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REGIONAL COOPERATION OF THE SOUTH EAST EUROPEAN COUNTRIES AS A PRECOGNITION FOR ACCELERATED AND SUSTAINABLE ECONOMIC GROWTH[1]

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ABSTRACT

The countries of South East Europe (SEE) have made considerable progress in their integration into the European and global economy, as well as in strengthening their mutual regional ties. Since the economic crisis of 2008, the Central European Free Trade Agreement (CEFTA) has become instrumental in securing open and accessible regional markets. While there has been good progress in establishing a web of regional cooperation structures over the last years, more efforts are needed. The purpose of this paper is to propose Integrated Growth Model of these countries aimed to promote regional trade and investment linkages and policies that are non-discriminatory, transparent, predictable and will enhance the flow of goods, investment, services and people within the region. This will contribute to the further integration of the region into the European and global economy through enhanced participation in international supply chains, grounded on improved international competitiveness backed by deepened regional trade and new investments. Coordinated regional effort and consequent national implementation are prerequisites to give the expected boost to intraregional trade while increasing attractiveness for investment in the region.

Key words: integrated growth, regional cooperation, South East European (SEE) countries

[1] prosfessional paper

INTRODUCTION

Although it has been more than nine years since the global financial crisis first struck, economies around the world continue to struggle toward recovery. Among those hardest hit by the crisis have been the EU membership candidates countries in the South East Europe (SEE) – Albania, Bosnia and Herzegovina, Kosovo, Macedonia, Montenegro, Serbia and Turkey. Over the past two decades the SEE countries have made great strides in their economic and political transformation, integration into the global economy and rapprochement with Europe. The economic crisis caused a severe blow to the fragile economies and labor markets of the region, halting the positive development trends of the last decade and highlighting the need for these countries to use this opportunity to improve their investment climates and reduce public debt, while simultaneously eliminating payment arrears in the public sector, which will help improve financial discipline in the overall economy of each country.

Despite progress, today these countries remain among the poorest in Europe, overtaken by the more successful neighboring countries in terms of convergence to EU standards of living (*World Bank, 2017*). In addition, SEE economies are highly interconnected and interdependent, which presupposes a high sensitivity of most of them when a single one is hit by economic difficulties (*Jeleva, 2012*). The recent global financial crisis and the present difficulties of the euro zone have highlighted the interdependence of national economies both within and beyond the EU. These events emphatically show the importance of further consolidating, economic and financial stability and fostering growth.

It is becoming clear that South East Europe needs to 'change gear' – and indeed change the actual model of growth – by accelerating socioeconomic reform and speeding up measures to modernize and reindustrialize its economy, to create more new jobs and to deliver better living standards for the population. In turn, this calls for concrete policy efforts at both the national and the regional level aimed at guiding the region towards a new development pathway. Indeed, regional integration is a key element of the EU policies towards this region, as a decisive factor to promote economic development, cohesion and political stability *(European Commission, 2006)*.

This paper argues that SEE countries can grow strongly again by realizing their trade potential through expanded regional cooperation. Greater openness and expanding trade to both regional and European markets could be part of the answer. Although trade patterns within the region are traditionally closely linked and economic integration into the West has deepened in recent years, trade flows have remained limited in many SEE countries. The aim of the paper is to describe economic challenges and solutions for Southeast Europe towards more sustainable, qualitative and inclusive growth and to provide concluding policy recommendations.

MACROECONOMIC OUTLOOK OF SOUTH EAST EUROPEAN COUNTRIES

Macroeconomic stability is a precondition for economic growth and integration as it guards against external shocks, helps to reduce uncertainty for consumers and investors, thereby promoting trade, investment, and capital market development. All SEE countries expect to improve their economic performance in the 2017-2019 period, compared to 2013-2016 (*see Table 1*).

Table 1: Real GDP growth SEE Countries – Economic Reform Programs 2017 Key indicators

	Real GDP growth (% change)						
	2013	**2014**	**2015**	**2016**	**2017**	**2018**	**2019**
Albania	1,0	1,8	2,6	3,4	3,8	4,1	4,2
Macedonia	2,7	3,5	3,8	2,3	3,0	3,5	4,0
Montenegro	3,5	1,8	3,4	2,4	3,2	4,4	2,6
Serbia	3,6	-1,8	0,8	2,7	3,0	3,5	3,5
Turkey	8,5	5,5	4	3,2	4,4	5,0	5,0
Bosnia and Herzegovina	2,4	1,4	3	3,1	3,4	3,8	4,0
Kosovo	3,4	1,2	4	3,8	4,5	3,3	3,8

Source: *European commission, 2017*

The expected growth acceleration faces some downside risks. In some countries, such as Albania and to a certain extent Montenegro, the projected investment surge relies on ongoing FDI-financed projects. In others it is seen as the consequence of expected improvements in the business environment (Bosnia and Herzegovina), ramped-up public capital expenditure (Kosovo, partly Montenegro), a return to political stability (Macedonia), or the continuation of a recent reform drive (Serbia) (*European Commission, 2017).* These factors all carry various degrees of uncertainty and, therefore, downside risks.

The projections for current account deficits appear somewhat optimistic. In many Western Balkan countries current account deficits increased further in 2016, often from an already high level. However, trade deficits are expected to remain high as structural weaknesses and a narrow production base continue to limit the export potential in most countries in the region over the medium term.

The SEE countries have experienced low inflation rates, or even decreases in overall price levels, as a consequence of low global food and energy prices, combined with limited domestic price pressures. The SEE countries rightly project a moderate increase in inflation consistent with faster economic growth, falling unemployment and recovering global commodity prices (*European Commission, 2017*).

While an economic recovery is underway it is fragile and the region remains very exposed to the vulnerabilities in the EU, its main trading partner. On average, the South East European economies still lag considerably behind the developed European economies. Production facilities in much of South East Europe are generally obsolete and in desperate need of massive new investment as is the public infrastructure necessary to serve them (roads, water, IT networks, etc.).

The main problem in the region is lack of employment and the general economic situation stemming from it or connected to it. In terms of the unemployment rate, shown in *Table 2,* it increased significantly in most economies, remained stable in Montenegro, but decreased in Macedonia and Kosovo. The levels are, however, exceptionally high. Still, given the low level of employment, the forecasted growth rates are below the potential ones. According to the estimates made by WIIW[2] the range of growth rates in the medium term is between 0 to 3 percent per year *(Regional Cooperation Council Secretariat, 2015).*

Table 2: Unemployment rate SEE Countries (% LFS)

	Real GDP growth (% change)						
	2013	**2014**	**2015**	**2016**	**2017**	**2018**	**2019**
Albania	16,4	17,9	17,5	15,7	14,4	13,3	12,5
Macedonia	29,0	28,0	26,1	23,9	23,0	22,1	21,1

[2] Vienna Institute for International Economic Studies

Montenegro	19,5	18,0	17,5	19,4	17,8	17,0	16,6
Serbia	22,1	19,2	18,2	17,0	16,0	14,7	13,2
Turkey	8,9	10,1	10,3	10,5	10,2	10,1	9,8
Bosnia and Herzegovina	27,5	27,5	27,7	25,4	24,7	24,0	23,2
Kosovo	30,0	35,3	32,9	/	/	/	/

Source: *European commission, 2017*

Lower welfare, incomes, and financial security must be the consequences of persistently depressed labour markets. The social and cultural problems also accumulate. There is no doubt that solutions to political and developmental issues need to be urgently found for economic growth to accelerate.

Progress towards EU membership has been uneven and some of the countries still face a long and bumpy road towards EU accession. All of these issues are central to the socioeconomic policies of each SEE country and are also critical elements of the EU accession process. SEE governments need to take a decisive step towards creating vibrant economies and thriving societies in each and every country of the region.

REGIONAL COOPERATION OF SOUTH EAST EUROPEAN COUNTRIES

Since the economic crisis of 2008, the Central European Free Trade Agreement (CEFTA) has become instrument in securing open and accessible regional markets. The CEFTA members[3] have made an important step towards deepening of regional cooperation by successfully completing an elimination of tariffs in goods, and substantial liberalisation of trade in agricultural products. CEFTA provides an ambitious agenda not only on liberalisation of trade in goods and services, but also with regard to trade facilitation, elimination of non-tariff barriers and other policy areas such as investment, public procurement, protection of intellectual property rights (IPR), competition and state aid rules. The agenda provided by the Agreement has already proven to be a driving force in the EU accession process of all CEFTA members.

Regional integration in general and trade integration in particular, are cornerstones of the EU Stabilisation and Association process with the Western Balkans (*European Commission, 2006)*. Regional ties reinforce the

[3] CEFTA has 7 members, all of which participate in the SEE 2020 Strategy, with the exception of Moldova.

economic performance of the countries concerned and thereby can contribute to preparing them to participate in the EU single market. Regional interplay is also an important test on the ability to conduct harmonious trade and political relations with neighbours.

While the recent global economic and financial crisis has reversed some of the positive achievements of the preceding years many of the economic problems in the SEE region are chronic and to some extent reflect suboptimal patterns of growth. Markets in the region perform in a way that is far from efficient: the result of an unfinished reform agenda during the transition to a functioning market economy. The local business environment is still marred by many impediments that reduce its attractiveness for investment.

SEE countries need faster modernisation and institutional transformation to support sustained economic growth. There is recognition within the SEE countries of the need for closer integration, not only with the EU but also with each other. A domestic growth strategy would have more chance of success if it was embedded in a system of regional cooperation in all relevant areas. The strategy would require cooperation at the regional level in order to stimulate accession to the EU and to speed up job-rich growth and development. Governments in the SEE region should have to implement their individual development strategies, including EU accession related goals, by enhancing national efforts through focused regional cooperation on those specific issues that can benefit from a shared approach.

The RCC's Balkan Barometer based on a broad public opinion survey of the population in the SEE region in 2015 offers some important messages in this regard: as much as 76% of the population in the region thinks that regional cooperation can contribute to an improvement of the political, economic and security situation in their place of living *(Regional Cooperation Council Secretariat RCC, 2015).*

However, the key instruments for achieving this objectives and for resolving the crucial economic problems in the SEE countries are in the hands of the national governments, that need to devise their own development strategies in line with specific priorities. In view of the extreme deindustrialization that has taken place in the region, the new growth model has to ensure one common objective: the strengthening of the real sector of the SEE economies, as this is a crucial element for improving export performance and increasing competitiveness on global markets. This will require a more targeted industrial policy that would strengthen key manufacturing industries, stimulate diversification and upgrading of the industrial base and facilitate reindustrialization.

The reindustrialization of the SEE countries would be in line with recent EU objectives that aim at increasing the share of manufacturing value added from the current 15% to 20% of GDP by 2020 (*Uvalic, 2015*). If reindustrialization is a key element for strengthening EU competitiveness, so much the more it needs to be an explicit objective of the SEE countries. A regional industrial policy that would facilitate the creation of transnational networks and supply chains would also be welcome: multinational companies created by enterprises from several SEE countries are bound to be more competitive on EU markets than small national firms (*Uvalic, 2015*).

Economic integration between SEE countries would facilitate a transition to an accelerated and sustainable growth model. Economic integration can reduce the costs of trade, thereby improving the availability and selection of goods and services in the economy and leading to greater purchasing power for citizens. For instance, economic integration may allow firms in one country to learn about the goods, technologies, and business relationships of firms in other countries, thus boosting productivity (*Bown et al. 2017*). Furthermore, regional integration within SEE countries can help build a "strong neighborhood". An interconnected region would support an easier exchange of goods and services like electricity, telecommunications, and land transportation, among others, for which policy-related barriers to trade stem mainly from differences in regulatory schemes rather than from tariffs. A similar argument can be made regarding labor markets. In particular, pooling resources to develop skills can help improve the quality of products sold abroad, outside the Western Balkans neighborhood, and enhancing intraregional mobility of labor can facilitate a more efficient allocation of workers across countries (*World Bank, 2017*).

However, significant discrepancies remain across the region and a multi-speed adoption of EU law could lead to additional barriers within SEE. It is therefore important that authorities collaborate also within the framework of CEFTA on these matters and encourage the mutual adoption of EU law *(Bartlett and Monastiriotis, 2010).*

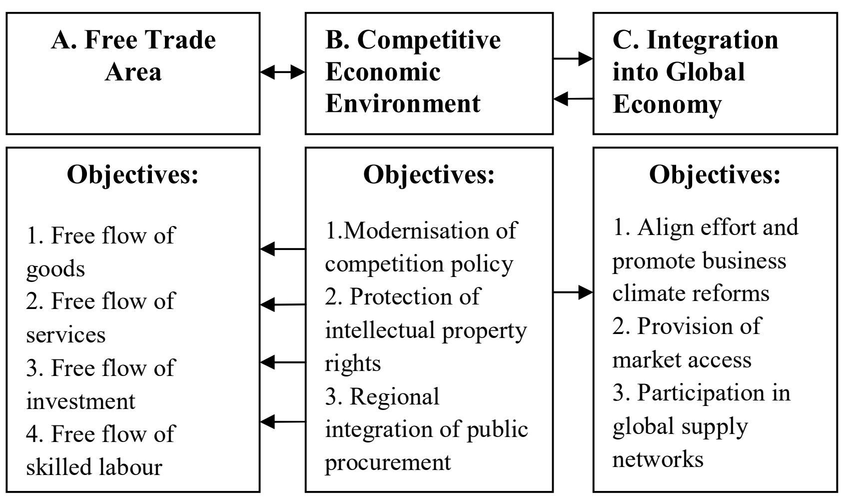
Finally, national governments in SEE should amend domestic policies to increase trade integration. Comprehensive information for local businesses on administrative procedures required for exports and imports is a first important step. Considering the importance of Small and Medium-Sized Enterprises (SMEs) in many SEE countries, authorities should further address SME development and support SME operations in higher added value sectors with export potential (*FES, 2018*). Lastly, a crucial aspect of trade policy should be to ensure that adequate competition policies are in place to increase productivity across the economies. This will also prepare local markets to cope with competitive pressures as the EU accession process continues.

INTEGRATED GROWTH MODEL OF SEE COUNTRIES

The objective of the proposed Integrated Growth model of SEE countries is to promote regional trade and investment linkages and policies that are non-discriminatory, transparent, predictable and that enhance flow of goods, investment, services and people within the region. This also contributes to further integration of the region into the European and global economy through enhanced participation in international supply chains, grounded on improved international competitiveness backed by deepened regional trade and new investment.

Integrated Growth perspective allows joint opportunities to be sought beyond a regional free trade agreement and market access to the region’s existing and potential export destinations to be enhanced. With the objective of accelerating further integration into the global economy, the regional initiative will target regional supply chains with the highest potential for participation in global supply networks (*RCC, 2013*).

Figure 1: Integrated growth model of SEE countries



Source: *Regional Cooperation Council, (2013).*

The signing of the CEFTA 2006 Agreement on 19 December 2006 set the stage for the establishment of a free trade area in South East Europe.

Since then, the free flow of industrial goods has become a reality, as tariffs and quotas were abolished. Furthermore, the core effort within the *Free Trade Area* dimension will be directed towards facilitating trade and liberalising trade in services among the CEFTA Parties. In order to attract new FDI the region will, together with establishing a free and open investment regime throughout the region, increase its competitiveness by facilitating the free flow of factors of production (goods, services and people), and by promoting further integration of regional markets.

Dimension *Competitive Economic Environment* addresses issues in facilitating competitive economic environment through strengthening synergies between trade and those areas which are most trade related: competition rules, public procurement and intellectual property rights (IPR). CEFTA was modernised to include modern trade provisions in areas such as the harmonisation of rules, services or the protection of intellectual property rights (*European Commission, 2006a*). The blueprint for action in the domain of competition rules involves turning the region into a trade defence instrument free area once alignment with the relevant EU acquis is completed.

Dimension *Integration into the Global Economy* seeks to benefit from economies of scale and/or specialisation in the region thus facilitating participation in global supply chains. Major efforts will be invested in coordination of relevant government policies, e.g. trade policy, proactive industrial policy, investment policy, etc. Improved market access is a precondition of successful integration into the world economy. The European Union is the largest trading partner of all countries in the region. The opportunities are that the European environment will improve with gradual growth recovery. Also, that EU institutions will strengthen and speed up investment and structural changes. With most of the exports from the SEE going to the EU market, that would help the transition to more export-driven growth in the region, which is certainly needed. The Western Balkan countries will work to complement the trade and transport facilitation with other instruments such as special economic zones - cross border economic zones, export processing zones, and industrial parks. This will foster further development of regional value chains (*European Commission, 2015*).

There is need for stimulating the key long-term drivers of growth through a set of interlinked development pillars which include specific sectoral dimensions of regional cooperation. The “changed gear” can indeed come from more regional cooperation in trade, investment, employment, energy, transport, R&D, innovation, social development and governance. Smallness and fragmentation are serious handicaps of the SEE countries that cannot be easily overcome, unless they engage in more intensive forms of regional cooperation.

CONCLUSIONS AND POLICY RECOMMENDATIONS

Three mutually - reinforcing factors highlight the differences in the pace of convergence between the SEE countries and its neighbors in the EU: macroeconomic stability, progress on structural transformation of the economies, and economic integration. A highly ambitious goal has been set. The policy objectives and measures should contribute to the creation of some one million new jobs during the next decade. By joining forces in the achievement of common goals and united by shared European values, South East Europe will succeed. There is a need for a strategic approach and to the adoption of comprehensive regulatory reform strategies, such as:

- Further integration into the European and global economy through participation in the international division of labour, based on improved international competitiveness. Coupled with further overall trade liberalisation and deeper regional trade andinvestment linkages, along with upgraded and developed transport infrastructure, this should give a strong boost to trade flows from and to the region and will support an export-led pattern of growth (*RCC, 2013*). The focus must be on maintaining price competitiveness, stabilising labour costs and improving productivity.
- Customs and trade regulations should be harmonised and adapted to European standards, and countries should collaborate to improve trade infrastructure. This will not only facilitate intra-regional trade but will help the SEE countries on the road to EU accession, as well as making the region more attractive to foreign investors.
- Eliminate distortive non-tariff barriers and unnecessary technical barriers to trade.
- Improve customs interconnectivity through the introduction of paperless methods in regional trade.
- Liberalise intra-regional trade in services by reducing restrictive measures and policies.
- Facilitate free flow of investment through coordination of investment policies and investment promotion, and through better protection of investors and investment.
- Facilitate free movement of experts, professionals and skilled labour.

- Strengthen competition rules by creating a trade defence instrument free trade area in the region.
- Strengthen protection of trademarks throughout the region.
- Create a fully liberalised public procurement market in the region.
- Establish an investment concept to enhance participation in regional supply chains and global supply networks.
- Further encouraging the fragile economic recovery and supporting economic growth, consolidating fiscal policy, balancing national budgets, solving liquidity problems and problems connected with national currency fluctuations.
- Further supporting the modernisation efforts of the countries in the region, including structural reforms in all the respective areas, but also strengthening the main domains of democratic development, such as the rule of law, good governance, political consolidation and ethnic tolerance.
- Removing obstacles to regional cooperation and stability.
- Align efforts on improving the business environment and promote business climate reforms.

In summary, to converge faster to EU living standards, the SEE countries need to continue to pursue a 'three-pronged' effort by implementing in parallel prudent macroeconomic policies, bold structural reforms, and measures to advance economic integration (*World Bank Group, 2017).* Macroeconomic and fiscal stability, accompanied by decisive structural reforms are two necessary conditions to promote a sustainable and strong growth model, one that is based on private sector growth, investment, and higher exports. Structural reforms are key to unlocking the benefits of regional integration including productivity gains, investments, and job creation, all of which will support convergence to EU living standards. Indeed, economic integration is linked to productivity, as productivity is inherent in achieving economies of scale. And the speed and depth of reforms that rekindle income convergence will help advance the pace of economic integration.

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