, and provides more credibility to policy commitments.² A case in point is Serbia and Montenegro, a nonmember, which is the only SEE country in which applied tariffs increased between 2001 and 2005 (for agricultural products, see table 2.4). Second, accession will allow guaranteed MFN access to other WTO members' markets. Third, countries have offered to subject (few or many) of their services sectors to multilateral discipline under the GATS, although this process is less advanced for services than for goods trade (see chapter 4). As for existing WTO members, they will need to seize the opportunity provided by the ongoing Doha Round of multilateral trade negotiations to further reduce barriers in merchandise and services trade.

Benefits from EU and regional integration would be maximized by creating a "shadow customs union" with the EU for industrial products. Currently, CEFTA countries' tariffs are higher and more dispersed than in the EU, providing scope for trade diversion. The Stabilization and Association Process (SAP) will not drive the countries toward further multilateral trade liberalization, nor toward the adoption of a common external tariff. It is therefore suggested that all CEFTA countries (who are simultaneously adopting CEFTA as well as the trade components of their SAAs) adopt EU MFN tariffs for industrial products.³ This would amount to creating a virtual customs union encompassing the SEE5 countries and the EU, and would reduce the extent of trade diversion. Also, speedy implementation of CEFTA would help to ensure that firms in SEE5 countries have as much access to each others' markets as EU firms would have after the implementation of the SAAs (see also the section titled "Policy Measures to Foster Deeper Integration" below).

The European Dimension

Access to important EU markets has improved for most SEE countries. Countries that signed their SAAs (Croatia and FYR Macedonia in 2001, Albania in 2006, and Montenegro in 2007) have locked in the otherwise temporary or informal nature of the Autonomous Trade Preferences (ATPs) provided since 2000, and have managed in some instances to gain further preferential access for their agricultural exports. Both Bosnia and Herzegovina and Serbia are in the process of negotiating SAAs. The ATPs have helped to increase the share of EU15 in SEE exports from 48 to 54 percent over 1996–2005.

The most important benefit from the SAAs is generated by the dynamic gains in the medium to long term. These benefits derive from the alignment of the legal and regulatory frameworks to the EU *acquis*,

as required under the rules for accession (see box 3.1). Experience from Central European economies and recent evidence from other signatories to the SAA point to the positive effect exerted by the dynamic of reform required under the SAA, in areas related to state aid, competition, standards, and technical regulations.

Another benefit derives from increased competition as a result of tariff dismantling. The SAAs have opened up (preferentially) a very large market to SEE countries.⁴ But they also bring obligations of progressive import liberalization on a preferential basis, which vastly increases the competition in SEE countries. In 2005, imports from EU27 formed 62 percent of total imports into SEE, and this is likely to increase with further preferential liberalization. Although the relationship between trade barriers and growth is complex and is probably predicated on the

Box 3.1

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. In general, careful phasing of such regulatory convergence would help to keep countries' development priorities in the forefront and would also be sensitive to the specific needs of countries with low income levels and weak administrative capacity.

The economic essence of the EU Single Market is the four freedoms for the movement of goods, services, capital, and workers. The quickest way to achieve those freedoms is through a targeted removal of barriers that currently obstruct these freedoms. In addition, *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, the main priority for most countries in the region will be to strengthen administrative capacity and build functioning market institutions, since introducing laws which cannot be enforced can in fact create problems for the rule of law. In this context, it is useful to note that the transposition of the *acquis* into national legislation often contains a clause which postpones the entry into force of the relevant legislation until the date of accession.

conditions that prevail in each country, a review of the historical evidence points out that “the evidence favors a negative effect of protection on rates of growth in the post-World War II period” (Helpman 2004, p. 79). Import competition tends to reduce the anti-export bias, reduce price-cost margins in manufacturing, and be particularly powerful when a few oligopolists dominate markets. Also, the benefits of FDI are greater when trade barriers are lower.⁵ Other aspects of deeper integration with the EU are discussed in chapters 2 and 4.

Deepening Integration at the Regional Level

Context for Deep Integration in SEE

Economic integration between countries is a continuum from shallow to deep integration. Shallow integration normally focuses on trade liberalization for goods, whereas deep integration refers to explicit government actions that reduce the market-segmenting effect of domestic policies and regulations, other than tariffs and formal nontariff barriers (Hoekman and Konan 1999). The vision as well as the challenge for SEE countries is to implement deep integration policies that will make each market more contestable. The conclusion of the CEFTA 2006 agreement represents a significant step forward in that regard (see box 3.2), since the agreement seeks to go well beyond trade. The eventual goal, of course, is full EU membership, which would allow the region to take advantage of a framework that in practice constitutes the deepest integration between countries. This report makes the case that regional integration is a stepping stone to the eventual goal of EU membership.

Increasing market contestability involves addressing the barriers to trade and resource flows between countries as well as behind-the-border policies. Although classical trade liberalization focuses on the removal of tariffs and quotas, a multitude of other barriers obstruct trade and resource flows between national economies. They can arise, among other things, from at-the-border policies such as customs clearance and certification requirements. Behind-the-border policy constraints can arise both through sector-specific policies affecting trade in services and through horizontal policies (e.g., competition policy or investment climate rules relating to FDI). While deep integration between economies ultimately manifests at the company-level through phenomena such as cross-border supply chains, retail networks, or foreign direct investment, such meshing requires reforms at the policy level to address both horizontal and sector-specific constraints.

Box 3.2**CEFTA and Other Regional Agreements in SEE**

The patchwork of 32 bilateral free trade agreements between the countries of SEE was consolidated into the Central European Free Trade Area (CEFTA) agreement, which entered into force in July 2007 for Albania, UNMIK (United Nations Interim Administration Mission in Kosovo)/Kosovo, FYR Macedonia, Montenegro, and Moldova, and in August 2007 for Croatia. In September 2007, the agreement was ratified by Serbia and Bosnia and Herzegovina. (Bulgaria and Romania, the latest EU members, who were signatories to the earlier CEFTA agreement, are no longer part of CEFTA). The CEFTA 2006 agreement will not only simplify the regional trade regime but 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 intraregional trade in SEE, trade between the Western Balkans and the EU is governed by a series of Stabilization and Association Agreements (SAAs). The trade protocols of the SAAs are already being executed with FYR Macedonia (since 2001) and Croatia (since 2001). SAAs were agreed with Albania in June 2006 and with Montenegro in October 2007, and have become partially effective through Interim Agreements, before the full SAAs become applicable upon ratification by all EU member states. Draft SAAs have been initialed in the case of Bosnia and Herzegovina and Serbia. This process is also anticipated to be open to Kosovo, once its status issues are resolved. For these countries, the EU has already granted far-reaching trade concessions through “autonomous trade measures until 2010.”

In addition to the CEFTA and SAA agreements, there are two regional integration agreements for specific sectors: the Energy Community Treaty (ECT) and the European Common Aviation Area (ECAA) agreement. In both cases, the signatories include not only the countries of SEE but also the EU (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 SEE. A similar agreement is now being discussed for railways. The pursuit of deeper integration in individual sectors will significantly facilitate eventual EU membership (see chapter 4 for more details).

The gains from deep integration are high, but so are the complexities. The benefits arise from the objective of creating a single economic space, and include greater contestability and a larger market size. Since deep integration targets a wider range of at-the-border and behind-the-border distortions, it tends to yield larger benefits, especially through its impact on the sectors that provide critical services to both exporting and non-exporting firms. The outcomes of deep integration will include more FDI and intraregional supply chains and will therefore enhance intraregional trade, more than would be yielded by a pure focus on trade issues. Since deep integration involves more complex behind-the-border reforms, however, it requires substantial negotiation, transition, and compliance costs. To tackle these complexities, a selective and prioritized approach to deep integration is likely to yield more dividends. These issues will be pursued further in this chapter and in chapter 4.

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 were previously 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 is mostly comprised of small economies, which would benefit disproportionately from participation in a larger regional market, and Montenegro's independence in mid-2006 increases the number of small economies.⁶ Third, a number of geographic and ethnic factors increase the interdependency between these countries: common languages, common ethnic minorities, and the crescent-shape geography of Croatia, which wraps around Bosnia and Herzegovina. Fourth, all Western Balkan countries aspire to EU membership (Croatia has started negotiations and FYR Macedonia is a candidate) and are thus converging toward the same regulatory framework over the medium to long term. These positive aspects notwithstanding, the proximity has also brought with it political and ethnic divides in the region. These challenges need to be overcome through economic integration and political statesmanship.

Cross-Border Supply Chains and Regional Production Networks

Trade integration between countries has allowed the emergence of production networks. In general, a reduction of trade barriers between countries, along with a reduction in transport costs and improvements in information technology has allowed countries to specialize. This has resulted in

the emergence of business trends, such as outsourcing and supply-chain management, with individual production stages in manufacturing becoming increasingly fragmented. Production stages have moved to foreign countries (offshoring) with comparative advantages (e.g. countries with low labor costs for labor-intensive tasks). This is most apparent in the increasing importance of trade in intermediates; especially in the emergence of production chains (see chapter 2). Since 1980, the export of P&C has increased significantly faster than world exports (Broadman 2005).

There are similar opportunities in services sector offshoring. With falling telecommunications costs and increasing openness to FDI, global sourcing of services is also increasing (more and more segments are becoming tradable) and follows the earlier trend of production sharing in manufacturing. Global sourcing has increased competition in services markets, ranging from low-skill activities such as data entry and call center work, to higher-end activities such as software development, medical services, consultancy, and R&D. The growth rate of this market has been high, especially for a few countries like India, Estonia, and Romania. One estimate puts the expected growth of the services market at 30 percent annually over 2003-08.⁷ Estimates of the potential market size for such services vary, but the market is large. An OECD estimate puts the eventual impact of information-and-communications-technology-enabled services offshoring at about 20 percent of total employment (see World Bank 2007b, chapter 4).

Although offshoring is conducted on a global scale, geographic proximity facilitates the maintenance of complex supply chains. Nearshoring is particularly common in those industries in which just-in-time production is important. Examples include much of car manufacturing and segments of the garment industry in which short-term repeat orders are demanded. SEE is close enough to the EU to permit such tight integration of its companies into pan-European production networks. Although geographic proximity to the EU Single Market constitutes an important source of comparative advantage for SEE, the region is competing with other emerging economies in the EU's periphery, such as Turkey, Ukraine, and several countries in North Africa. To attract nearshoring activities, Western Balkan countries need to raise productivity and offer an attractive business environment.

Effective participation in supply chains also demands minimal disruptions in transport and communication between the different stages of production. Trade in P&C is particularly sensitive to delays and disruptions

between individual stages of the supply chain. A range of trade-related services is needed for cross-border supply chains to function properly. These include transport, telecommunications, financial, distribution, and business services. Improving the efficiency of these services is thus important for the region to participate more effectively in supply chains, and is the subject of chapter 4.

The region suffers from considerable frictions in border crossings. Widespread problems in the region include administrative red tape, corrupt practices, a multitude of border controls by different agencies, and a lack of cooperation between authorities on both sides of common borders. This is illustrated by the fact that a relatively small region (i.e., the Western Balkans) 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, traveling between Salzburg and Thessaloniki must cross four different borders—each with its own controls. At these borders, the truck 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 must present his or her visa and driving permit, and the truck may be checked for compliance with vehicle standards, insurance, and so on. Table 3.1 presents some general data for trading across borders.

However, customs and border restrictions between SEE countries have eased in recent years. The multidonor 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 project helped to improve the efficiency and reduce corruption in target sites in Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Moldova, FYR Macedonia, Romania, Serbia, and Montenegro. For example, between 1999 and 2004, import clearance times for trucks at Tirana, Albania, fell from 245 minutes to 74 minutes; between 2001 and 2004, it fell from 239 to 67 minutes in Banja Luka, Bosnia and Herzegovina (see table 3.2).

In addition, more recent data shows major improvement in border clearance times in Serbia, Romania, and Croatia. Between 2005 and 2006, the World Bank's *Doing Business* data shows that the time taken to export and import improved significantly for these countries. The result was an improvement in "trading across borders" rank from 121 to 35 for Romania, 142 to 51 for Serbia, and 140 to 92 for Croatia (table 3.1).

Table 3.1. Doing Business Data for Trading across Borders

<i>Economy</i>	<i>Year</i>	<i>Rank</i>	<i>Trading across Borders</i>					
			<i>Documents for export (number)</i>	<i>Time for export (days)</i>	<i>Cost to export (US\$ per container)</i>	<i>Documents for import (number)</i>	<i>Time for import (days)</i>	<i>Cost to import (US\$ per container)</i>
Albania	2005	91	6	37	818	12	38	820
Albania	2006	101	7	34	818	12	34	820
Bosnia and Herzegovina	2005	53	5	22	1,150	7	25	1,150
Bosnia and Herzegovina	2006	56	5	22	1,150	7	25	1,150
Bulgaria	2005	95	7	26	1,232	10	25	1,201
Bulgaria	2006	104	7	26	1,233	10	25	1,201
Croatia	2005	140	9	35	1,250	15	37	1,250
Croatia	2006	92	7	26	1,250	9	18	1,250
Ireland	2005	29	5	7	1,145	4	14	1,139
Ireland	2006	30	5	7	1,146	4	14	1,139
Macedonia, FYR	2005	123	10	32	1,070	10	35	1,070
Macedonia, FYR	2006	127	10	32	1,070	10	35	1,070
Montenegro	2005	72	6	19	1,515	8	17	1,715
Montenegro	2006	80	6	19	1,515	8	17	1,715
Romania	2005	121	7	27	1,300	15	29	1,200
Romania	2006	35	4	14	1,300	4	14	1,200
Serbia	2005	142	9	32	1,240	15	44	1,440
Serbia	2006	51	6	11	1,240	8	12	1,440
Slovakia	2005	79	9	20	1,015	8	21	1,050
Slovakia	2006	88	9	20	1,015	8	21	1,050
Slovenia	2005	101	9	20	1,069	11	24	1,107
Slovenia	2006	108	9	20	1,070	11	24	1,107
Tunisia	2005	36	5	18	770	8	29	600
Tunisia	2006	39	5	18	770	8	29	600

Source: World Bank and International Finance Corporation (2006).

Table 3.2. Clearance Times for Import Shipment

	<i>Clearance actual time (minutes)</i>			
	<i>1999</i>	<i>2001</i>	<i>2003</i>	<i>2004</i>
Tirana, Albania	245.0	—	—	73.9
Banja Luka, Bosnia and Herzegovina	—	239.1	—	66.9
Plovdiv, Bulgaria	—	218.2	—	58.4
Jankomir, Croatia	—	246.3	—	151.4
Kumanovo, Macedonia	—	352.7	—	118.3
Bacau, Romania	—	160.2	—	68.0
Belgrade, Serbia	—	—	190.6	228.7

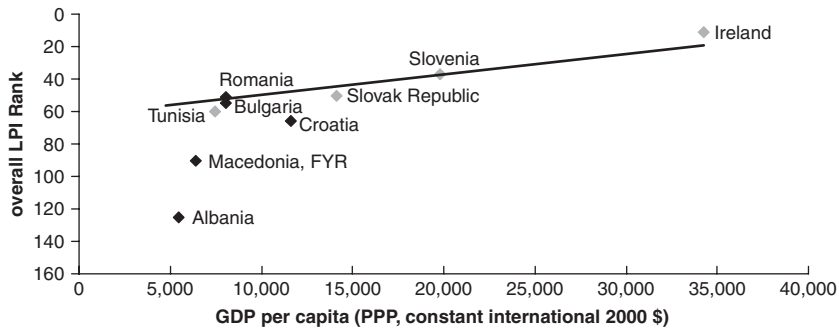
Source: TTFSE project.

Note: — = not available.

However, despite such improvements, SEE countries have some way to go before their overall logistics measure up to those of competitors. Figure 3.1 shows that the Logistics Perception Index (LPI) in 2006 for almost all SEE countries falls below expectations at their PPP income levels. Although Albania is an outlier, other countries also fall well below their norms, except for Bulgaria and Romania. And while the coverage of the LPI is somewhat wider than the *Doing Business* indicator for “trading across borders,”⁸ the essential point is that without a further reduction in the transaction costs of cross-border trading, the region will be unable to function as a single economic space.

Also, network trade within the region is well-below potential. Chapter 2 shows that P&C trade of the region with the rest of the world was below potential. Given the geographic and cultural proximity, one would expect that intraregional P&C trade in SEE form a significant and growing share of overall manufactured exports. Not so. Table 3.3 indicates that intra-SEE P&C exports were only 5.2 percent of manufactured exports in 2005, down from an already low 6.2 percent in 1996; in dollar terms, the amount in 2005 is less than \$200 million. This contrasts with the more respectable figure of 11.3 percent P&C export share to EU27 in 2005 (however, recall that this is dominated by Romania) but is well below the 20 percent figure of EU8 countries (which represents a much larger figure in dollar terms).

Although FDI and P&C trade is low overall, there has been some FDI from the broader neighboring region, and much of the investment is in services. For reasons stated earlier, the Western Balkans has many advantages in its pursuit of deeper integration. In practice, some neighboring EU countries tend to be more active investors. Depending on the

Figure 3.1. Logistics Perception Index and GDP Per Capita (PPP)

Source: Calculated from the World Bank's Logistics Perception Index.

Table 3.3. P&C Trade to Total Manufactured Exports

(%)

	1996	2000	2003	2005
SEE to SEE	6.15	5.59	5.51	5.23
SEE to EU27	5.13	9.74	9.29	11.35
SEE to world	5.96	9.02	9.13	10.88
EU8 to world	12.20	17.74	20.86	19.76

Source: Calculated from the UN COMTRADE database.

sector, companies from individual EU neighbors tend to be particularly active in the region, examples include Austrian banks, Italian textile manufactures, and Greek energy companies. Hungarian telecom and banking companies are also active: Magyar Telecom, majority owned by Deutsche Telekom, bought telecom operators in Montenegro and FYR Macedonia, and Hungary's OTP Bank has recently acquired banks in Croatia, Serbia, and Montenegro. Geographic proximity plays a role here. Albania, for instance, has a particularly close relationship with Italy and Greece, and the same is true for trade between FYR Macedonia and Greece; Croatia has close links with Austria and Germany. These patterns are the result of migration, as well as geographic, economic, and historical factors. There are also some intraregional 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 (see box 3.3). Box 3.4 documents the development of a steel-related supply chain between Bosnia and Herzegovina and FYR Macedonia, arising from a common overseas investor.

Box 3.3**Intraregional FDI Flows in the Western Balkans**

Even though the bulk of FDI to the Western Balkans continues to come from the EU, intraregional investments are on the rise. Intraregional FDI flows are mostly concentrated in a few sectors (e.g., banking, retail, and 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, Bosnia and Herzegovina, 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 Bosnia and Herzegovina. Agrokor, a leading Croatian food processing company, has made a series of investments in Serbia and Bosnia and Herzegovina, 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.

Box 3.4**The Privatization of Zenica Steel Mill and its Impact on Regional Supply Chains**

In 2004, the world's largest steel company, Mittal Steel, bought a 51 percent share of the Zenica steel plant in the Federation of Bosnia and Herzegovina, in Bosnia and Herzegovina's largest foreign investment to date.^a Mittal Steel paid \$80 million in share capital and committed itself to investing 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 tons by 2007/08, with employment rising 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 Republika Srpska and have 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

(continued)

bought the Jelsingrad steel foundry from the government of Republika Srpska. Most of the production of the Zenica plant is exported and has already given a boost to Bosnia and Herzegovina's overall exports. Since the main target markets are in South East and Eastern Europe, this also increases the extent of intraregional production networks. In fact, around half of the output is exported to FYR Macedonia for additional processing in another one of Mittal's 2004 acquisitions, Mittal Steel Skopje. The latter produces more downstream steel products such as coils and sheets, and in turn exports to the Balkans, Turkey, and the rest of Europe.

Zenica not only illustrates the importance of FDI for the development of exports and cross-border supply chains, but also the potential 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 practices among 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 sent to provide assistance with the handling of iron ore by their colleagues in Algeria.

a. Information on the Mittal Steel case study was taken from: Marsh (2005a, 2005b); EBRD Feature Story (January 2006), see <http://www.ebrd.org/new/stories/2006/060111.htm>; EBRD (2005); the Mittal Steel website (<http://www.mittalsteel.com/Facilities/Europe>); and Economist Intelligence Unit, Bosnia and Herzegovina Country Profile 2005.

A recent MIGA study found that there is potential in the Western Balkans to attract more FDI. This study analyzed FDI potential in car parts, food processing, and leather and shoe production. It found, for instance, that Croatia and Serbia have potential for FDI in the automotive component industry; Serbia is well positioned to export berries and greenhouse fruit/vegetables; and Albania has a competitive edge in fish products as well as shoe and leather manufacturing (in which Italian investors already play a key role). The findings would, among other things, feed into efforts of the European Investor Outreach Program (EIOP) to attract sector-specific FDI to these countries.⁹ Another example of a donor-funded initiative to foster regional supply chains in a specific sector is an automotive cluster project for SEE by Germany's GTZ.

Policy Measures to Foster Deeper Integration

Although deeper integration is a company level phenomenon, different initiatives can encourage companies to more actively seek economic relationships within the region. These are discussed below, and include rules of origin, border frictions, standards, public procurement, and state aid. Other issues relating to regional cooperation in services are discussed in chapter 4.

Implementing CEFTA—While the SAAs offer prospects for attracting FDI, an effective implementation of CEFTA is necessary to reduce the potential hub and spoke effect. The decision to replace the complex system of bilateral FTAs with CEFTA, a regional FTA, is a critical step that needs to be consolidated. CEFTA is expected to reduce trade diversion and distortions and to serve as a springboard for eventual EU accession. Trade diversion could be reduced further if all CEFTA countries adopted the EU MFN tariff. It is also expected to reduce business transaction costs and the administrative strain on customs, enhancing the flow of exports and imports across SEE countries. It is important to ensure that CEFTA is well-implemented in order to ensure successful liberalization of trade among SEEs. Failure to do so could give rise to negative “hub and spoke” effects. The latter emerge because of distortions that provide EU firms (the hub) with better market access to other SEE markets (the spokes) than that provided to SEE firms. If this occurs, it could work against the objectives of increasing intraregional trade and investment.

The multilateral aspects of CEFTA 2006 need to be stressed through consolidating a common list of exemptions and reducing the extent of nontariff barriers and quantitative restrictions in agriculture. Tariffs on industrial products will be eliminated once CEFTA 2006 is effective in Albania, Bosnia and Herzegovina, and Serbia; FYR Macedonia, Moldova, and UNMIK/Kosovo have kept a few exceptions. Liberalization of trade in agricultural products remains similar to that which occurred under the bilateral FTAs, as CEFTA adopts a system of quantitative restrictions and maintains a series of differentiated exemptions by country. The parties have committed to reviewing these exemptions and concessions by May 2009.

Border frictions—Despite improvements, border frictions remain an impediment.¹⁰ In the planned second phase of TTFSE, 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 EC'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. Additional progress can be made through the implementation of domestic integrated border management (IBM) programs aimed at improving interagency coordination and cooperation within an individual country. Also, an integration of common border formalities across countries, including the establishment of a single management of border crossing points, should be seriously contemplated.¹¹ Based on these programs, countries within CEFTA can start discussing the establishment of joint border crossing facilities designed to allow for integrated border management and nonduplication of work across agencies.

Standards can be harmonized and technical barriers reduced. Sanitary and phytosanitary measures (SPS) and technical barriers to trade (TBT) are addressed in Articles 12 and 13 of CEFTA 2006. The agreement calls for cooperation between the parties under the overall umbrella of the relevant WTO agreements. It may be useful to harmonize CEFTA standards according to EU regulations, which would help achieve the objective of developing a full FTA between CEFTA and the EU. In any case, collaboration between CEFTA parties would be necessary to achieve the goal of reducing disparities in SPS and reducing TBT, both for intraregional trade as well as for trade with the EU.

Rules of origin—Diagonal cumulation needs to be effective at the CEFTA level first.¹² Diagonal cumulation allows economic operators to use components originating from any of the participating countries in the agreement without losing the preferential status of the final product when exported to the EU. As a first step, CEFTA countries need to agree to diagonal cumulation among themselves, so that the origin of the product, as long as it is made within the CEFTA region, is not an issue in qualifying for free trade status. In this context, the CEFTA 2006 agreement (Article 14, annex 4 and 5) includes provisions on the adoption of pan-European and Mediterranean rules of origin within the CEFTA region.

Increased intraindustry trade, exports, and FDI inflows could result from the planned diagonal cumulation of rules of origins under the Pan-European Cumulation of Origin across all countries.¹³ The European Commission (EC) is currently preparing a zone of diagonal cumulation

involving the EU and all countries of the Western Balkans which have an FTA (SAA) with the EU.¹⁴ As a second step, these countries will integrate into the pan-Euro-Mediterranean zone of diagonal cumulation.¹⁵ The CEFTA 2006 agreement has similar rules of origin (Article 14, annexes 4 and 5) as those applied to the pan-Eur-Mediterranean cumulation system, which allows for smoother integration. Application of these rules will help overcome current asymmetries, which stem from a lack of diagonal cumulation implementation. Under this system, CEFTA exporters are constrained when using inputs from their SEE partners, as only inputs sourced from the EU would be accepted as local content under the bilateral cumulation of origin rules, thereby discouraging intraregional trade.^{16,17} FYR Macedonia and Croatia will be the first ones in the Western Balkans to receive the benefit of the pan-Euro-Mediterranean cumulation system.¹⁸

The extension of the cumulation system to SEE5 requires concerted efforts to strengthen the capacities of customs and local producers. Even though the EU has in principle agreed to permit cumulation in its trade with the Western Balkans (see EC 2006b), further action is needed to ensure the full integrity of certificates of origin. Failure to do this in a system allowing for cumulation could lead to considerable abuse. However, rules of origin under the Pan-Euro-Med system are sophisticated and could be difficult to implement by local customs authorities and by small and medium enterprises of EU partner countries.¹⁹ Targeted support is needed to integrate the cumulation system into the customs regime and strengthen the capacities of customs. A parallel effort is needed to raise the awareness of local producers and exporters about the requirements for proving origin and to support them in bearing its cost.

Public procurement—Fair and transparent cross-border competition for public contracts is an important building block of a truly integrated regional market. The procurement of goods and services by the governments and public entities can account for 10 percent of a country's GDP. 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, noncompetitive contract awards or rigged tenders. These types of discrimination not only constitute important nontariff barriers for trade, but also impose significant costs to the government budget. An analysis of OECD countries (Francois et al. 1997) found the “margin of preference” (i.e., the premium paid by governments to favor domestic suppliers) ranged between 13 and 50 percent.

Moreover, nontransparent procurement practices create a fertile breeding ground for corruption, which constitutes a major impediment for economic development in the Western Balkans.

Moving toward nondiscrimination in procurement laws, especially in practice, is a challenge for the future. The two accession candidates Croatia and FYR Macedonia started to open their procurement markets by introducing the principle of nondiscrimination between domestic and foreign suppliers in their procurement laws, in compliance with the respective EU *acquis*. In most Western Balkan countries, however, nontransparent practices and discrimination between domestic and foreign suppliers remain widespread. The CEFTA agreement contains provisions on public procurement in Articles 34 to 36. Even though it introduces the principle of nondiscrimination, a transition period until May 2010 will apply. In fact, 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 EC contain procurement chapters and monitor progress in this regard.

Competition and state aid policy—Anticompetitive behavior by firms not only reduces economic efficiency at the national level, but also can be an important barrier to market access and thus reduce trade between countries. Small markets like those in the Western Balkans are particularly prone to cartels, restrictive practices, or the abuse of market power. This, along with state aid to national companies, can reduce the incentives as well as the flow of cross-border investment. The EU's strict competition and state aid rules constitute a central pillar of the Single Market and are enforced both by the EC 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, and slot allocation at airports), cross-sector competition rules are a flexible instrument to counter anticompetitive behavior on a case-by-case basis. This, however, requires a high degree of institutional capacity and technical skills of antitrust authorities.

Compliance with, and enforcement of, EU rules on competition and state aid can only be a long-term goal, owing to capacity bottlenecks. 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 antitrust 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 EC contain chapters on competition and state aid and are a useful instrument to monitor and encourage the gradual convergence toward EU practices.

Notes

1. See E. Helpman (2004). Helpman quotes a study showing that an increase of one standard deviation in the degree of openness increased the growth rate of a small country like the Seychelles (population less than 100,000) by 1.4 percent. However, a larger country like Mali (population more than 10 million) increased by only 0.4 percent with a corresponding increase of one standard deviation.
2. According to the GATT, tariff binding cannot be changed without compensation or resorting to the dispute settlement mechanism.
3. The complexity and extent of EU farm support, of which tariffs are just a component, could imply that convergence to EU agricultural tariffs may not be beneficial.
4. Of course, for those that are now part of the EU, namely Bulgaria and Romania, EU access is even more complete and across a broader range.
5. For a survey, see World Bank (2003), chapter 3.
6. With 660,000 inhabitants and a fraction of the EU's income level, 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). See World Development Indicators (2005).
7. This is almost certainly an underestimation. For details, see World Bank (2007b), chapter 4.

8. Also, the LPI is based on perceptions.
9. MIGA (2006). The EIOP is also managed by MIGA through a European investor outreach office in Vienna (www.miga.org/index.cfm?aid=141). An IMF study also shows a considerable gap between actual and potential FDI (Demekas et al. 2007; see also chapter 2 in this book).
10. See chapter 5, the section on “Key Bottlenecks,” which shows that within many countries in SEE5, perceptions are more favorable to the quality of infrastructure than to overall logistics, which supports an emphasis on the softer side of infrastructure.
11. National and regional EU CARDS financed projects have supported the development of “Guidelines for Integrated Border Management in the Western Balkans” in 2003.
12. The concept of cumulation is an important element of preferential rules of origin. It allows inputs originating from one party in a preferential agreement to count as originating in another when those goods are used in further processing. Diagonal cumulation applies, for example, in preferential trade between the EU and groupings of countries in which the parties to an agreement share identical rules of origin (for example, EFTA countries). It allows materials originating in the EU or in one or more of the country groupings to count towards fulfillment of the rules of origin. The same concept applies within CEFTA countries.
13. EU preferential rules of origin define the requirements for the local content of raw materials, components, and value added, including the minimum level of transformation necessary for a final product to qualify as originating and thus for it to benefit from preferential treatment in access to the EU market. Since 1997, a system of European cumulation, based on a network of free trade agreements and protocols, has been established among the EU, the EFTA countries, the Central and Eastern European countries, and Turkey. Since 2002, the system has been extended to the Southern Mediterranean countries as signatories of Association Agreements with the EU.
14. At present these comprise Croatia, FYR Macedonia, and Albania. Montenegro signed the SAA in 2007 and will be able to benefit from the cumulation arrangements since an Interim Agreement (pending full ratification of the SAA) has now entered into force. Serbia and Bosnia and Herzegovina are still negotiating the signature of the SAA.
15. This zone includes the EU, Turkey, EFTA countries, and the Mediterranean countries participating in the EU’s Barcelona process.
16. Thus, if Albania took in inputs from, say, Montenegro, it would not enjoy preferential access to the EU; inputs from Hungary or Bulgaria (as EU members), however, would qualify it for such status.

17. See “Study on the economic impact of extending the pan-European system of cumulation of origin to the Mediterranean partners’ part of the Barcelona process,” the Sussex European Institute, University of Sussex.
18. See http://ec.europa.eu/taxation_customs/customs/customs_duties/rules_origin/preferential/article_784_en.htm. All SAAs allow for bilateral cumulation only. The SAAs with Croatia and FYR Macedonia are now being amended to establish the so called “SAP + DC” (where DC is diagonal cumulation), which would include the EU, the SAA countries, and Turkey.
19. The cost of proving origin involves a number of administrative procedures, and there is also the cost of maintaining an accounting system that accurately accounts for imported inputs from different geographic locations (Brenton and Manchin 2003).