Pushing on a string?

An evaluation of regional economic cooperation in the Western Balkans

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I. Abstract

This study evaluates the success of the EU's strategy of regional cooperation in the Western Balkans over the last two decades from an economic perspective.

First, we define the prerequisites for successful regional cooperation in an institutional, political and economic sense, and assess the extent to which they existed in the Western Balkans at the start of the 2000s. Second, we identify the key facets of the EU's strategy to deepen trade, investment and infrastructure connectivity in the Western Balkans, and establish the impact that this has had. Third, we assess the state of play in 2020, and make some suggestions for the way forward.

Our main findings are a) that many of the most important prerequisites for regional cooperation have not existed in the Western Balkans during the past two decades, and that the potential gains from the EU strategy have therefore always been quite limited; b) that regional trade, investment and infrastructure integration has increased somewhat, but that there are still many gaps and challenges ahead; and c) that these efforts have not fundamentally altered the main obstacles to normalising political relations in the Western Balkans and, ultimately, to the EU accession of its constituent countries.

Our findings lead to two main conclusions. First, regional cooperation efforts should continue, but more effort should be focused on securing the maximum possible level of economic integration with the EU. Second, economic development and EU accession in the region are severely hamstrung by territorial disputes and constitutional deadlock. Without a breakthrough on these issues – and especially the normalisation of relations between Serbia and Kosovo – no amount of regional cooperation initiatives can fundamentally change the situation.

II. Key findings

1. This study set out to answer the question of whether the **EU strategy of regional cooperation** has produced concrete results in terms of economic connectivity and rising living standards, and whether this in turn has had a positive impact on the normalisation of political relations in and progress towards EU accession of the Western Balkans. In reassessing the various initiatives and outlining the state of play in 2020, it has also sought to form a basis for thinking about the areas in which the efforts of regional and EU policymakers can be best directed in the next decade.

2. Many of the **institutional underpinnings necessary for effective regional cooperation have not existed in the Western Balkans during the past 20 years**. Granted, the EU and US have acted as important outside forces driving the process, and local ownership has gradually strengthened over the period. However, territorial issues remain outstanding, many local elites have never 'bought into' the process, and institutional and governance standards generally remain low across the region. Together, these factors have created significant hurdles to the success of regional cooperation.

3. We establish that the **political incentives required for effective regional cooperation have not always been aligned**. Countries that are more economically advanced or do not have bilateral disputes with other Western Balkan countries have had fewer incentives to engage in the process, which has helped to foster a persistent tension between regional cooperation and the bilateral accession process with Brussels. Serbia's size relative to all other countries involved in regional cooperation – particularly after Croatia joined the EU in 2013 – has also been a complicating factor. There has not been a single outside threat that could have spurred the Western Balkan elites to become more thoroughly committed to and engaged in regional cooperation.

4. The **economic fundamentals of the region in the early 2000s added to the hurdles currently facing the EU's regional cooperation strategy**. Some supportive factors did exist. At least before 2008, growth in the EU and global economies was strong, providing a supportive backdrop, while the Western Balkan countries had different comparative advantages, meaning that, in theory, there was a complementarity in production structures. However, even taking into account the disruption to regional trade caused by the wars of the 1990s, the potential upside to regional economic integration – for both trade and investment – was not very high. All countries were poor and, with the partial exception of Serbia, very small, which further limited the feasible gains from increased regional economic

integration. Non-tariff barriers to trade and weak connectivity were also major obstacles. A genuine leap forward in terms of regional economic integration would have also required significant policy coordination, which is something that never materialised.

5. The material institutional, political and economic barriers to the EU's regional cooperation strategy have meant that **Brussels would necessarily have to offer major incentives to the Western Balkan countries in order for the plan to work**. A multitude of initiatives in trade, investment and infrastructure have been launched.

6. We establish that the bilateral **free trade agreements (FTAs) signed between Western Balkan countries beginning in 2002 have had a positive impact on intraregional trade**. However, we measure the positive impact of these FTAs on regional exports at 13.9 percent, which is only around half of the positive impact that an FTA has on trade between two signatories on average. Our results were significantly affected by Serbia, which has notably expanded its trade with the EU over this period. Excluding Serbia, we found that the positive impact of FTAs between the other five Western Balkan Six countries was a much more impressive 70 percent.

7. We find that the introduction of **the 'new' Central European Free Trade Agreement (CEFTA) in 2007 has been more successful than the FTAs for the Western Balkans as a whole, and has increased intraregional trade by 37.7 percent**. Again, we find that Serbia is a notable outlier, which reflects its increased economic integration with the EU. As for the FTAs, when we remove Serbia from the sample, we establish a strongly positive impact of CEFTA on intraregional trade, of around 70 percent. For the five smaller Western Balkan countries, CEFTA has had an important positive impact in terms of increasing competitiveness, rebuilding the regional market, and increasing the flow of goods, all of which would otherwise not have been possible.

8. **Regarding investment, we have generally found less impressive outcomes.** The bilateral investment treaties (BITs) between Western Balkan countries, which started in the late 1990s, have not produced any statistically significant results. One of the key reasons for this has been the generally low institutional standards in the region. If this were not the case, we believe that higher intraregional investment would have materialised.

9. **The Stabilisation and Association Agreements (SAAs) signed by the Western Balkan countries have had a positive impact on integration with the EU.** Exports have increased by 24.6 percent as a result of the SAAs, while the inward foreign direct investment (FDI) stock from the EU has risen by 46.2 percent. However, the Western Balkan countries have not been able to attract the same value of FDI from Western Europe as the Visegrad countries, the original CEFTA members, have. With very few exceptions (e.g. Fiat-Chrysler in Serbia), large Western multinational investors have been notable for their absence in the Western Balkans, which stands in stark contrast to their presence in the Visegrad countries.

10. Our study establishes that the **EU strategy regarding infrastructure, combined with the initiatives of other actors, has produced some positive outcomes**. The Western Balkan countries have been integrated into the Trans-European Transport Networks (TEN-T) and Trans-European Networks for Energy (TEN-E). Since 2013, transport

infrastructure investment in the Western Balkans has generally been higher than for the EU members in Southeast Europe (SEE). In most countries, there has been a decline in the number of firms reporting transport and energy infrastructure as a major constraint.

11. **However, we also identify many gaps and challenges ahead for infrastructure development and connectivity in the Western Balkans.** Motorway and railway densities are low, existing transport infrastructure is of poor quality, electricity outages and loss are a serious issue in some countries, and ICT infrastructure is poorly developed. Challenges to improving these shortcomings include financing constraints, corruption and regulatory deficiencies. Therefore, despite the major efforts of the EU and other partners over the past two decades, the standards of transport, energy and ICT infrastructure have generally lagged behind those of regional peers, which in turn has hindered regional connectivity and economic convergence.

12. **Taking stock of the state of play in 2020, we observe many positive aspects of regional cooperation.** We highlight the increased local ownership of the past decade and survey data showing that citizens are highly supportive of and engaged in regional cooperation efforts. There are a multitude of initiatives, and a great deal of important work is being done. Further efforts led by the Regional Cooperation Council towards developing a Regional Economic Area are welcome.

13. **However, taking into account what the EU originally set out to achieve over the past two decades, we highlight many reasons for being disappointed.** The increased trade, investment and infrastructure integration has not had a strongly positive impact on economic development and convergence, nor has it had any material impact on breaking the most intractable aspects of the 'geography of animosity'. It remains the case that the political incentives for elites to engage fully in the process do not exist, and that institutional and governance weaknesses remain an impediment to effective regional cooperation. No matter how much work is done to advance regional economic integration, the fact remains that the countries are mostly small and quite poor, so the potential gains are necessarily limited. The negative demographic trends in evidence across the region indicate a lack of hope among younger educated people, and bear testament to the generally disappointing outcomes of the last 20 years.

14. **While regional cooperation should certainly continue, it would make sense to focus efforts on the maximum level of economic integration possible with the EU.** Greater access to the EU budget could have a material impact on the Western Balkan economies, while the increased contributions this would require would barely register in the budgets of net contributor states in the EU. Additional steps for consideration could include joining the EU Customs Union and expanding the existing SAAs. Even if full EU accession is many years away, steps to integrate the Western Balkans more fully into the bloc should be considered in the meantime. The Western Balkans constitute less than 1 percent of the EU's GDP; even a moderate increase in economic integration and access to financing could have significant economic spillovers. Demographic trends and the ongoing Covid-19 pandemic add an extra element of urgency to these deliberations.

15. **Ultimately, economics can only provide part of the answer to how to advance regional integration, the normalisation of relations,**

and the EU accession of the Western Balkan countries. Serbia stands at the heart of the 'geography of animosity', yet its incentives to fully engage in regional cooperation are limited, with the current situation allowing it to extract concessions from all sides while not having to formally renounce its territorial claims on Kosovo. We have shown that Serbia has integrated quite successfully into EU value chains, while it has also maintained and intensified important strategic relationships with Russia and China. The EU is likely going to have to make a specific proposal to Serbia if it wishes to advance the EU accession process. Until that point, it is likely that only North Macedonia and Montenegro – neither of which is really involved in the 'geography of animosity' – will have a feasible path towards EU accession anytime soon.

16. This study was written during a time of increasing despondency about the EU accession prospects of the Western Balkan countries, rapid outward migration from the region, the re-emergence of the dangerous idea of territorial swaps, and the outbreak of the Covid-19 crisis. In addition to underlining the urgency of the situation, all of this emphasises the need for more imaginative solutions for enhancing the EU accession prospects of the countries in the Western Balkans.

III. Introduction

Regional cooperation has been a key part of the EU's strategy towards the Western Balkans for well over two decades.[1] This has especially been the case since the end of the Kosovo War in 1999. In this sense, the Western Balkans countries' EU accession process has been somewhat different from that of the 10 other formerly communist countries that joined the EU between 2004 and 2007. For those countries, regional cooperation was encouraged, but not required.[2] By contrast, in addition to their bilateral accession process with Brussels, the Western Balkan countries have also had to achieve benchmarks in terms of their mutual relations.

Most of Western Europe did not want to let the Western Balkan countries into the EU until the various conflicts in the region had been resolved. They therefore formulated the strategy of regional cooperation, which was based on the following assumptions:

- Intensifying economic contact would lead to better economic outcomes.
- Better economic outcomes would lead to a convergence of economic interests.
- This convergence, in turn, would lead to a greater readiness to peacefully resolve political conflicts.

Aside from resolving political conflicts, regional cooperation was seen as a way to prepare the region economically for EU accession, as restated in the EU strategy for the Western Balkans (European Commission 2018).

Regional cooperation: An idea with deep historical roots

The idea that countries which are more economically integrated are less likely to go to war goes back at least as far as Plutarch. The liberal idea rests on two assumptions: 1) trade brings people into more contact with each other (and, therefore, they are less likely to fight); and 2) trade increases the prosperity and power of the productive and peaceful members of a society. Later, a similar idea formed a key part of Kant's theory of perpetual peace, which stipulates that economic interdependence makes accommodation more attractive than war. Adam Smith developed these ideas further with his dismantling of the theory of mercantilism in The Wealth of Nations.

Especially in Europe, this old theory has two more modern and highly successful examples in practice: the process of post-Second World War reconciliation, and the economic integration of France and Germany. Starting in the late

1 This paper largely deals with the so-called 'Western Balkan Six': Albania, Bosnia and Herzegovina, Kosovo, Montenegro, North Macedonia and Serbia. However, since Croatia was also part of the regional cooperation process until its EU accession in 2013, it will also be considered here whenever relevant, and context will inform the reader whether references to the 'Western Balkans' also include Croatia.

2 For example, with the Visegrad countries and the original Central European Free Trade Agreement (CEFTA).

1940s, after having fought three devastating wars in less than a century, France and Germany have pursued a course of ever-closer economic integration, which initially started with the European Coal and Steel Community (ECSC) and is still ongoing.

Over this period, war between the two countries has become unthinkable. Although the real reasons for the lack of armed conflict between them may have more to do with the nuclear deterrent and the US security role in Europe, there is a widespread perception that it is due to economic and political integration under the EU umbrella. This perception has framed a lot of the thinking in Brussels, Berlin and elsewhere about regional cooperation in the Western Balkans. Moreover, economic regional cooperation as a structural means of resolving conflicts has also been a natural route for the EU to pursue since it does not have a security arm of any consequence. Kant's thinking on this – specifically the importance of the rule of law and open markets to post-conflict political union – have played an important role in the justification of postwar European integration. What's more, it has also inspired the process of EU enlargement to help to transform formerly fascist and formerly socialist countries.

The 'geography of animosity'

To say that the application of this idea has been less successful in the Western Balkans in the past two decades than in Western Europe since 1945 is hardly controversial. Three decades since the fall of the Berlin Wall, and two decades after the wars in the region ended, parts of the former Yugoslavia are still defined by the 'geography of animosity' (Gligorov 2008). Gligorov used this term to describe unresolved territorial and constitutional issues. Although there have been many positive developments in the region, the key political conflicts – particularly those between Serbia and Kosovo and within Bosnia and Herzegovina – have not been resolved. Indeed, ethnonationalism – or at least its instrumentalization by politicians – remains a rather strong factor in the region's politics.

The key conflicts of the Western Balkans over the last century or so have been between Serbs and Croats, and the comparison with Franco-German conflicts is useful in this case. Rather than in the European way, the Serbo-Croat conflict was resolved by accepting Croatia into the EU while leaving Serbia to play the dominant role within the Western Balkan region. That has transformed the geography of animosity from a Serbo-Croat conflict into one in which Serbia has territorial issues with most of the other countries in the region, albeit to rather different degrees. This all makes for a very lopsided regional distribution of power. Serbia's neighbours are significantly weaker than it by almost any measure, including population size, military power and fiscal resources. As a result, it is very difficult for a regional equilibrium to emerge.

As was feared at the start of the process, the geography of animosity contributes to and, in some ways, reinforces the economic weaknesses of the region. Political antagonisms have consumed a great deal of time and drawn focus away from progress on economic and social development. On top of that, there are also 'frozen' or 'semi-frozen' conflicts. In general, 'frozen' conflicts limit or constrain the level and form of overall connectivity across parties to a conflict and with the outside world.

There is a key difference between postwar Western Europe and the Western Balkans of the 2000s. While the European integration process in the postwar decades was a broad enough framework to permanently put aside the Franco-German conflict and, indeed, to encourage their cooperation in jointly leading the EU, this has not been the case for the Western Balkans. The latter region has simply not been a sufficiently broad framework for settling regional conflicts. To do

so, it would need a European framework rather than the regional one. This tension between the European perspective and the condition of regional cooperation has proved persistent.

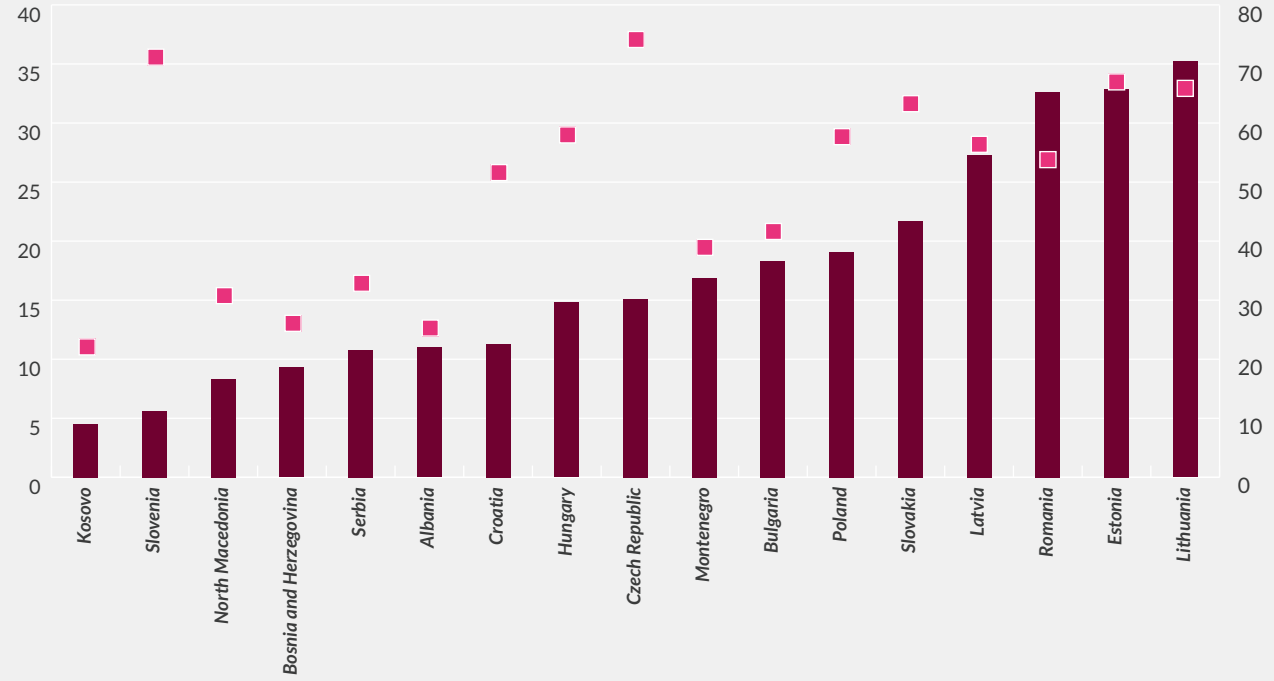
Two lost decades for the region's economies

Almost without exception, the Western Balkan countries have recorded the worst rates of economic convergence with Germany over the past 20 years in the whole of Central and Eastern Europe (CEE; see Figure III.1). This is despite the fact that, in 2000, most of the Western Balkan countries were much poorer than even Bulgaria and Romania, and that, all else being equal, poor countries tend to grow faster than rich ones.

This weak economic performance has contributed to – and been reinforced by – a huge brain drain from the region. Between 2000 and 2019, the populations of Serbia and Bosnia and Herzegovina decreased by over 7 percent, and of Albania by more than 6 percent. Around half of Bosnians already live abroad. According to a recent study by the Vienna Institute for International Economic Studies (wiiw), between now and 2050, the working-age population of all Western Balkan countries will shrink by between 17 percent in Montenegro to around a third in Bosnia and Herzegovina (Mara 2020).[3] These figures point to the limited prospects and lack of hope regarding the future among much of the region's population.

3 NB: Kosovo was not included in this study.

FIGURE III.1 **Convergence performance versus Germany, 2000–2018**



Sources: Eurostat, wiiw. | **© Bertelsmann Stiftung and wiiw.**

Is EU accession still even possible?

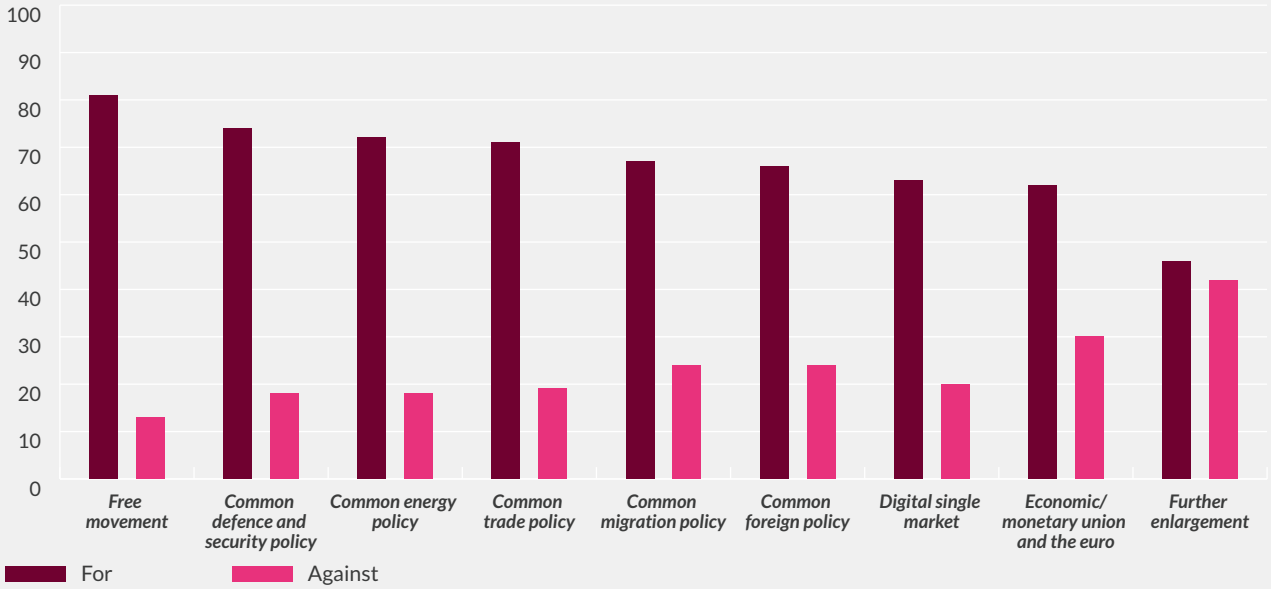
Meanwhile, the EU accession process is dragging on for the region, but at a very slow pace. Even for Serbia and Montenegro, which started EU accession negotiations some time ago, full membership is still many years off (Grieveson, Grübler and Holzner 2018). At best, they will join the EU two decades after Romania and Bulgaria, their fellow CEE countries, did. In fact, it will most likely be significantly longer than that, although after several challenging years, North Macedonia and Albania are at least now able to start accession talks (European Commission 2020b).

France has been the most important country when it comes to delaying the start of accession talks for North Macedonia and Albania. French President Emmanuel Macron would prefer to first focus on reforming the EU before accepting any new members. In 2019, France published a short 'non-paper' laying out its demand for a reform of the enlargement process, which includes a staged process and reversibility (French Government 2019).

Plenty of other countries have at least some sympathy for the French position. The Netherlands[4] and Denmark are also sceptical about accession for Albania specifically. But there appears to be growing opposition to enlargement across Western Europe more broadly. The experience of Bulgarian accession in 2007, in particular, left many in Western Europe feeling that more could have been done in the pre-accession period to strengthen the rule of law in the country. Thirteen years on, Bulgaria and Romania are still under special monitoring in the fields of corruption, judicial reform and organised crime.

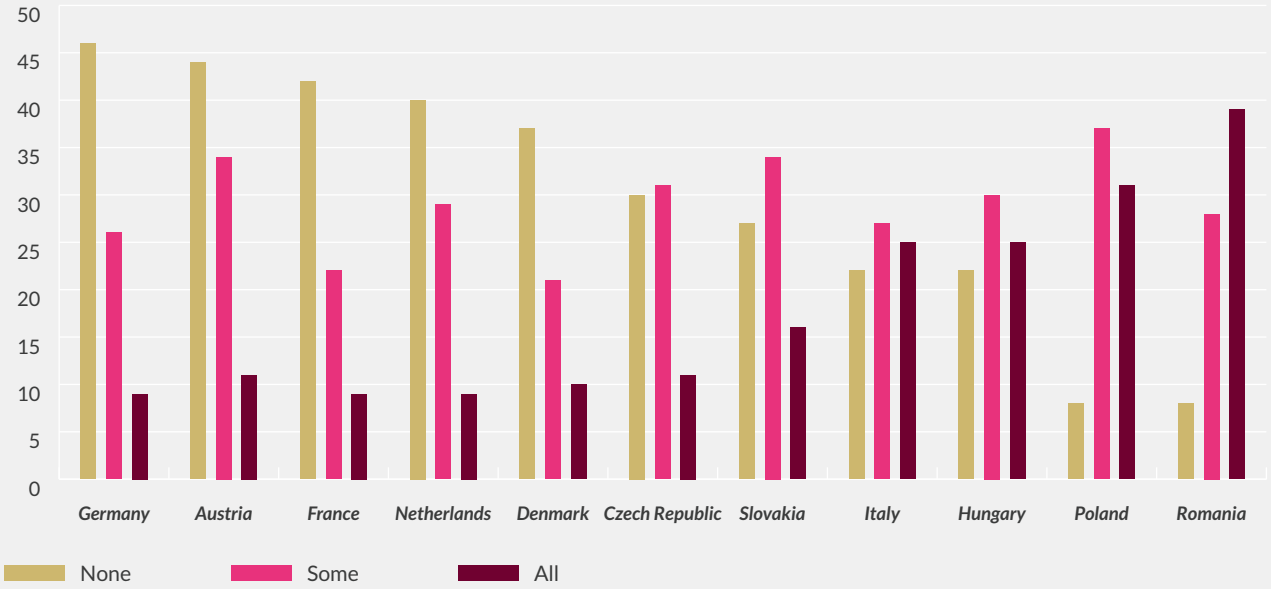
4 The Netherlands has a particular issue with Albania. In fact, the Dutch government asked the European Commission to suspend visa-free travel for Albanians in early June 2019 owing to concerns about organised crime.

FIGURE III.2 **Views of EU citizens on common policy areas (in percent)**



Source: Eurobarometer Spring 2019. | **© Bertelsmann Stiftung and wiiw.**

FIGURE III.3 **How many Western Balkan countries should join the EU in the next decade?**



Source: Tcherneva 2019. | **© Bertelsmann Stiftung and wiiw.**

Furthermore, two surveys indicate that there is wavering commitment and, in fact, more general hostility to enlargement among EU citizens. First, Eurobarometer data show that enlargement has substantially less support among EU citizens than any other key policy area surveyed by Eurobarometer (Figure III.2). Second, according to the European Council on Foreign Relations (ECFR) (Tcherneva 2019), only 22 percent of French and 26 percent of Germans think even 'some' Western Balkan countries should be allowed to join the EU in the next decade despite the Commission's 2025 target date for the accession of Serbia and Montenegro (Figure III.3).

The changing political backdrop in the EU itself is having an important influence on such sentiments. Granted, Brexit and the rise of Eurosceptic parties in other member states don't have much, if anything, to do with the Western Balkans. However, they could have an indirect negative impact on their potential accessions, and they have prompted a great deal of thought among centrist politicians on how to protect and strengthen the EU. The decision pushed most vigorously by French President Emmanuel Macron is that it is better to press ahead with integration (as the Eurobarometer survey shows) rather than to further enlarge the EU, but also to keep integration quite shallow in plenty of areas.

In March 2020, the European Council agreed to start accession talks with Albania and North Macedonia (European Council 2020). It stipulated, however, that Albania must first make progress in a number of areas, including electoral and judicial reform as well as actions related to organised crime. The Council also endorsed the Commission's proposed new enlargement methodology, which was announced in February 2020 (European Commission 2020a), in part in response to French concerns.

This was followed up by the Zagreb Summit at the beginning of May 2020. The fact that

the Zagreb Summit was held at all during the lockdown triggered by the coronavirus pandemic indicates that the Western Balkans have some degree of importance for the EU. However, the declaration issued at the end of the summit only mentions the region's 'EU perspective' rather than 'enlargement', which suggests a high degree of caution among at least some member states about the accession prospects of the Western Balkan states (EU 2020). In concrete terms, this statement said nothing about EU enlargement for the Western Balkans that had not already been said 17 years earlier in Thessaloniki.

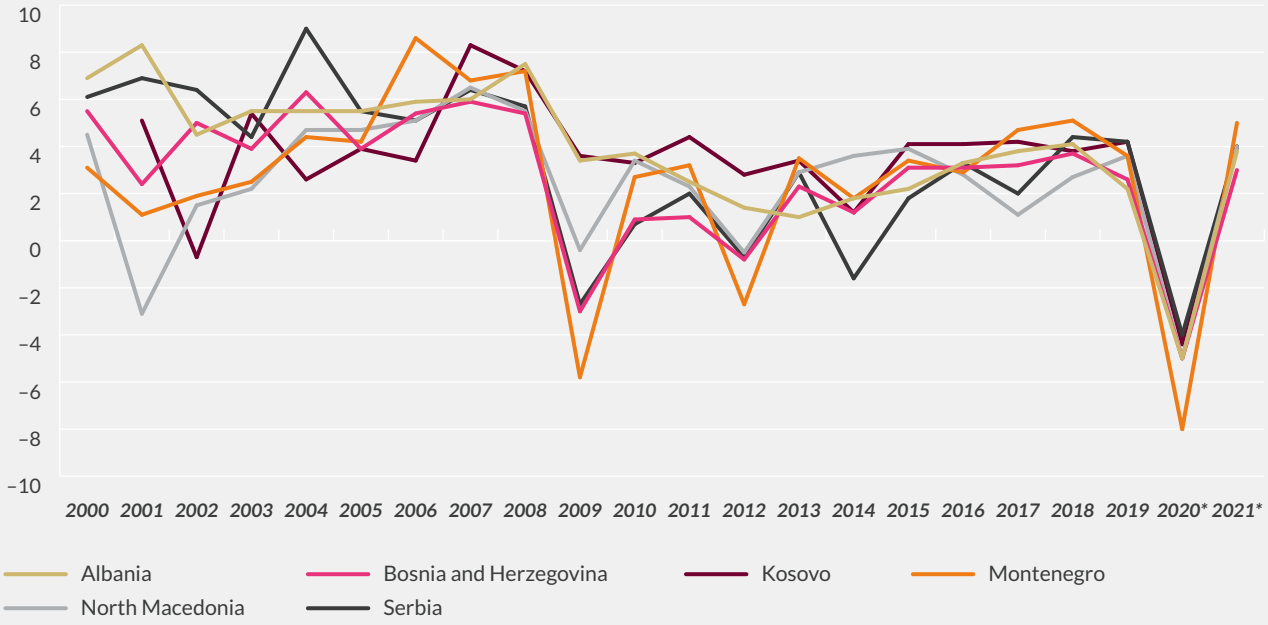
An issue more important than ever

In mid-2020, the question regarding the best way to ensure political and economic development as well as to bring the Western Balkans into the EU is more relevant than ever. Two recent developments reinforce the importance of this discussion.

First, tensions within the region along the traditional lines (Serbia-Kosovo and within Bosnia and Herzegovina) are perhaps as high as they have been for some time, and they are only being heightened by the potentially dangerous considerations of border adjustments and territorial swaps along ethnical lines. Second, there is the Covid-19 pandemic and the impact it will have on the region in economic, social and political terms. In 2020, many Western Balkan countries will experience their worst recessions in the past two decades (Figure III.4). Weak healthcare capacity, a heavy reliance on capital flows (e.g. remittances and FDI) and, in some cases, a strong dependence on tourism will exacerbate the scale and duration of their economic downturns. This, in turn, has the potential to set back regional cooperation initiatives.

Recent contributions to the debate around the efficacy of regional cooperation in the Western

FIGURE III.4 **Real GDP growth, percent change, year on year**



Source: wiiw. *2020 and 2021 data are wiiw projections made in May 2020. | **© Bertelsmann Stiftung and wiiw.**

Balkans have suggested various paths forward. Despite the apparently disappointing results of the last 20 years, some within the region have argued for a renewed push towards regional cooperation and integration, and the most prominent suggestions have called for a Regional Economic Area (REA) for the whole region or a 'mini-Schengen' comprising Albania, North Macedonia and Serbia. By contrast, others have suggested that now is the time for a more radical rethink and for focusing more intensely on greater integration with the EU (Bieber 2019).

Aims of this paper

In this challenging context, this paper sets out to analyse and evaluate the EU strategy of regional cooperation in the Western Balkans from an economic perspective. We want to take another look at what the EU is setting out to do as well as at the measures and instruments that have been put in place in addition to ascertaining the outcomes as concretely as possible. If the EU has indeed failed, it is crucial to understand why and to what extent the strategy has failed in order to be able to plot a more realistic and hopeful path forward for the region in terms of its economic development and EU accession.

In order to answer these questions, we will take the following steps:

First, we will look at the political and institutional context for regional cooperation in the Western Balkans as it existed at the beginning of the 2000s. Using the example of postwar Franco-German cooperation as a guide, we will ask to what extent the political, institutional and economic prerequisites for regional cooperation existed at that time. Our assumption here is that the political and institutional barriers were large, which meant that the EU would need to offer something very attractive in economic and financial terms to overcome them.

Second, we evaluate EU regional economic cooperation initiatives in two stages: i) we outline exactly what the EU did; and ii) we assess the outcomes. Here, our hypothesis is that the condition set in the previous paragraph was not met, i.e. that the economic and financial incentives offered to the Western Balkans were not big enough to fully overcome the political, institutional and economic barriers to fostering regional cooperation.

Third, we will sum up the state of play in 2020. In doing so, we will evaluate the extent to which the prerequisites for successful regional cooperation – in the political, institutional, economic and financial senses – exist in 2020 in a significantly different way than was formerly the case.

Fourth, we will look at the concrete ways in which the Western Balkans could be integrated into the EU in economic terms, and ask whether this would represent a potentially more promising strategy for economic development and regional integration.

Finally, on the basis of this evaluation, we will conclude this study with some suggestions for a way forward.

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IV. Theoretical prerequisites for regional cooperation and their existence in the Western Balkans

In this chapter, we will address the theoretical prerequisites for regional cooperation, and examine whether they existed in the Western Balkans at the beginning of the 2000s. To do so, we will ask three main questions: First, did the necessary institutional underpinnings for regional cooperation exist? Second, were the political incentives for the key players sufficiently aligned to give regional cooperation a fighting chance of succeeding? Third, did the economic conditions exist to make regional cooperation even possible?

Previous successful regional cooperation initiatives, such as the postwar rapprochement of France and Germany, can provide a useful guide to which kinds of institutional, political and economic factors are important for regional cooperation to work. In this chapter, we will regularly refer back to this example.

IV.1 Institutional underpinnings

At least some of the following institutional prerequisites would have needed to be in place for successful regional cooperation:

- A strong outside force or forces pushing countries to cooperate and willing to intervene if necessary
- Some degree of local ownership
- The absence of territorial issues or a realistic path towards solving them
- A functioning political relationship between the countries and a reasonable level of trust among the partners
- Decent institutional and governance standards across all parties

Outside forces

Since the end of the Second World War, the US has maintained a large and active presence in Western Europe in military, political and economic terms, and played an important role in underpinning Franco-German reconciliation and cooperation. In some ways, this is comparable with the role of the EU and the US in the Western Balkans beginning in the mid-1990s. Both were strong outside forces with a clear commitment to the region, and each of them sought to use their strengths to play a stabilising role and to push for regional cooperation. What's more, starting in the late 1990s, the EU and the US also put in place a series of important institutional structures to foster and drive regional cooperation.

The different roles of the two outside actors has been characterised as an EU 'carrot' and a US 'stick'. The former provided incentives, with eventual EU accession being the major one, but also other economic and financial support. Meanwhile, the US ensured security and played the role of 'bad cop', when necessary. The US played a decisive role, for example, in bringing the conflict in Bosnia and Herzegovina to a close

with the Dayton Agreement in late 1995 and by bombing Serbia in 1999 to get it to end the war in Kosovo. This division of labour continues in more or less the same form to this day.

From the outside, the EU and the US have sought to push for greater cohesiveness across many fields (political, economic, social, cultural, etc) within the region. The thinking behind this has been that countries will be forced to cooperate and become more economically integrated with and dependent on each other, and that the geography of animosity would be reduced over time and therefore make EU accession possible. According to this logic, the appeal of EU accession would be so powerful for elites in the Western Balkans that it would change the internal political dynamics of the countries in the region, and eventual EU accession would make these changes in dynamics permanent.

Although the EU's military role cannot be compared to that of the US, it has had an important political role to play, particularly in maintaining post-conflict stability and in providing mediation on issues that did not involve any significant territorial dispute. Mediation in Albania after the 1997 civil war, the secession of Montenegro from Serbia in 2006, and the resolution of the name dispute between North Macedonia and Greece can probably be viewed as the main political successes of the EU in the Western Balkans over this period. In the case of Kosovo, the EU was partly successful both in maintaining stability within the country and in securing the decision of the International Court of Justice on Kosovan independence.

Local ownership

Although the US role in postwar Europe has been key in terms of fostering Franco-German cooperation, local ownership of the process and the 'buy-in' of elites in the two countries has been crucial to the effective implementation and eventual success of the initiatives. In the Western Balkans, as well, regional cooperation has never been entirely driven from outside. For example, the South-East European Cooperation Process (SEECP),[5] launched by Bulgaria in 1996, marked a continuation of the initial ministerial conferences of the Balkan countries during the late 1980s, which had ceased during the Yugoslav wars. These conferences resulted in the Sofia Declaration, with its commitment to maintaining borders and security cooperation. In addition to looking forward to regional cooperation in terms of infrastructure, telecoms and trade, the SEECP was also part of the region's attempt to rebrand itself, so to speak, following the wars of the 1990s and to promote a more positive image to the rest of the world.

However, it wasn't long before the momentum of the SEECP initiative stalled. One contributory factor was the growing impression in some Balkan countries that their commitment to regional cooperation might ultimately come at the expense of their EU accession ambitions. Croatia and Slovenia participated as outsiders, while North Macedonia did not attend due to its dispute with Greece over its name. Bulgaria and Romania vetoed a Greek proposal to establish a permanent secretariat because they worried it would delay their EU accession process.

Since 2008, there has been a much greater sense of local ownership of the process of regional cooperation. In that year, the Regional Cooperation Council (RCC) become operational. The RCC has 46 participants, including the aforementioned Western Balkan Six, other countries from the region (including Bulgaria, Croatia, Greece, Romania, Slovenia and Turkey), the EU, the US, the UN and various other international organisations and countries. Its

5 Launched by Bulgaria, the SEECP also included Albania, Bosnia and Herzegovina, Greece, North Macedonia, Romania, Serbia and Montenegro, and Turkey. Croatia, Moldova, Montenegro (as an independent state), Slovenia and Kosovo joined later.

role has been to coordinate the various regional cooperation initiatives that have been launched.

In addition to the RCC and SEECP, many other 'locally owned' regional cooperation initiatives are present in the region. Indeed, the period since 2008 has seen a "flourishing of regional initiatives, networks, task forces, and projects" (Minic 2018). Bechev, Ejdus and Taleski (2015) propose an additional useful framework in this context, categorising the regional cooperation initiatives according to whether they are externally or locally owned, but also according to whether they are top-down or bottom-up. Even when supported by the EU, these organisations are locally managed and directed (Minic 2018). The locally owned, bottom-up initiatives are a particularly positive development, as they indicate that there is an actively engaged group of citizens in the Western Balkans who are keen to take ownership of regional cooperation not only from outsiders, but also from their own 'elites'.

At the elite level, there have also been some important steps. Prompted above all by Montenegro, the Western Balkan countries teamed up to form the Western Balkans Six in 2013. The initiative was formally launched at the London-based European Bank for Reconstruction and Development (EBRD) in February 2014. Croatia, which had just joined the EU, also participated. The Western Balkans Six format exists within the wider SEECP. However, the meetings of all six prime ministers in this smaller format was seen as important given their stronger set of overlapping interests. What's more, in May 2014, the Parliamentary Assembly of the SEECP was formed (although the SEECP had had a parliamentary dimension since 1997) in order to foster more cooperation among the individual state parliaments (Bechev, Ejdus and Taleski 2015).

Initially, it was announced that there would be a Multi-annual Action Plan (MAP) on a Regional Economic Area (REA) in the Western Balkans, which was put forward at the Trieste Summit of 2017 and endorsed by the leaders of the Western Balkan Six. The MAP was coordinated by the Regional Cooperation Council (RCC) in response to a request by the six leaders and in cooperation with the European Commission (Regional Cooperation Council 2017). The idea was to remove barriers to enable the free flow of goods, services, capital and 'highly skilled' labour, to achieve digital integration, and to introduce standardised rules for businesses.

The EU's support for this effort was reaffirmed with the adoption of a Digital Agenda for the Western Balkans in June 2018, and for the REA in general at the Western Balkans Summit held in London in July 2018 (European Commission 2018). In a press release following the summit, the European Commission specifically mentioned upgrading digital skills, ways to mobilise non-banking financing for SMEs and startups, the energy transition (including better mobilisation of hydrocarbon resources), and a new guarantee instrument worth up to EUR 150 million for the 2019–2020 period. This guarantee instrument aims to leverage investments of up to EUR 1 billion in a range of sectors in an attempt to improve access to finance in the region.

This was followed in the second half of 2019 by the plan for a 'mini-Schengen' comprising Albania, North Macedonia and Serbia. Unlike with the MAP for the REA, Kosovo refused to take part in the 'mini-Schengen', while Montenegro and Bosnia and Herzegovina had not yet made a decision regarding whether to participate. However, even before the outbreak of the coronavirus pandemic, there was a sense that this initiative had lost its momentum (Maksimović 2020).

Territorial issues

The wars in the former Yugoslavia ended with a host of territorial disputes and constitutional issues within the successor states. Among the Western Balkan countries, only North Macedonia did not have any unresolved border disputes with the other former Yugoslav countries, but it did have serious disputes with both Greece and Bulgaria regarding its name. These unresolved territorial and constitutional issues lie at the heart of the geography of animosity, and they represent quite an important difference from the situation in postwar Western Europe. In this sense, the Western Balkans in the early 2000s is more comparable to France and Germany after the First World War. Unlike in Western Europe after the Second World War, there wasn't any final defeat and/or unconditional surrender of one of the parties in the Western Balkans.

Political relationships and trust

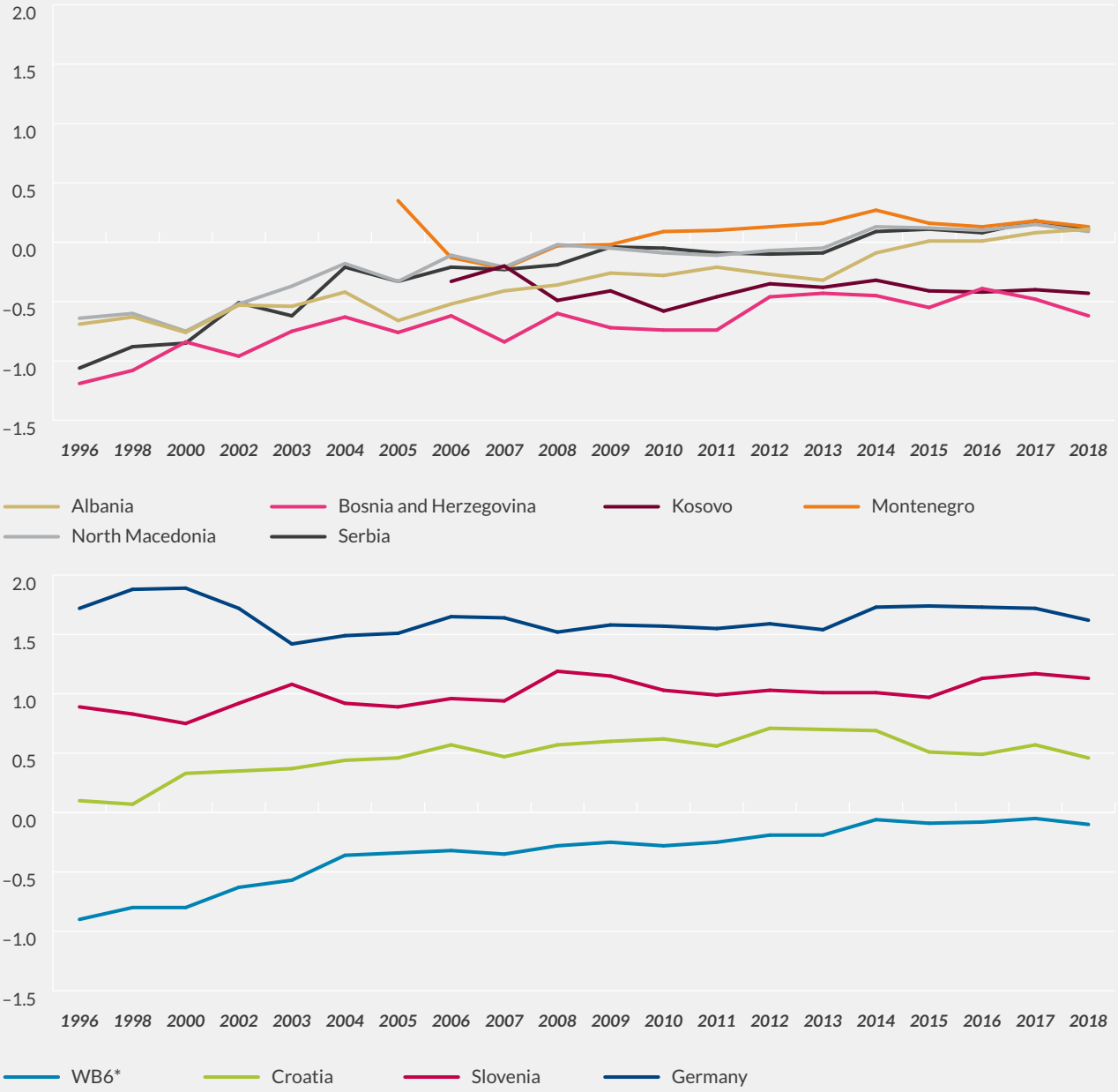
One of the really challenging issues in terms of solving the geography of animosity via regional cooperation has been getting local elites to buy into this process. In Western Europe after the Second World War, elites in both France and Germany played an important role in ensuring the success of cooperation between the two countries. Unfortunately, this has so far not been the case – or at least not to the same extent – in the Western Balkans. Gligorov (2008) has written that Balkan states have a "weak political will and weak inclination for regional cooperation". Bechev, Ejdus and Taleski (2015) reached a similar conclusion, stating that regional cooperation has a low level of priority for politicians in the region. No matter what the EU has done, it is clear that this reality has had the potential to seriously undermine regional cooperation initiatives in the region.

Institutional and governance standards

A decent level of state capacity is a prerequisite for interstate cooperation and, by extension, regional cooperation. Moreover, even when the political will exists, a reasonable level of institutional and governance standards is required to ensure that the decisions taken are also actually implemented. This is especially important when the decisions are politically difficult, such as when making compromises with a recent enemy. By contrast, persistent animosity between states, like the one that has been present in parts of the Western Balkans over the last two decades, can be viewed as lending support to autocratic and non-democratic regimes.

The particular weakness of governance and institutions has been identified as a barrier to economic recovery and political normalisation immediately after the wars of the 1990s (Gligorov, Kaldor and Tsoukalis 1999). Below, we use the World Bank Worldwide Governance Indicators to assess governance standards in the Western Balkans over the past 20 years. It can hardly be argued that governance standards were of a high standard in any of the Western Balkan countries, nor can that be said to be the case today (see Figure IV.1). This is likely to have impeded regional cooperation efforts.

FIGURE IV.1 **World Bank Worldwide Governance Indicators; Government effectiveness score; 2.5 = best, –2.5 = worst**



Source: World Bank. *WB6 = simple average of all 'Western Balkan Six' countries for which data was available in each year. | **© Bertelsmann Stiftung and wiiw.**

IV.2 Alignment of political incentives

At least some of the following political incentives to cooperate would have had to exist in the Western Balkans in the early 2000s for regional cooperation to have succeeded:

- The countries pursuing regional cooperation should be a unified group.
- All players (but especially the big ones) need to feel they are getting something important out of this cooperation and, crucially, something that they can 'sell' to their populations to justify having to cooperate with (in many cases) a recent enemy.
- An outside threat (as the USSR was perceived to be in Germany, France and other countries by the late 1940s).

Unified group

The idea of European integration has a long history in Western Europe and, as a result, those pushing for the rapprochement of France and Germany after the Second World War had an extensive intellectual and emotional legacy to fall back on. On the other hand, there is no real equivalent to the 'European idea' for the Western Balkans in a way that would include the whole region in efforts to foster regional cooperation.

During the last two decades, there have really only been two things that defined the Western Balkan countries as a distinct group. First, they had a theoretically realistic EU 'accession perspective', as defined in Thessaloniki in 2003. This distinguished them from other countries, such as Georgia, Moldova and Ukraine. Second, they had not (and still have not) yet joined the EU, which distinguishes them from Bulgaria, Croatia and Romania.

Otherwise, it is very difficult to say what defines these countries as a group. Albania was not part of Yugoslavia, and neither Albania nor North Macedonia has significant border conflicts within the region. Furthermore, the geography of animosity essentially connects three countries: Bosnia and Herzegovina, Kosovo and Serbia, with Albania being indirectly involved via its relationship with Kosovo. While both Serbia and Montenegro have started EU accession negotiations, an agreement to begin talks with Albania and North Macedonia has also been taken. But Kosovo and Bosnia and Herzegovina will probably have to wait at least a few more years. Together, this makes having a single regional cooperation template – whether imposed from outside or generated internally – quite awkward.

In this context, the relationship of the Western Balkan countries with the EU has been defined as a "broken cobweb" (Gligorov 2004). The EU is the centre of the cobweb, with the Western Balkan countries arranged around it in a 'hub-and-spoke' model. However, the spokes are not all equal, and neither are the connections between the countries around the hub. While some Western Balkan countries have cooperated and enjoyed stronger ties with each other, others have effectively not had any relationships at all in economic and political terms.

Benefits for all

It is by no means clear that all countries involved have felt like they would enjoy any significant benefits from regional cooperation. There are four key reasons for this:

First, countries that were more advanced economically (e.g. Croatia) would almost certainly feel held back by the less developed countries and/or those engaged in bilateral regional conflicts. As Figure IV.2 shows, the Western Balkan countries were and continue

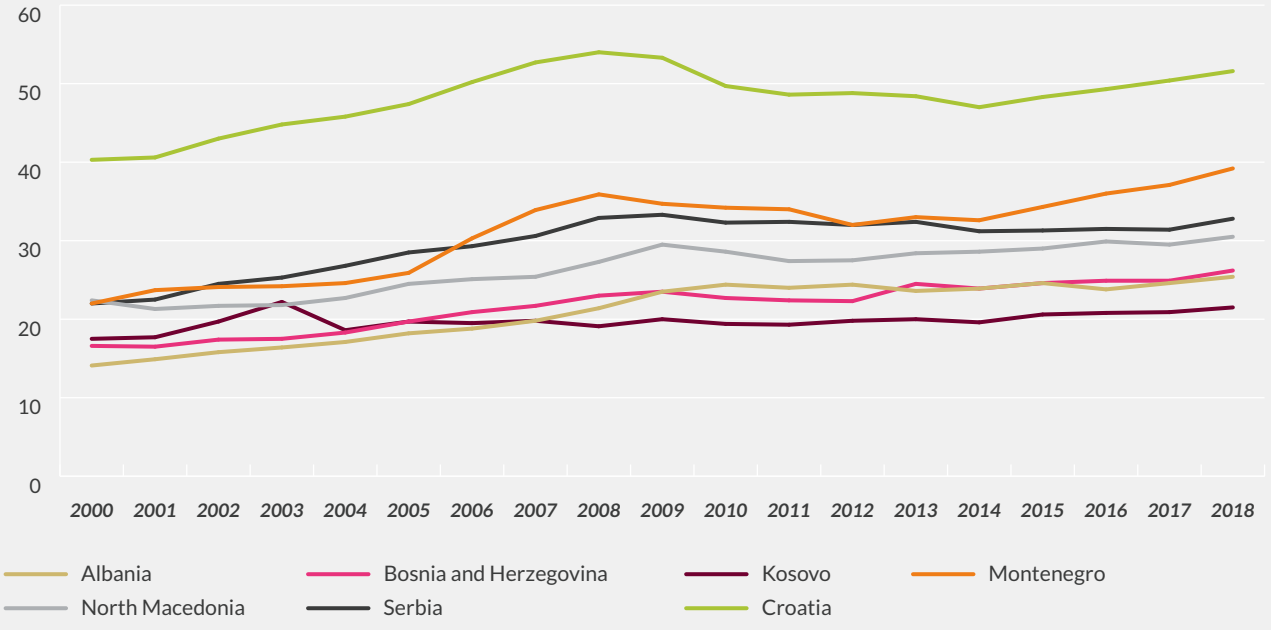
to be at quite different stages of development. This was especially the case as long as Croatia was involved in regional cooperation. In 2000, Croatia's GDP per capita was 40 percent of the German level, compared with around 17 percent for Kosovo and Bosnia and Herzegovina. After Croatia 'graduated' out of regional cooperation by becoming a member of the EU in 2013, the differences in economic development levels have become less stark. However, they have grown somewhat over time. In 2018, Montenegro's GDP per capita was around 40 percent of the German level, compared with 33 percent for Serbia and 22 percent for Kosovo.

Second, Serbia's total nominal GDP has generally been roughly the same as the combined total of the other five countries in the Western Balkan Six throughout the last two decades, and it has had better opportunities for integrating outside the region than its peers have. Therefore, as long as Serbia isn't given some kind of leading/dominant role within a system of regional cooperation, its incentives to cooperate would naturally be lower than those of the other five countries.

Third, those countries that did not have serious bilateral disputes with others in the Western Balkans and were not directly involved in the geography of animosity would also naturally see the rationale for and benefits of regional cooperation differently. This particularly applies to North Macedonia and Montenegro.

Fourth, for both elites and the general population, it would be quite natural to prioritise EU accession over regional cooperation. The potential for EU funds (for governments), investments by major Western companies (for firms), and the opportunity to travel, work and live in Western Europe (for ordinary citizens) would naturally be very attractive. There has therefore always been an inherent tension between regional cooperation and the bilateral

FIGURE IV.2 **GDP per capita, PPP, Germany = 100**



Sources: National sources, Eurostat, wiiw. | **© Bertelsmann Stiftung and wiiw.**

process of EU accession. In fact, this is a procedural shortcoming of the EU integration process in the Western Balkans: While requiring regional cooperation, it not only relies on, but also fosters competition among the candidate countries through bilateral negotiations and evaluation of their progress.

Outside threats

The Western Balkan countries have experienced many (real and perceived) outside threats over the last two decades. However, these have not been the same for each country.

Different countries have had different views of the EU as a security provider working in parallel with NATO. However, this can mainly be attributed to dynamics within the region rather than to what any outside actors have actually done. For Montenegro and North Macedonia, and previously for Slovenia and Croatia, the EU has been a source of security in an internal constitutional sense as well as a protector from external foes.

On the other hand, Russia has often been perceived as a threat, even though Serbia and Republika Srpska, the Serb entity within Bosnia and Herzegovina, have viewed it as a friend. North Macedonia has seen Greece and Bulgaria as a threat. Croatia has had serious territorial issues with Slovenia. But at no point has there been a single, feared, outside enemy that all of the countries shared in common and that could mitigate the importance of local antagonisms in the way that the USSR was for France and Germany beginning in the late 1940s.

IV.3 Economic fundamentals

Building on the European Coal and Steel Community (ECSC) example, and taking into account the Western Balkan context of the early 2000s, we define the prerequisites for effective regional cooperation in the Western Balkans in an economic sense as follows:

- The proposed economic area should be of a sufficient size and level of economic development to make the participants feel that the potential upside is significant and worth whatever political capital has to be spent to make it work. It should also be attractive enough to remove the incentive to prioritise economic integration outside the region.[6]
- Trade and investment among the parties should be below historical levels, meaning that there should be a high level of potential for increased intraregional trade and investment.
- The participants should have roughly similar shares of intraregional trade and investment compared to these shares outside the region.
- There should be some degree of complementarity in terms of production structures.
- The participants should have similar priorities in terms of economic development and their willingness/ability to coordinate policy.
- There should be proper transport, energy and other infrastructure connectivity or at least the means and desire to create this.

6 The parallel here is with the UK in the late 1940s. There were various reasons why the UK didn't join European integration at the start. But, in economic terms, it was because its main economic ties were not with the rest of Europe, unlike the case with France and Germany (and the smaller countries, such as Belgium and Luxembourg).

- There should be concomitant strong growth in the regional and global economies, as taking difficult political steps is easier when wider economic conditions are supportive.

Trade and investment relative to historical levels

The conflicts of the 1990s caused a breakdown of trading relationships, which meant that there was much potential for increased intraregional trade in the short term. However, beyond this immediate effect, the upside for regional trade and investment integration at the start of the 2000s was limited. Even if all the old links could have been quickly re-established – which, admittedly, is hardly realistic after an armed conflict – this would not have generated much extra economic growth or rising prosperity compared with increased trade and investment with those outside the Balkans and especially with Western Europe. Various studies (e.g. Christie 2001; Damijan, de Sousa and Lamotte 2009) have shown that intraregional trade was already at or even above potential in the early years of the 2000s, whereas trade with the rest of the world was often far below potential.

Size and level of economic development

The regional cooperation economic area of the Western Balkans was not very big or economically developed, and especially not in comparison with Western Europe. Including Croatia, the Western Balkan Seven had a nominal GDP equivalent to 3.3 percent of that of Germany in 2000, and only 0.7 percent of what would become the EU28. Excluding Croatia, the respective figures for the Western Balkan Six were 2.2 percent and 0.5 percent in 2000. In per capita terms, the region's level of economic development was also very low relative to Western Europe. In 2002, no country in the Western Balkans apart from Croatia had a GDP per capita of more than 22 percent of the German level in PPP terms (i.e. adjusted for local costs).

In this context, the expected gains from regional economic integration were understandably not very high. With the exception of tourism in Croatia and Montenegro, few industries in any of the countries were at an advanced stage, which further limited the potential for cross-border trade and integration. In just a very few cases, the potential upsides from increased regional economic integration were attractive enough to avoid prioritising integration outside the region for those that were in a position to do so.

This point particularly applies to Serbia, which has integrated quite extensively into the German and Italian manufacturing clusters over the past two decades at the expense of regional economic integration. Serbia has also signed a free trade agreement (FTA) with the Eurasian Economic Union[7] and, more recently, it has started to attract larger amounts of Chinese investment and other forms of foreign capital. In addition to making regional economic integration more difficult, greater economic integration with China and Russia are also likely to make eventual EU integration much trickier. This is not because investment from China or Russia is problematic per se, but because the type of money coming from these sources (e.g. investment in natural resources and loans for infrastructure) can go against various EU rules and thereby complicate the adoption of the acquis.

Shares of trade and investment within/outside the region

The split between intra- and extraregional trade and investment among the Western Balkan countries varies widely. Although the data for

7 Signed in late 2019, this FTA replaced existing FTAs with Russia, Belarus and Kazakhstan. In order to join the EU, Serbia would have to give this up.

2000 are very piecemeal and likely to have been strongly affected by the recent conflicts, we have a fuller picture beginning with the data for 2005. At this point, the two smallest and most closed economies in the region – namely, those of Montenegro and Kosovo – both conducted a large share of their trade within the region. In that year, Kosovo sent 51 percent of its exports to other Western Balkan countries, and Montenegro 41 percent. However, the analogous figures for the other countries were much lower: 7 percent for Albania, 17 percent for Bosnia and Herzegovina, 23 percent for Serbia, and 26 percent for North Macedonia.

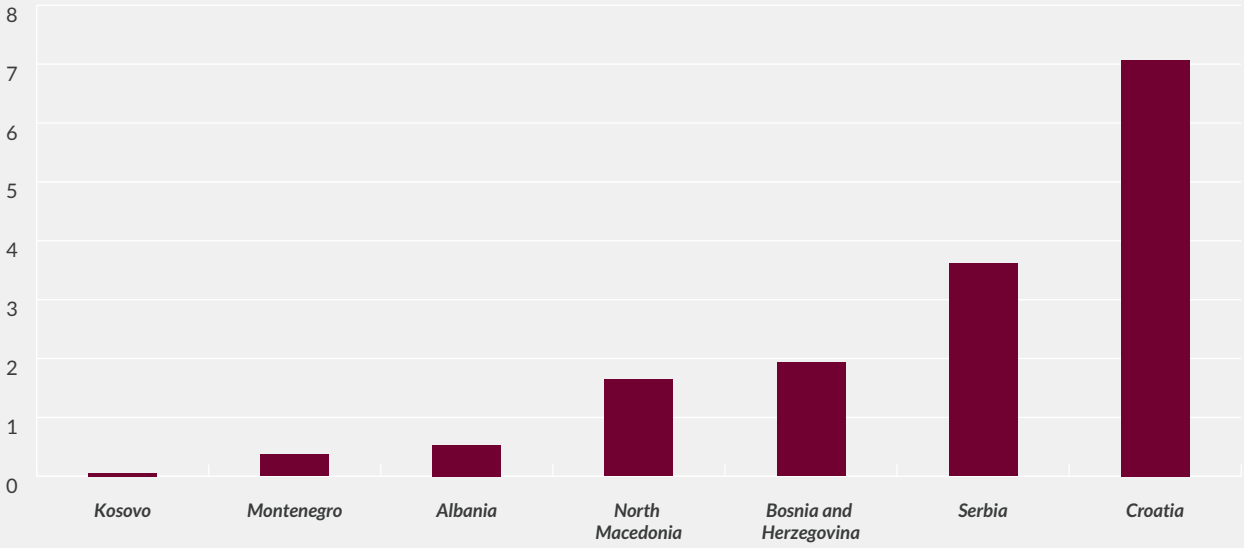
Even for Kosovo and Montenegro, the most likely explanation for the high share of intraregional trade is that they didn't really trade much with anyone and had few industries capable of exporting outside the region. For example, Kosovo's total exports in 2005 were worth EUR 56.3 million and Montenegro's EUR 369.3 million, compared with EUR 3.6 billion for Serbia (Figure IV.3).

Data on intraregional foreign direct investment (FDI) in the Western Balkans in the early 2000s are quite limited. As of 2005, data are available for Albania, Bosnia and Herzegovina, North Macedonia and Serbia. These data show that only a tiny share of the total inward FDI stock originated from the rest of the Western Balkans (Figure IV.4). For all Western Balkan countries, the only realistic source of large-scale FDI at this point was from outside the region and particularly from the EU.

Complementarity in production structures

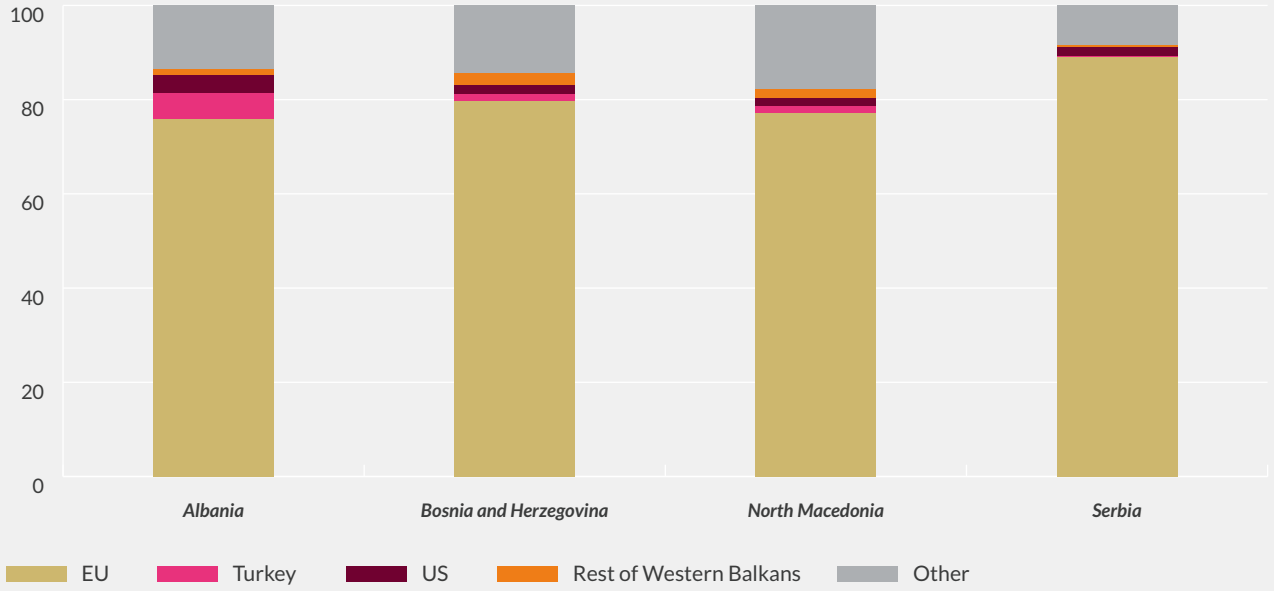
A lack of diversity in production structures could be a serious problem when attempting to create a regional economic area including several countries. If the countries are underdeveloped and produce by and large the same low-end final products or raw materials, there will be little trade or other cooperation between them.

FIGURE IV.3 **Total exports, EUR bn, 2005**



Source: wiiw. | **© Bertelsmann Stiftung and wiiw.**

FIGURE IV.4 **FDI inward stock by source, percentage of total, 2005**



Source: wiiw. | **© Bertelsmann Stiftung and wiiw.**

There is some evidence for a complementarity of production structures in the Western Balkans in the early 2000s. It is certainly not correct to say that they all produced the same things; as mentioned, the countries had different comparative advantages. However, there was no obvious anchor in terms of economic structure for regional cooperation that could be compared to coal and steel for France and Germany in the postwar period. At that time, France wanted cooperation because its steel industry needed coal and a market to export to, and Germany was willing to engage in cooperation to remove the political obstacles to production (Petzina, Stolper and Hudson 1981).

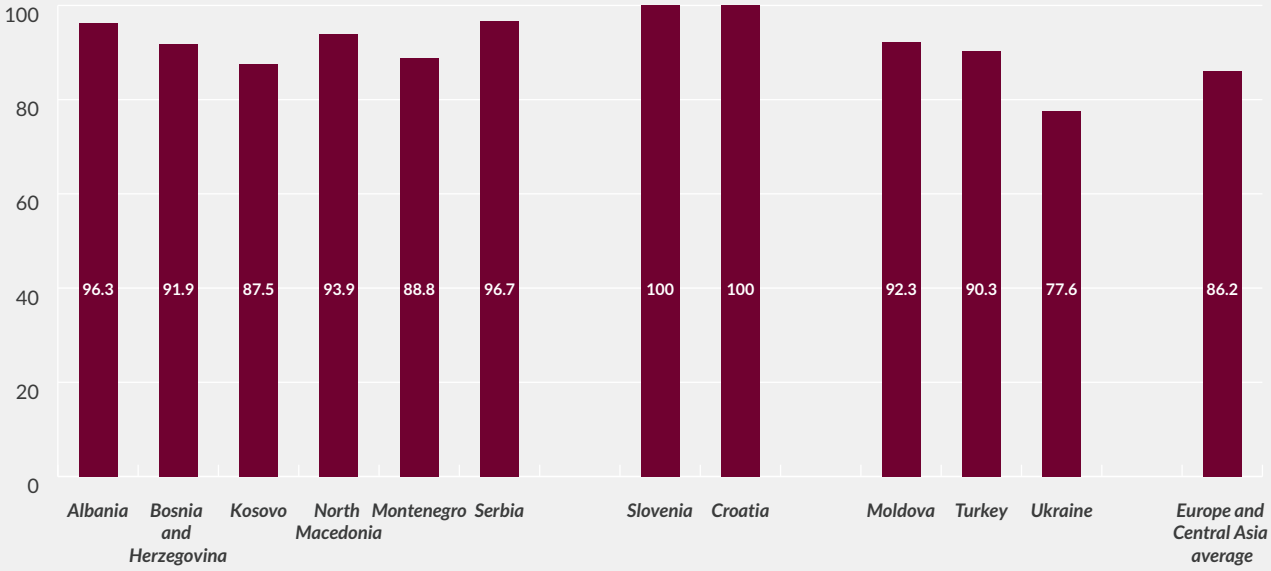
However, even if production structures are theoretically complementary, integration can be impeded by tariff and non-tariff barriers. As Levitin and Sanfey (2018) point out, although there has been some progress recently, "significant trade barriers exist" in the Western Balkans, and "customs and trade regulations are a major problem for many exporters". Kaloyanchev, Kusen and Mouzakitis (2018) found a significant and negative impact of non-tariff trade barriers. Moreover, Damijan, de Sousa and Lamotte (2009) showed that firms exporting within the region – at least to the less competitive parts – could see a negative impact on their productivity growth.

The World Bank's "Doing Business" ranking sub-component for trading across borders provides some further insight into barriers to trade for the Western Balkan countries (Figure IV.5).[8] Taken together, the data suggest the following conclusions:

- First, barriers to trade for Western Balkan countries, in terms of both time and cost, are considerably higher than for Slovenia and Croatia (and EU members in general).

8 These data do not allow for differentiation between intra- and extra-Western Balkan trade.

FIGURE IV.5 **Trading across borders score (max = 100), from the World Bank's "Doing Business" indicators**



Source: World Bank. | **© Bertelsmann Stiftung and wiiw.**

- Second, using Croatia as a benchmark, on average for the other Western Balkan countries, the biggest problem, both in terms of time and cost, is border compliance for imports.

- Third, the restrictions on trade for Western Balkan countries are often at least as high, if not higher, than those for some comparable non-EU members, such as Moldova, Turkey and Ukraine, although in most cases, the Western Balkan countries have lower restrictions on cross-border trade than the averages for Europe and Central Asia.

- Fourth, there is significant differentiation within the region. Trading conditions are generally better for Serbia and worse for Kosovo (and to a certain extent Montenegro). This may reflect Serbia's increased specialisation in the production of autos and automotive parts, its integration into global value chains and, consequently, the greater efforts its policymakers make to ease restrictions on trade. The relatively more closed nature of the economies of Kosovo and Montenegro (at least in terms of goods) may explain the tougher trading conditions there, as it is less of a priority for policymakers.

Economic development priorities and policy coordination

At the start of the 2000s, the Western Balkan countries had marked differences not only in terms of their respective levels of development, but also in terms of economic specialisation and, in some cases, development priorities. Indeed, conditions like those that existed between France and Germany after the Second World War, such as their overlapping interests in terms of economic development priorities, cannot really be said to have existed in the Western Balkans in the last 20 years.

However, most countries have increasingly specialised in their areas of comparative advantage, which is not a barrier to regional cooperation. Instead, these different production structures can be seen as complimentary. Albania, Croatia and Montenegro all have comparative advantages in tourism, while landlocked Serbia and North Macedonia have followed a development path based on manufacturing exports. Both have integrated into the German manufacturing core, albeit at a relatively low-value section of the production chain in the case of North Macedonia, in particular (Gligorov 2017). The exception is Kosovo, which has an extremely closed economy with little international integration except in terms of remittance inflows from citizens working abroad.

The real issue here is not that the economies have been similarly specialised or have had necessarily different developmental priorities. Instead, it relates to policy coordination within the context of regional cooperation. As economies become more integrated with each other, it produces 'agglomeration effects' – meaning that wealthy areas attract capital and skills, and poorer areas lose out. There is some evidence that this effect persists over time, causing ever-wider regional disparities and requiring a high degree of policy coordination and intervention to address it. For example, this is a huge problem in the EU (Graebner et al. 2018). For regional cooperation to have truly worked, policy coordination would have been required. However, for political but also other reasons, policy coordination has been very limited in the Western Balkans during the period studied here.

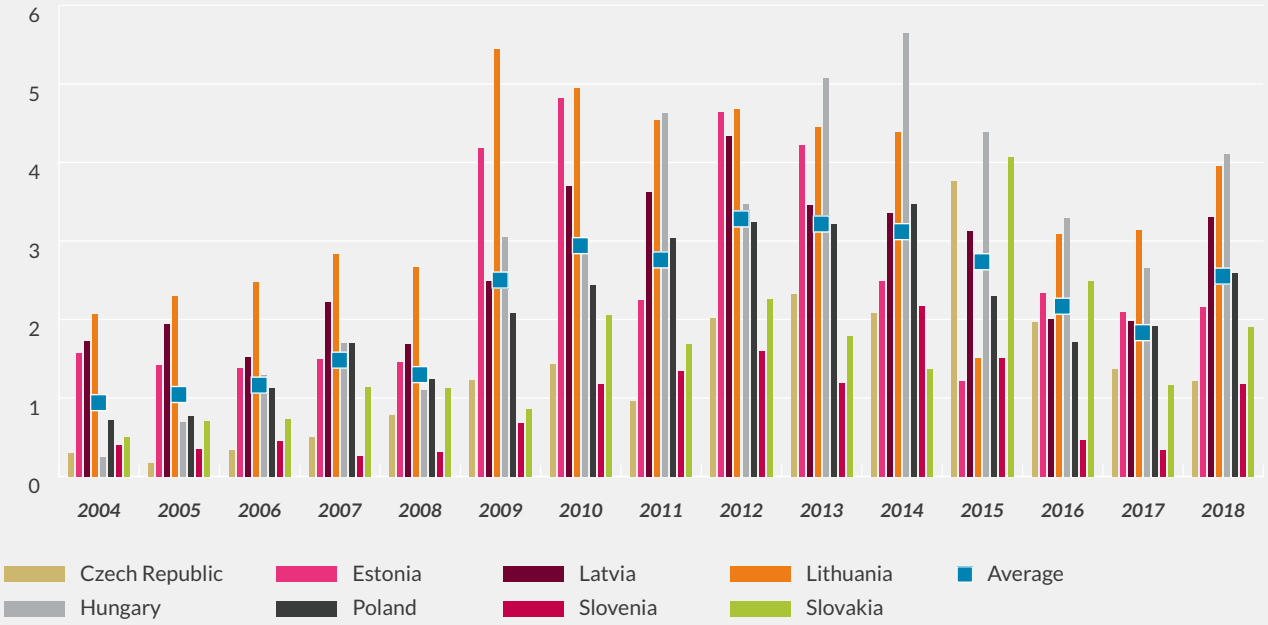
Exchange rate misalignments and the risks of devaluation due to shocks are part of the reason for the historically weak regional trade integration. Meanwhile, fiscal policy coordination is still far off. There are several reasons to better coordinate fiscal policies in the region: first, to support trade liberalisation, as strong tax competition can significantly reduce the impact of lowering tariffs; second, to decrease distortions and rent-seeking by firms (as a simplified and more transparent tax system in the Western Balkans could help to reduce resource misallocation); and, third, to potentially reduce the size of the informal economy. Indeed, the informal economy is often helped by opportunities to exploit differences in fiscal policies. In any case, fiscal policies are difficult to coordinate. This can even be seen in the EU, where tensions regularly emerge over fiscal policy both between member states and between individual member states and the European Commission.

Connectivity

Even compared with most of the rest of Eastern Europe, connectivity in the Western Balkans has been weak for at least a couple of centuries (Holzner 2015). As it does almost everywhere else, infrastructure development mirrors political developments in the Western Balkans. However, this has often been most problematic within rather than between countries in the region. In infrastructure terms, as in much else, most Western Balkan countries are oriented outward rather than inward.

Croatia, for example, has historically suffered from bad internal connections, which is a legacy of the Austro-Hungarian Empire. Thus, Istria is connected to Italy, but has not been well connected with Zagreb. The Dalmatian hinterland has also been difficult to reach from other parts of the country. In some cases, the connections between the different states of Yugoslavia were better. The key transport route in the region roughly followed that of the old Orient Express, starting in Thessalonica and then winding its way through Skopje, Belgrade, Zagreb and Ljubljana before heading up to Munich. However, there have been disruptions since 1991, such as the train connections from Split to Belgrade, and many of these connections have not been re-established.

FIGURE IV.6 **Net inflows from the EU budget, as a percentage of Gross National Income**



Source: European Commission. | **© Bertelsmann Stiftung and wiiw.**

Financing options to try to overcome these poor connections were limited at the start of the 2000s, not least because the Western Balkan countries only had limited access to EU funds relative to the CEE member states, where net inflows in some recent years have been more than 5 percent of gross national income (GNI; Figure IV.6).[9] In fact, in the formerly communist countries that joined the EU beginning in 2004, EU funds have financed the majority of public infrastructure spending.[10]

Growth in the regional/global economy

All else being equal, strong growth in the European and global economies would have been supportive of regional cooperation efforts in the Western Balkans. This would have filtered through to the Western Balkans in various ways, including export demand, tourism and various types of capital inflows (e.g. remittances, FDI, etc). This, in turn, could have made it easier to demonstrate the benefits of regional cooperation and to force through politically difficult decisions to integrate the region's economies.

This supportive backdrop existed at the outset of the period covered in this paper. In the 2000–2007 period, global real GDP growth was around 4.5 percent, compared with an average of 3.5 percent for the 1980–2019 period. In the last four decades, the best three years for the global economy have been 2004, 2006 and

9 The European Commission publishes this data as a share of GNI rather than of GDP. GNI is GDP plus income earned abroad in any year by a nation's citizens and firms. For most countries, the difference is quite small. The main exception is when a particularly large share of a country's production is owned by foreigners, with the famous example of this being Ireland.

10 A more extensive look at infrastructure investment in the Western Balkans is provided in Chapter V.

2007. However, since the global financial crisis of 2008/2009, real GDP growth in the global economy has been much weaker. Much of the Western Balkans effectively experienced a 'lost decade'. Under these conditions, not only has regional cooperation been more difficult in general, but the incentives for economic integration within versus outside the region have also changed. With domestic demand in many parts of the Western Balkans – including, most crucially, in Serbia – effectively flatlining for almost a decade, the incentive to prioritise economic opportunities outside the region have gone up even more, with the regional economies trying to adapt as price-takers to the vast EU market.

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V. The EU strategy for economic integration: Implementation and results

As Chapter IV has outlined, the institutional, political and economic obstacles to regional cooperation in the Western Balkans (as the EU intended it) have been substantial. Therefore, in economic and financial terms, the EU would have to offer a whole lot – in terms of incentives and support – to achieve a level of regional economic cooperation and integration that could surmount these political and institutional hurdles.

In the early 2000s, policymakers, the think-tank community and other stakeholders had an intense debate about how to achieve regional cooperation in the Western Balkans in an economic sense. Two main approaches were discussed.

First, some pushed the idea of focusing on stronger economic integration within the region, specifically with a regional free trade agreement (FTA) (see e.g. Maur and Messerlin 2001). The argument for a regional FTA was based on the assumption that there was a lot of potential to increase intraregional trade, in part because so much trade at that time went along 'ethnic' lines. This was perhaps not an unreasonable assumption in the context of the early 2000s, as the wars of the 1990s had badly disrupted regional trade flows, and some country pairs effectively did not trade with each other at all.

The second argument was to focus more on integration with the much bigger EU market instead of prioritising specifically intraregional Western Balkan integration (Gligorov 1998; Emerson 2005). It was assumed that there was much greater growth potential for exports to and investment from the EU than within the region owing to the weakness of demand in the Western Balkans and the small size of the markets. Proponents of this idea also argued that trade liberalisation within the Western Balkans would be at least partly offset by policy divergences, different customs regimes and other non-tariff barriers to trade. They probably also felt that such an arrangement would drive a more concrete 'Europeanisation' of the region by transposing EU legislation onto domestic policy agendas. Finally, the importance of borders in the region could only be reduced, according to this thinking, once the Western Balkans were part of a bigger unit (i.e. the EU).

In the end, the EU chose a combination of the two approaches, although the first one – regional integration – was pushed more strongly. In this chapter, we will look at how the EU strategy was implemented and what the results were. Our focus is on trade, investment and infrastructure for two reasons: First, these were the key instruments used by the EU to drive regional economic integration. And, second, measuring progress in these areas will provide us with an answer to the question of just how successful efforts at regional economic cooperation and integration have been.[11]

11 The trade and investment sections of this chapter summarise the results of a longer technical paper (Grieveson, Holzner and Vuksic 2020), which will be published in parallel with this study.

V.1 Trade and investment

In this section, we will address the trade and investment aspects of the EU strategy. There have been a number of regional cooperation initiatives that have contributed to bilateral investment and trade flows between Western Balkan countries. Under these various umbrella arrangements, various bi- and multilateral trade and investment treaties have been initiated in the Western Balkans over the past two decades.

In this section, we will outline briefly what each of these initiatives has entailed before addressing their specific impacts. These initiatives included:

- Bilateral investment treaties (BITs)
- Free trade agreements (FTAs)
- The Central European Free Trade Agreement (CEFTA)
- EU Stabilisation and Association Agreements (SAAs)

All were either implicitly or explicitly part of the EU's regional cooperation strategy. What's more, to our knowledge, this is the first empirical analysis focusing on the BITs in the Western Balkan countries.

Bilateral investment treaties (BITs)

The investment aspect of Western Balkan economic integration has proceeded unevenly. A couple of agreements (i.e. North Macedonia's BITs with Albania and Serbia) entered into force at the end of the 1990s, but momentum did not really pick up until the early 2000s (Table V.1).[12] Currently, Albania has a BIT with every other Western Balkan Six country, but Kosovo only one with Albania. In total, there are 10 BITs in force among the Western Balkan countries.

We applied a structural gravity empirical modelling framework to test whether there is a relationship between BITs and FDI among the Western Balkan Six countries. Such treaties aim to encourage, promote and protect investments between two countries (UNCTAD 2000, 2007). While widely recognised empirical studies have found a strong positive relationship between BITs

12 In contrast, many transition countries in CEE already had BITs in place (with other countries from the same group) by 1995, many entered into force by 2000, and only a smaller fraction did so in the early 2000s.

TABLE V.1 **Bilateral investment treaties in force among Western Balkan Six countries**

	Albania	Bosnia and Herzegovina	Kosovo	Montenegro*	North Macedonia	Serbia
Albania		2009	2005	2004	1998	2004
Bosnia and Herzegovina	2009				2004	2004
Kosovo	2005					
Montenegro*	2004				2011	2010
North Macedonia	1998	2004		2011		1997
Serbia	2004	2004		2010	1997	

Source: CEFTA (http://cefta.int/reports-and-related-documents/). | **© Bertelsmann Stiftung and wiiw.**
*According to the Decision on Proclamation of Independence of the Republic of Montenegro, adopted on 3 June 2006 by the Parliament of the Republic of Montenegro, which defines taking over and implementation of international treaties that have been concluded or joined by the State Union of Serbia and Montenegro and related to Montenegro, which are fully compliant with Montenegro's legislations, Montenegro implements these Agreements and Conventions.

and FDI (e.g. Egger and Pfaffermayr 2004), the evidence is mixed on the whole.[13]

Our results indicate that BITs do not correlate with FDI stock in a statistically significant way for either a broader sample of transition economies or for the Western Balkan countries. We also came up with similar conclusions after testing the relationship between FTAs and inward FDI stock. Although changing trade costs (caused by FTAs) may have affected some investors' decisions to invest or not, the direction of the effect is not pronounced at the aggregate level.

How institutional factors have influenced the effectiveness of bilateral investment treaties (BITs)

The difference in institutional quality between sending and receiving countries can affect FDI flows (see e.g. Bénassy-Quéré, Coupet and Mayer 2007) by influencing how successful BITs turn out to be (Desbordes and Vicard 2009). This is because foreign investors tend to commit for the long term, which makes them worry about whether their rights will be protected over many years (i.e. beyond the current political cycle). If the FDI-receiving country has better institutions, there is a higher likelihood that it will protect these rights over the long term.

This is important in the context of regional cooperation in the Western Balkans. The upgrading of institutional quality and independence is a key part of the EU accession process. This, in turn, can boost the effectiveness of BITs between Western Balkan countries and thereby foster regional cooperation.

Using six World Bank Worldwide Governance Indicators, we performed a regression analysis of the interplay of the institutional quality and BITs in affecting FDI stock.[14] In each case, the scores for the Western Balkan countries were quite similar to each other, whereas the scores for the FDI source countries were on average higher.

We found that BITs have a greater impact when the FDI-receiving country has better institutions relative to the source country. Given that the Western Balkan countries have a low level of institutional quality and that the differences between them are not very big, BITs have been less effective. The implication here is that countries in the Western Balkans could increase the effectiveness of their BITs and possibly attract more FDI if they could manage to implement reforms that enhance the quality of their institutions. This holds true for FDI from countries both within and outside the Western Balkans.

One should, however, stress that the difference in institutional quality between sources and recipients of FDI is not the only factor that may lead to higher effectiveness of BITs and to more FDI in general. As shown by related research, this relationship may depend on the strength of BITs (Frenkel and Walter 2018) or on the prevailing type or sector of foreign investment (Colen, Persyn and Guariso 2016). Finally, the research by Estrin and Uvalic (2014) on the determinants of FDI shows that, after accounting for a broad set of other factors (including institutions), the Western Balkan countries receive less FDI, which the authors interpret as being a long-lasting consequence of the history of conflicts and political tensions.

13 This is why the more recent studies try to look into details of this relationship, e.g. by considering the varying effects of BITs across sectors of FDI (Colen, Persyn and Guariso 2016) or the differences in the strength of BITs as investment-protection mechanisms since BITs are not uniform (e.g. Frenkel and Walter 2018; Dixon and Haslam 2016). While our data does not allow for such detailed analysis, we do check for other factors that may influence the relationship between BITs and FDI, such as institutional development.

14 For this, we used six different indicators available for all countries in our sample over most of the period covered from the World Bank's Worldwide Governance Indicators database: Rule of Law; Control of Corruption; Political Stability and Absence of Violence/Terrorism; Regulatory Quality; Government Effectiveness; Voice and Accountability.

Free trade agreements (FTAs)

Owing to the wars of the 1990s, the first bilateral FTAs arrived in the region relatively late (Table V.2). In 2002, North Macedonia signed separate FTAs with Albania and Bosnia and Herzegovina, while the latter also concluded a deal in the same year with Serbia and Montenegro (which was a single country at the time). Additional deals were signed in the 2003–2006 period.

We analysed econometrically the impact of FTAs on economic integration between the Western Balkan countries. Across the whole sample used in our analysis (including many other non-Western Balkan countries), we found that FTAs generally facilitate trade. All else being equal, an FTA between two countries increases exports by 27.1 percent. However, the impact of FTAs between Western Balkan countries specifically produced a smaller, albeit still clearly positive, effect. All else being equal, Western Balkan FTAs increased regional exports by 13.9 percent.

Still, given the small sample size and brief pre-CEFTA period, our results for the Western Balkans could be affected by other factors. We applied various statistical techniques, including adding the CEFTA period. We found that Serbian exports had a big (and negative) influence on our results. When Serbia was excluded from the regression, we established a much stronger impact of FTAs on regional trade, of almost 70 percent.

Serbia is by far the region's biggest economy, and its exports as a share of GDP increased sharply – more than fivefold – between 1999 and 2018. This came at the same time as Serbian exports to Western Balkan countries as a share of its total exports declined strongly, while its share of exports to the EU increased from 51 to 67 percent. This indicates quite a significant redirection of Serbian exports away from the region and towards the EU (which, as discussed later, was probably at least partially facilitated by the SAA). Therefore, we can say that FTAs have had a strong and positive impact on intraregional trade ties for the five smaller Western Balkan countries. However, for Serbia, the one country that could really expand its exports outside the region, this impact has been negligible relative to increased trade with the EU.

TABLE V.2 **FTAs concluded among Western Balkan Six countries before CEFTA**

Destination	Albania	Bosnia and Herzegovina	Kosovo	Montenegro	North Macedonia	Serbia
Albania		2004	2003	2004	2002	2004
Bosnia and Herzegovina	2004			2002	2002	2002
Kosovo	2003				2006	
Montenegro*	2004	2002			2006	
North Macedonia	2002	2002	2006	2006		2006
Serbia	2004	2002			2006	

Source: DESTA (https://www.designoftradeagreements.org/downloads/). | **© Bertelsmann Stiftung and wiiw.**
*The database does not contain information on these FTAs for Montenegro, as it was part of Serbia until 2006.

Central European Free Trade Agreement (CEFTA)

The 'new' CEFTA[15] included the Western Balkan Six countries, Moldova and three other CEE states that would later join the EU and therefore leave the CEFTA (i.e. Bulgaria, Croatia and Romania). The importance of regional economic integration in the context of preparing for future EU membership was recognised in the preamble to the new agreement.

The 'new' CEFTA came into force in 2007 and formed a free trade zone between its members, with 32 previous bilateral agreements being replaced by a single multilateral agreement. It aimed to rebuild the regional market by facilitating intraregional trade, but it also contained provisions on promoting and protecting intraregional FDI. Among CEFTA's priorities was overall trade facilitation, which especially comprised investment, transparency, technical barriers to trade, sanitary and phytosanitary measures, and arbitration for resolving disputes among members.

In our econometric exercise, we find that CEFTA was much more significant for intraregional trade than the previous FTAs implemented by the Western Balkan countries. Its entry into force was associated with a 37.7 percent increase in exports. However, Serbia again seems to have a special place in our results. When we remove it from the sample, the positive impact of CEFTA on intraregional trade increases to nearly 70 percent.

This result indicates two things: First, all else being equal, and as with the FTAs, CEFTA did not have that much of an impact on trade between Serbia and the rest of the Western Balkan countries. The diversion of Serbian exports to the EU – at least partly because of the SAA – is part of this.

However, the second implication of the results is that CEFTA had a significant and positive impact on intraregional trade for the other countries. Excluding Serbia, the Western Balkan countries did not have very high potential to integrate into European value chains and export more to the EU. Therefore, as stated by Petreski (2018), in addition to being important for boosting members' competitiveness and increasing their cooperation capacities in general, CEFTA played an important role in rebuilding the regional market and helping to increase trade in a way that would otherwise not have been possible for most Western Balkan countries.

One issue with CEFTA – which applies perhaps especially in the Serbian case – is that the agreement was accepted in the region not for the benefits that would come with it, but as an instrument to satisfy the EU's requirements for regional cooperation. In return, the Western Balkan countries expected not only improved prospects of EU accession, but also greater and higher value investment in industry from firms in the EU.

Assessed against these expectations – both accession prospects and extra investment in industry – CEFTA has failed to be rewarded by the EU. In contrast to the original members of CEFTA – the Visegrad countries – it is striking just how minor the presence of bigger (and especially German) multinationals is in the Western Balkans.[16] Although the 'new' CEFTA countries generally receive a similar level of FDI relative to their GDP as the Visegrad countries, this reflects the much lower GDP levels of the CEFTA countries, and the type of FDI received by CEFTA is of a notably lower quality (Hunya et al. 2017). Fiat-Chrysler is perhaps the only genuine top-

15 The original CEFTA had been created in 1992 and involved only the Visegrad countries; hence the name, which makes less sense for a collection of countries mostly in Southeast Europe.

16 This is important, not least because the big multinationals tend to drive a high share of productivity growth and are the main source of technology transfer in CEE countries.

tier EU multinational with a visible presence in the Western Balkans, whereas there are many in the Visegrad countries. This can be interpreted as indicating that CEFTA has failed to overcome the key barriers to greater multinational investment (specifically in small national markets), and that the regional market does not function especially well.

Stabilisation and Association Agreements (SAAs)

When the Stabilisation and Association Process (SAP) for Western Balkan countries was launched in June 1999, there were hopes that it would pave the way for eventual EU accession. The EU designated the Western Balkans as 'potential members' at the Feira Council in 2000, and Croatia and North Macedonia signed the first of the EU's SAAs with the region in 2001. In these years, the SAP became the main instrument of EU relations with the Western Balkans, and all countries of the region invested more energy into EU accession and less into cooperation with each other. The 2003 Thessaloniki Summit, during which the EU reaffirmed the Western Balkans' 'European perspective', was another move in the direction of the 'hub and spoke' model. In 2003, Albania started to negotiate an SAA. In the same year, Croatia became the first SAA country to submit an application to join the EU, followed by North Macedonia in 2004. By this point (at the latest), it was clear that EU accession would be a multi-speed process for the region.

The SAAs provide for free trade in goods as well as quite liberalised conditions for investment. Article 12 of the SAAs provide for cooperation in labour and capital mobility, business establishment rights between SAA signatories, and the liberalisation of trade in services. Along with free trade provisions, the SAAs also cover competition, protection of intellectual property rights, and enhanced cooperation in customs matters. They also include rules on public procurement, legislative 'approximation' (including standardisation), and provisions for services. Furthermore, along with Turkey, the Western Balkan countries participate in a system of 'diagonal cumulation' of origin. This allows exporters in any of the partners to the agreement to use materials from any other partner to then manufacture goods to be exported to the Western Balkans, Turkey or the EU. All Western Balkan countries now apply the same rules of origin. Since 2000, the EU has granted autonomous trade preferences to all Western Balkan countries. Almost all Western Balkan exports enter the EU on this basis without customs duties or quantity limits (with the exceptions being sugar, wine, veal and some fishery products).

It is difficult to separate out intraregional trade and investment developments from the broader integration of the Western Balkans with the EU. In this context, we also looked at the impact of the SAAs on trade, investment and broader economic developments in the region. All Western Balkan Six countries now have such an agreement in place.[17] We find that the existence of SAAs has had a positive impact on inward FDI flows and exports for the Western Balkan countries. However, the impact on the former is much more significant than on the latter.

For countries with an SAA in place (including both Western Balkan and non-Western Balkan countries), all else being equal, the inward FDI stock from the EU is 41.9 percent higher than for countries without such an agreement.[18] For the Western Balkans alone, the impact is even higher, at 46.2 percent.

17 Starting with North Macedonia (in force since 2004), Albania (2009), Montenegro (2010), Serbia (2013), Bosnia and Herzegovina (2015) and, finally, Kosovo (2016).

18 Splitting the Western Balkan countries off from the rest, we found that the coefficients are similar in size, with a slightly stronger relationship between SAAs and FDI for the Western Balkan countries than for the other ones.

These strong and positive results for FDI inflows are unsurprising given the free movement of capital in the EU as well as the comparatively high level of investment protection. The SAAs provide some assurance to foreign investors that the country is on its way to EU membership, and their implementation can be perceived by investors as a sign of strong willingness to implement all the reforms required to become an EU member. These include fully liberalising capital flows and securing a high level of rule of law in general (including on important issues such as property rights and investment protection). FDI interest may also have been influenced by the availability of acquisition opportunities in the host countries, for example through privatisation as part of the post-communist transition process.[19]

We also found that having an SAA or European Agreement[20] in force had a clearly positive impact on external trade. In fact, exports to the EU from a country with an SAA or European Agreement were 70 percent higher than would otherwise have been the case. This reflects the strong reduction in trade barriers during the accession process, accompanied by other reforms potentially improving the competitiveness of countries with SAAs in force. It also reflects the scale and wealth of the EU market relative to those of individual transition countries. However, the impact for the Western Balkans, while still positive, was not as strong as for the sample overall. We find that SAAs have led on average to a 24.6 percent increase in exports for the Western Balkan countries.[21]

19 As stated for the Western Balkans by, for example, Botrić (2010) or Estrin and Uvalic (2014).

20 These were agreements between the EU and the countries from CEE that joined in 2004 and 2007.

21 This positive and significant coefficient of the SAA variable for the Western Balkan countries is in line with the findings of Reiter and Stehrer (2018).

V.2 Infrastructure

In this section, we will address the infrastructure element of the EU strategy. As was the case for trade and investment, we want to look both at what was done and at the impact that it had. In this section, we will also address how the EU strategy complemented or was affected by infrastructure investments from other players, especially those of international financial institutions (IFIs) and China.

Overview of the EU's strategy and its key steps

The Western Balkans have long faced substantial financing constraints, which reflects, among other factors, their political instability, an often-narrow tax base and weak economic growth. Thus, for the funding of large-scale infrastructure projects, the region has been and continues to be greatly dependent on international initiatives. Foreign governments and international institutions have been initiating a myriad of infrastructure investments in the Western Balkans since the late 1990s (Bechev, Ejdus and Taleski 2015). While there were some collaborations launched by the countries in the region in the initial postwar period, Jacobsen (2005) argues that they were "limited to declarations that actually amount to little more than exercises in goodwill". Not a lot has changed since then, and regional cooperation initiatives are still mainly driven by external players (Bechev, Ejdus and Taleski 2015).

The EU's approach to the region has been characterised by a 'stability via connectivity' philosophy. Bechev, Ejdus and Taleski (2015) also conclude that regional cooperation facilitated by infrastructure projects is very popular in the EU and the region. In addition to positive impulses for the economy, it also brings political benefits for domestic politicians. The South East Europe Transport Observatory (SEETO) was established in 2004, and the Energy Community in 2005.

Together with the European Common Aviation Area, they can be viewed as the main regional institutions that have fostered infrastructure projects in the energy and transport sector.

The inception of SEETO in 2004 was a consequence of the EU's efforts to establish the 'indicative extension' of the Trans-European Transport Network (TEN-T) to the Western Balkans. Its objective was to promote cooperation in the development of a multimodal network. Furthermore, it fosters cooperation in the harmonisation of the transport sector with the EU acquis, enhances local capacity for its implementation, collects data and produces analysis of investment programmes. A list of priority infrastructure projects suggested by SEETO was signed in 2015 and 2017 (Holzner and Schwarzhappel 2018). In order to deepen the integration of the Western Balkan region with the EU transport market, the Transport Community Treaty was signed between the EU and the Western Balkans in 2017. As a result, the Transport Community superseded SEETO in an effort to implement common standards as well as to improve network efficiency and safety.

The Energy Community[22] was set up in 2006 to develop a South East Europe Regional Energy Market (SEEREM) with the aim of having it ultimately form part of the wider European energy market (Kennedy and Besant-Jones 2004). Its main objective is to coordinate the implementation and monitoring of the adoption of EU standards in the electricity market. The Energy Community Secretariat's annual implementation report is one of its instruments for assessing the progress made by each contracting party in the various energy sectors.

Various infrastructure cooperation projects were initiated in the early 2000s, including ones that permit smaller groups of Western Balkan countries to cooperate on projects rather than requiring all to agree. These developments have received support from EU programmes, such as the Community Assistance for Reconstruction, Development and Stabilisation (CARDS) programme. Starting in 2007, these efforts have been coordinated under the Instrument for Pre-accession Assistance (IPA), which includes the provision of financial aid with a specific regional cooperation aspect under both 'component I' (transition assistance and institutional building) and 'component II' (cross-border cooperation).

Since 2007, official candidate countries (Albania, Montenegro, North Macedonia, Serbia and Turkey) and partly potential candidates (Bosnia and Herzegovina and Kosovo) have been eligible to receive IPA funding. Country-specific IPA grants allocated to the region amounted to around EUR 3.8 billion in the 2007–2013 period and EUR 4.2 billion in the 2014–2020 period. Countries generally received the equivalent of 0.5 to 1 percent of GDP per year, or a bit more in the case of Kosovo (1.3 to 2 percent). Around one-quarter of these funds are earmarked for infrastructure projects. In general, this amount is significantly lower than the one for the EU member states of CEE.

Western Balkan Investment Framework (WBIF)

To maximise the impact of the IPA's infrastructure funding, grants are usually blended with loans from IFIs through the Western Balkan Investment Framework (WBIF). The WBIF is a joint initiative between the EU, several IFIs[23] and bilateral donors to support infrastructure and private-sector development in the region. For each country, so-called national investment

22 In addition to the Western Balkans, this also includes Georgia, Moldova and Ukraine as contracting parties.

23 The Council of Europe Development Bank (CEB), the European Bank for Reconstruction and Development (EBRD), the European Investment Bank (EIB), the Kreditanstalt für Wiederaufbau (KfW), and the World Bank.

committees[24] identify a list of priority projects. If the project's assessment process is successful, it is supported by an investment loan by one of the participating IFIs and blended with IPA grants, either for technical support or in the form of an investment grant.

Between the establishment of the WBIF in 2008 and the end of 2019, 229 projects were planned and supported by EUR 1.3 billion in grants as well as potential loans worth around EUR 13 billion. Together, these are expected to mobilise more than EUR 21.2 billion in investments after the implementation of all the projects (roughly 20 percent of the combined 2019 GDP of the Western Balkan Six countries). However, the respective contribution of WBIF projects that are completed or in the implementation phase to national economies varies substantially. Investments triggered by WBIF projects as a share of domestic investment[25] range from around 1.1 percent in Kosovo and 1.5 percent in Albania to 7.1 percent in Bosnia and Herzegovina. Nevertheless, these differences can largely be attributed to the fact that many projects are still in the planning phase. This is particularly the case in Albania and Kosovo, where only 26 and 18 percent of the projects, respectively, have reached the implementation phase.

In its first two years, the WBIF granted sizeable loans to finance the construction of the indicative extension of TEN-T roads. More recently, the focus has shifted to rail, renewable energies and pipelines. For example, some major projects include ones related to sections of the Mediterranean and Orient/East-Med rail and inland/waterway corridor, the Cebren hydropower plant in North Macedonia, the Ionian-Adriatic Pipeline (IAP) and an upgrade of the Port of Belgrade.

In December 2017, the WBIF included digital infrastructure as an additional key sector. In this respect, the WBIF will mainly support the deployment of digital infrastructure through technical assistance and the preparation of investment projects. The priorities are to connect 'white zones' (i.e. areas without access to a broadband network) and rural areas as well as to improve digital connectivity of educational, healthcare, municipal and governmental institutions. Since then, the WBIF has approved digital infrastructure projects (mainly broadband development) in each of the Western Balkan countries, though none of these projects has reached the implementation phase yet.

Since the WBIF started operating in 2008, the overall volume of loans granted to the region has increased considerably. Measured in terms of the total worth of the loans granted, the WBIF has now become the largest investor in the region. Levitin and Sanfey (2018) point out that the WBIF has become the main tool for financing regional cooperation projects, particularly those involving infrastructure. Between 2008 and 2018, approximately two-thirds of all the projects receiving funding aimed at improving intra- and interregional connectivity. Developments in road, rail, gas and electricity networks constitute the largest share of WBIF cross-border projects.

Berlin Process

The Berlin Process, initiated by Germany in 2014, is an intergovernmental initiative linked to the future accession of the Western Balkan Six to the EU. Two of its main objectives are to intensify regional cooperation and to increase prosperity through sustainable economic growth. The latter is expected to be achieved via strengthened transport and energy infrastructure as well as the more efficient use of EU pre-accession funds (Holzner 2016).

24 These are usually composed of line ministries, other central non-ministerial institutions, bilateral donors, the European Commission and the IFIs (as observers).

25 Cumulative gross fixed capital formation from 2008 to 2020; source: Eurostat.

In order to support this initiative, the European Commission announced the Connectivity Agenda in 2015 and set aside an extra EUR 1 billion from EU pre-accession funds, which in turn are is supposed to leverage a total of EUR 4 billion in key infrastructure investments. Priority infrastructure projects related to the Connectivity Agenda have generally been signed during the annual Western Balkan Summits. Between 2015 and the end of the summit held in Poznan in July 2019, EUR 881 million in grants had been pledged under the Connectivity Agenda. So far, the Connectivity Agenda has had a bias towards transport infrastructure, both in terms of the number of projects (32 transport, 7 energy) and the financing volumes. However, as Holzner (2016) notes, EUR 1 billion in grants between 2015 and 2019 for co-financing infrastructure projects is rather modest when compared to the EU's structural funds. For example, Romania, whose population is almost as big as those of the Western Balkan Six combined, has had access to funds for transport and energy infrastructure that were six times as large for a similar period of time.

Another initiative that has also been pushed during Western Balkan Summits and is strongly related to infrastructure and connectivity is the Digital Agenda for the Western Balkans, which was launched at the Digital Assembly held in Sofia in 2018. However, the scope of the Digital Agenda is rather limited, as only around EUR 30 million in EU grants were made available under the WBIF to deploy broadband infrastructure. In addition to improvements in the national broadband networks, the participating countries also endorsed a roadmap to reduce roaming charges within the region as well as between the region and the EU.

Interaction between the EU and other infrastructure investors in the region

Fully separating out the EU's infrastructure strategy, initiatives and even funding in the Western Balkans from that of other players is not always easy. Especially in recent years, both IFIs and China have become increasingly important players in regional infrastructure financing, which has important implications for the EU's connectivity goals.

From the EU's perspective, the involvement of IFIs has been broadly positive, as they have played a crucial role in supporting the EU's strategy of 'stabilisation through connectivity'. As mentioned above, IFIs are also an essential pillar of the WBIF in that they allow the EU to leverage its IPA funds. But even before the launch of the WBIF, IFIs played a crucial role in financing reconstruction, modernising existing infrastructure and financing new initiatives in this field. This was necessary owing to the often-narrow fiscal space of local governments and political instability.

The various IFIs active in the region have generally had different objectives. For example, the European Bank for Reconstruction and Development (EBRD) focuses on supporting a country's transition to a market economy. The European Investment Bank's (EIB) main activities lie in financing large infrastructure projects and developing national financial markets. The Kreditanstalt für Wiederaufbau (KfW), Germany's state-owned development bank, targets energy, water and waste projects. And the World Bank particularly concentrates on institution-building and supporting the creation of functioning electricity grids.

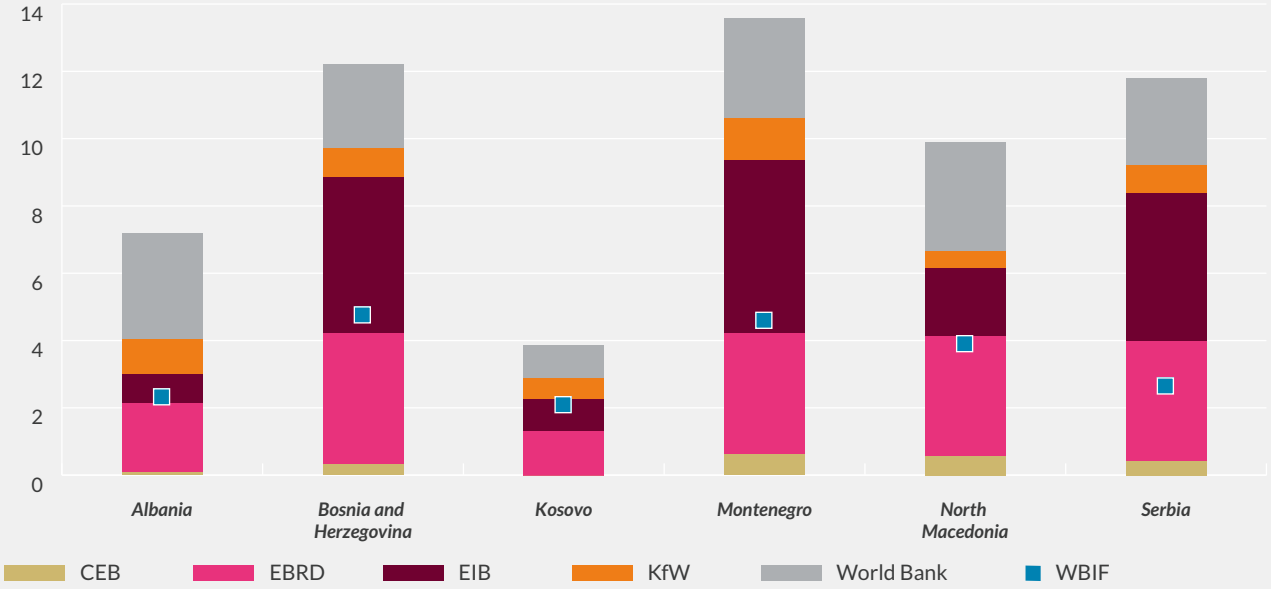
Thus, while the IFIs' strategies are rarely based specifically on an attempt to foster regional cooperation, many of the projects they have supported have contributed to improved

connectivity and thereby, at least indirectly, to the EU's goal of stabilising the region through regional cooperation. What's more, they have mobilised significant resources. Between 2000 and 2019, the World Bank, the EBRD, the EIB, the KfW and the Council of Europe Development Bank (CEB) together approved more than EUR 32 billion in loans for the Western Balkans. While the IFIs' projects related to transport have focused almost exclusively on building and modernising road infrastructure, more funding has gone to rail-infrastructure projects since 2013.

Figure V.1 shows that the loans approved and signed by IFIs made up between 4 and 13 percent of the total gross fixed capital formation of the Western Balkan countries between 2000 and 2020. Due to a lack of comparable data provided by the IFIs, it is impossible to gauge the total investment triggered during this same period. However, since loans are usually accompanied by national co-financing, the overall impact on total investment is presumably a lot larger than what is depicted. So far, Kosovo has enjoyed relatively few benefits from IFIs, which might be due to its difficult international status and relatively late membership in the IFIs. Overall, it appears that IFIs rather than national investors have financed the largest share of infrastructure investment in the region.[26]

26 Reliable and comprehensive data on infrastructure investment in the region is not available. However, our own simplified calculations suggest that loans provided by the EIB, EBRD, KfW and the World Bank covered at least half and perhaps as much as 70 percent of infrastructure investment in Bosnia and Herzegovina, Montenegro and Serbia between 2002 and 2017.

FIGURE V.1 **Loans granted by lending institutions and countries, as a percentage of cumulative GFCF, 2000–2020**



Sources: EBRD, World Bank, EIB, WBIF, KfW, wiiw Annual Database. | **© Bertelsmann Stiftung and wiiw.**
Note: This chart shows loans granted by the respective lending institutions. The WBIF does not issue loans itself; all loans channelled through WBIF are issued by the respective IFIs. Only projects that have been completed since 2000 or have been signed since 2000 are included. Thus, some projects are still in the preparation or implementation phase. GFCF for 2020 is predicted based on the 2018/19 GFCF growth rate, and GFCF for Kosovo and Bosnia and Herzegovina is calculated for the 2000–2003 period based on GDP growth rates. GFCF = Gross Fixed Capital Formation.

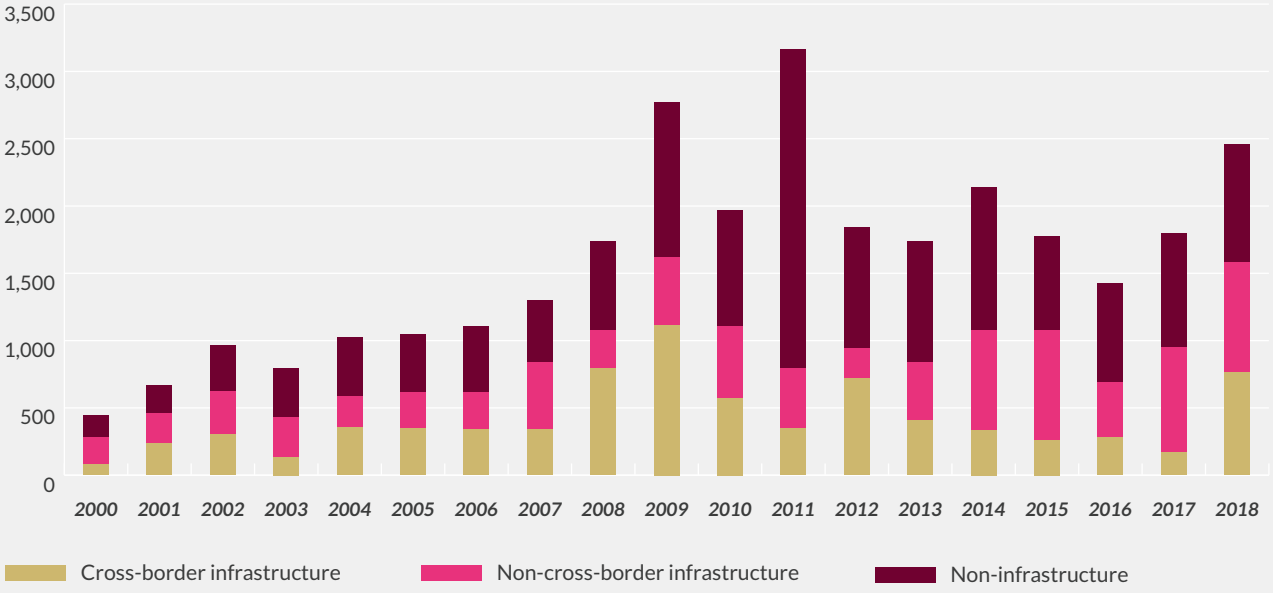
Figure V.2 also highlights the success that the WBIF has had since its inception in 2008. While IFIs issued loans worth on average around EUR 1 billion per year between 2000 and 2007, this amount increased substantially beginning in 2008. Thus, it appears that the WBIF has significantly boosted the IFIs' activity in the region.

We also classify all infrastructure projects co-financed by IFIs as being either cross-border or non-cross-border.[27] On average, a bit more than a quarter of these projects have met the cross-border criteria since 2000. Cross-border projects are mainly comprised of transport infrastructure linked to the TEN-T or electricity and gas infrastructure linked to the Trans-European Networks for Energy (TEN-E). On the other hand, non-cross-border infrastructure encompasses projects related to transport, energy, environment, telecommunication, water and waste that do not directly link two countries. Such projects include sewage and waste, electricity generation, and local transport and electricity infrastructure. Non-infrastructure projects mainly consist of credit lines to the private sector and to public-sector development, meaning that they also include health and education facilities.

The other major player in the region in terms of infrastructure investment is China, albeit only in recent years. The Western Balkans constitute an important part of China's Belt and Road Initiative (BRI), a huge programme of infrastructure development designed to export excess capacity and increase control of supply routes between

27 Projects are labelled as 'cross-border' if the intention is to improve or create a direct link between two countries (or two ethnic regions in the case of Bosnia and Herzegovina). While improved local infrastructure networks may eventually lead to better connectivity, they are classified as 'non-cross-border' in our exercise.

FIGURE V.2 **IFI loans to the Western Balkans, by type, in EUR m**



Source: Own calculations based on information from IFI websites (EIB, EBRD, KfW, World Bank). | **© Bertelsmann Stiftung and wiiw.**
Note: Projects are labelled as cross-border if the intention is to improve or create a link between two countries (or two ethnic regions in the case of Bosnia and Herzegovina). This includes roads and railways, electricity lines and pipelines that connect two regions.

China and its main markets. The Western Balkans are located between the Greek port of Piraeus (of which China acquired a controlling stake in 2016) and the major markets of Western Europe.

Between 2007 and 2017, (announced) Chinese construction projects linked to the BRI in CEE amounted to over EUR 12 billion, according to wiiw calculations (Grieveson, Grübler and Holzner 2018). Such projects are predominantly in the Western Balkans, with around 30 percent of the total going to Serbia, 20.7 percent to Bosnia and Herzegovina, and 7.4 percent to Montenegro. These volumes are at least comparable to EU funding for infrastructure in the region, and dwarf anything committed by Russia or Turkey.

The Chinese focus on infrastructure development and the Western Balkans' infrastructure needs therefore represent what could be a win-win situation, and it can be argued that it fits in to a certain extent with the EU's broad agenda. Holzner, Heimberger and Kochnev (2018) point out that there are potential synergies between the EU's Connectivity Agenda and China's BRI, particularly in the transport sector.

However, this is far from always the case for three main reasons. First, China is investing according to its own priorities and on its own terms. Although these often overlap with the Connectivity Agenda and the overall aims of regional cooperation, this does not apply across the board and there is no guarantee that this overlap will persist over the long term.

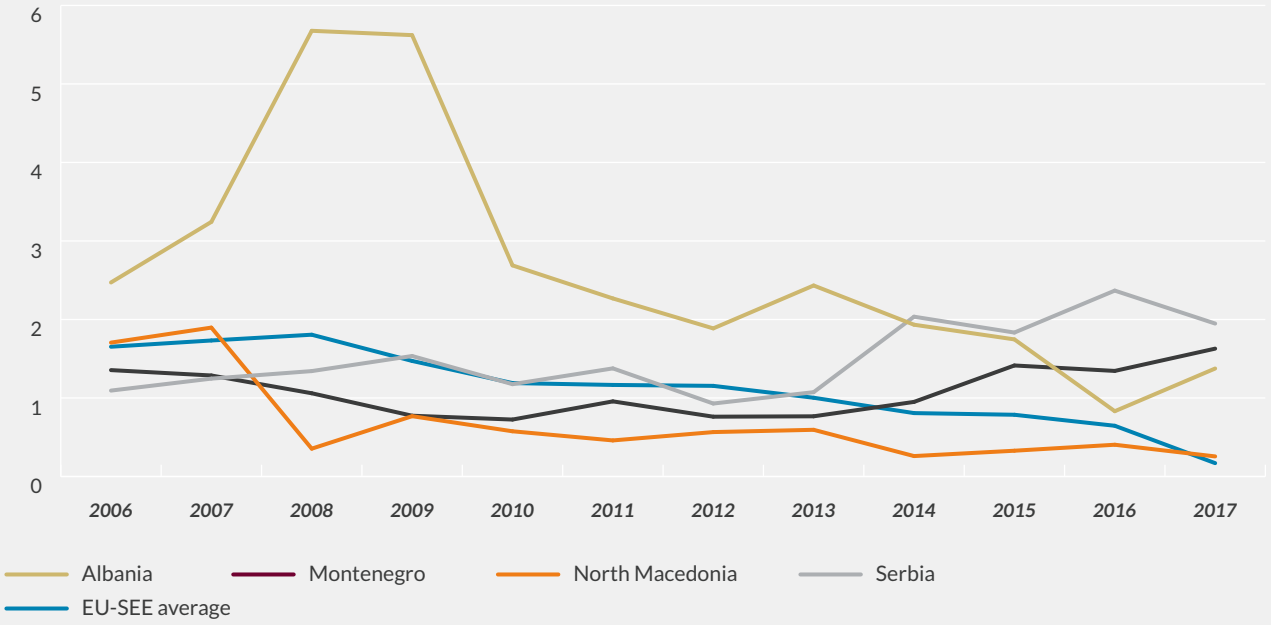
Second, it raises serious risks regarding public debt. Since Chinese infrastructure funds only come in the form of loans, they may unsustainably increase the debt burdens of some countries in the region. Indeed, especially in the cases of Montenegro and Bosnia and Herzegovina, the IMF has warned that the scale of the increase in debt (on top of an already quite high debt load for these countries) could create problems. A separate study included Montenegro among eight countries at 'high risk' of encountering debt problems associated with BRI loans (Hurley, Morris and Portelance 2018). In extreme cases, this can lead to asset seizures by China (as happened in the case of Sri Lanka's Hambantota Port in 2017).

Third, Chinese investment raises concerns about public procurement, potential corruption and environmental standards. From the Chinese perspective, aside from its location, the Western Balkans have the added advantage of not being part of the EU, meaning that there are less stringent rules on public procurement and environmental standards. In fact, it won't be easy for a liberal, highly regulated and rules-based organisation like the EU to work with China on investment issues. Given the EU's climate goals, the Paris Climate Agreement and the region's poor air quality, in particular, the Western Balkans are under pressure to move away from using its coal-fired power plants. Nevertheless, five out of 11 Chinese energy infrastructure investments in Serbia and Bosnia and Herzegovina have involved building new or upgrading existing coal-fired power plants.

Impact of the EU's strategy on transport infrastructure and connectivity

Positive developments can be seen in transport connectivity, including integration into the Trans-European Transport Network (TEN-T) through road and rail investment. This generally positive picture reflects the fact that, as described above, transport infrastructure and connectivity (and roads, in particular) have been a key focus not only of EU investment, but also of that from IFIs and, more recently, of China. According to OECD data, in some years, more than 90 percent of total transport infrastructure investment in the Western Balkans has been channelled towards new or improved road networks. The overall

FIGURE V.3 **Investment in road infrastructure, as a percentage of GDP**



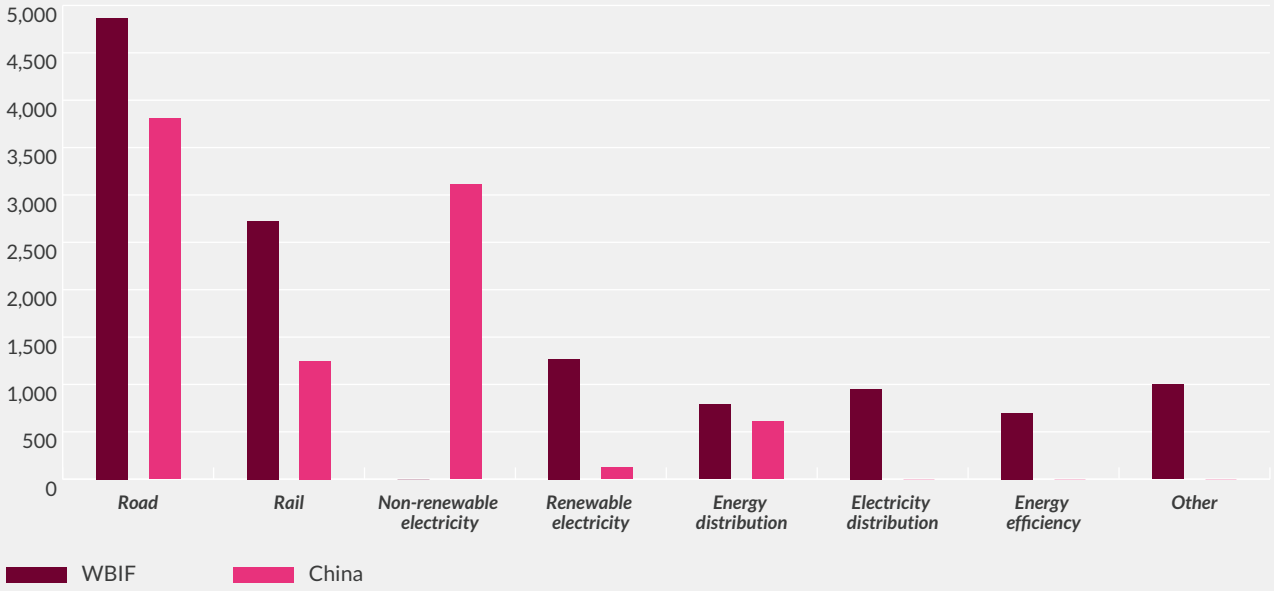
Sources: International Transport Forum (OECD), Eurostat. | | **© Bertelsmann Stiftung and wiiw.**
Note: Data for Bosnia and Herzegovina and Kosovo are not available; EU-SEE average = simple average of Bulgaria, Croatia, Romania and Slovenia.

umbrella of regional cooperation has played an important role in this, and the EU's TEN-T and the respective integration into the local transport system have been important in catalysing and implementing new infrastructure projects. The value of transport infrastructure investment (excluding maintenance) was equivalent to around 2 percent of GDP in 2017 in Albania, North Macedonia and Serbia and, since 2013, it has generally been much higher than in peer countries (Figure V.3).

Meanwhile, the World Bank's Enterprise Survey has revealed that around 10 percent of all firms in the Western Balkans claimed that transport infrastructure was a major constraint in the 2007–2009 period, and that this percentage decreased for all countries (except Kosovo) until 2019. In Kosovo, 37 percent considered transport to be a major constraint in 2019 compared to only 8 percent in 2009. While business demand for infrastructure has increased substantially in Kosovo, the country is a laggard when it comes to several connectivity initiatives. This is in part due to the fact that many countries (including some in the EU) still do not recognise its sovereignty, which might make it more difficult for Kosovo to cooperate in international initiatives than it is for other countries in the region.

It must be said, however, that not all of the success in improving transport infrastructure can be attributed to regional cooperation initiatives. More recently, Chinese investment has led to some further improvements in regional transport connectivity and, in the transport sector, Chinese investors are providing funding for large TEN-T projects. For example, a section of the so-called Corridor XI that links the Port of Bar on Montenegro's Adriatic coast to Belgrade is being implemented by China Communication Construction Company and partially financed

FIGURE V.4 **Chinese and WBIF infrastructure planned and completed investment volumes in the Western Balkans, by type, in EUR m, 2008–2020**



Sources: China Global Investment Tracker, WBIF. | **© Bertelsmann Stiftung and wiiw.**
Note: Includes planned, in-implementation and completed projects; China: contract volume; WBIF: estimated total investment volume.

by a loan from the Export-Import Bank of China (EXIM China). Furthermore, the modernisation of the railway link between Belgrade and Budapest is being partially funded by loans from the same bank, and the new port in Belgrade is also going to be financed by China Environmental Energy Holdings.[28] Thus, in the context of transport infrastructure, Chinese investments have contributed significantly to the region's connectivity.

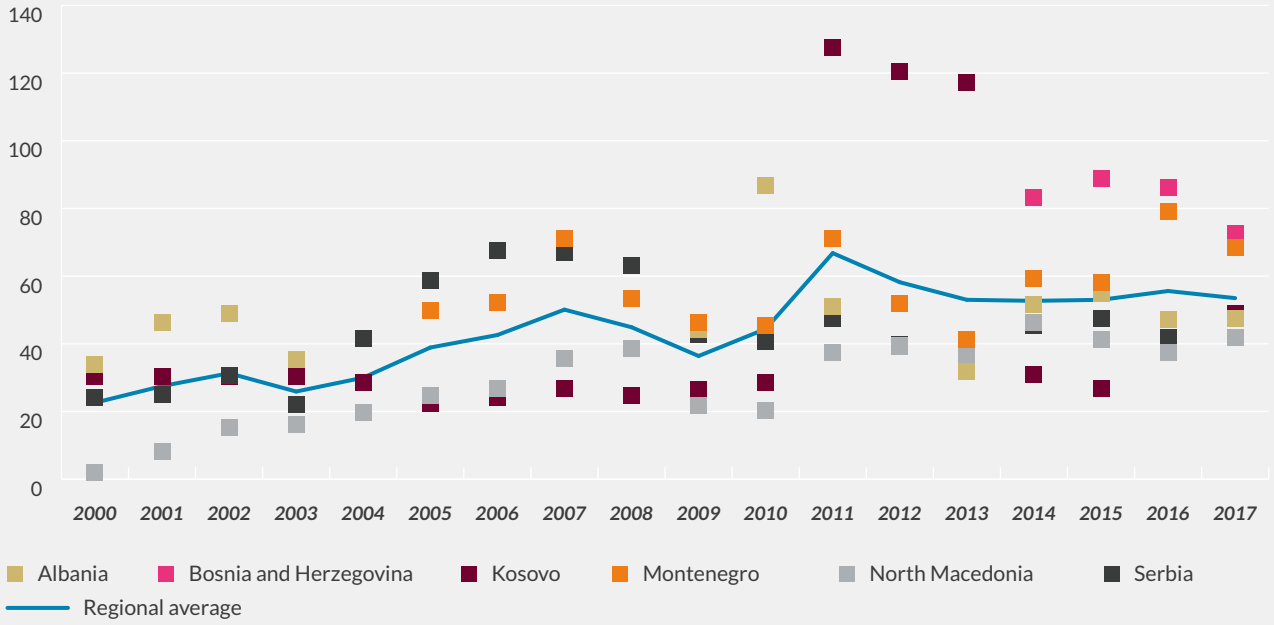
Figure V.4 compares the Chinese sectoral focus to WBIF investment, which has a strong connectivity-enhancing objective. As the chart shows, Chinese investors are particularly prominent in the transport and (non-renewable) energy sectors. However, the European WBIF projects are more important overall and particularly contribute to road, rail and renewable-energy infrastructure.

Impact of the EU's strategy on energy infrastructure and connectivity

In addition to transport infrastructure, the impact of EU and other international investment on the energy sector has also been quite large. Since 2000, most of the Western Balkan countries have significantly expanded their capacity to generate electricity. According to Eurostat data, between 2000 and 2017, Serbia boosted its capacity by more than 150 percent, Albania and Kosovo by 50 percent, North Macedonia by 26 percent, and Montenegro by 6 percent. What's more, actual gross electricity production has increased relatively more since 2000.

28 For more details on Chinese investments in the region, see https://www.ebrd.com/documents/comms-and-bis/see-china-investments.pdf.

FIGURE V.5 **Trade in electricity, as a percentage of final consumption**



Source: Eurostat. | **© Bertelsmann Stiftung and wiiw.** | Note: Trade with rest of the world measured as sum of exports and imports.

Major progress has also been made in integrating the Western Balkans into the Trans-European Energy Networks (TEN-E), mainly through electricity generation and distribution and the construction of gas pipelines. Improvements in energy connectivity appear particularly strong in Kosovo and Albania, where the number of firms that reported electricity as a major constraint substantially declined between 2009 and 2019, according to the World Bank. This trend has also been confirmed by the World Economic Forum's Global Competitiveness Index, presented in Figure V.7 below, which shows that (at least recently) the quality of electricity infrastructure in Croatia, Bulgaria and Romania does not compare too badly. At least on this measure, electricity infrastructure in the Western Balkans also seems to be of a higher standard than other types of infrastructure in the region. However, power outages still remain a big problem in the region, especially in Albania, Kosovo and Montenegro.

Another way to assess improvements in the electricity grid and the connectivity between countries, in particular, is to look at the trade in electricity. While it is clear that many factors determine the extent of electricity trade between countries, it provides an indication of whether countries possess the required infrastructure and cooperate across borders to connect the national grid to neighbouring countries. Figure V.5 shows that, on average, there is a positive trend towards increased electricity trade (imports and exports). Kosovo and Albania have decreased their trade recently, partly thanks to their increased capacities and therefore lower need for imports.

China has also played an important role in financing the development of the energy sector. However, in contrast to the transport sector, Chinese investment has contributed relatively little to connect the region's electricity networks. As shown in Figure V.4 above, Chinese investment in the energy sector has mainly

focused on the generation of electricity from non-renewable sources. The energy projects receiving funding exclusively involve (environmentally questionable) coal- and gas-fired power stations in Bosnia and Herzegovina and Serbia. Since this conflicts with the EU's climate goals, it could create problems for these countries during the EU accession process.

Persistent gaps and challenges ahead

In recent years, efforts to improve the state of infrastructure have made progress in most areas. However, one can argue that the transport, electricity and ICT sectors in the region generally lag behind relative to those in other, more advanced regional peers. To date, investments have failed to deliver a quick catch-up, and the lack of infrastructure continues to hinder economic development and regional integration. The development of a comprehensive national and cross-border infrastructure network that meets high quality and environmental standards is a gradual process and faces many financial and political constraints. The fact that substantial efforts by the EU, IFIs and other international investors over the last 20 years have only resulted in limited progress shows that the process is slow-going and faces many obstacles.

Both the IMF and the EBRD have identified large infrastructure gaps in the Western Balkans that will require substantial investment. The IMF's Infrastructure Gap Index aggregates national infrastructure indicators and compares them to the EU average. It shows that most of the Western Balkan region suffers from poor infrastructure not only compared to the EU average, but also relative to Bulgaria, Croatia and Romania, which were the latest countries to become members of the EU and whose state of economic development was similar to a certain extent before EU accession. Within the Western Balkan region, Serbia seems to be doing slightly better than the rest. What's more, as discussed earlier in this study, one the reasons why Western Balkan states lag behind the EU member states in Eastern Europe is the different access to EU funds.

In order to quantify the infrastructure investment required to fill these gaps, the EBRD (2017) conducted an econometric exercise and used its results to compare the current state of infrastructure in the Western Balkans to that of a benchmark group of advanced economies. The results, depicted in Figure V.6, reveal that the required investments are still large and would require average annual expenditures ranging in value from 8 to 12 percent of GDP. This is two to three times as high as in other Eastern European countries as well as roughly three times the current infrastructure investment spending in the region.

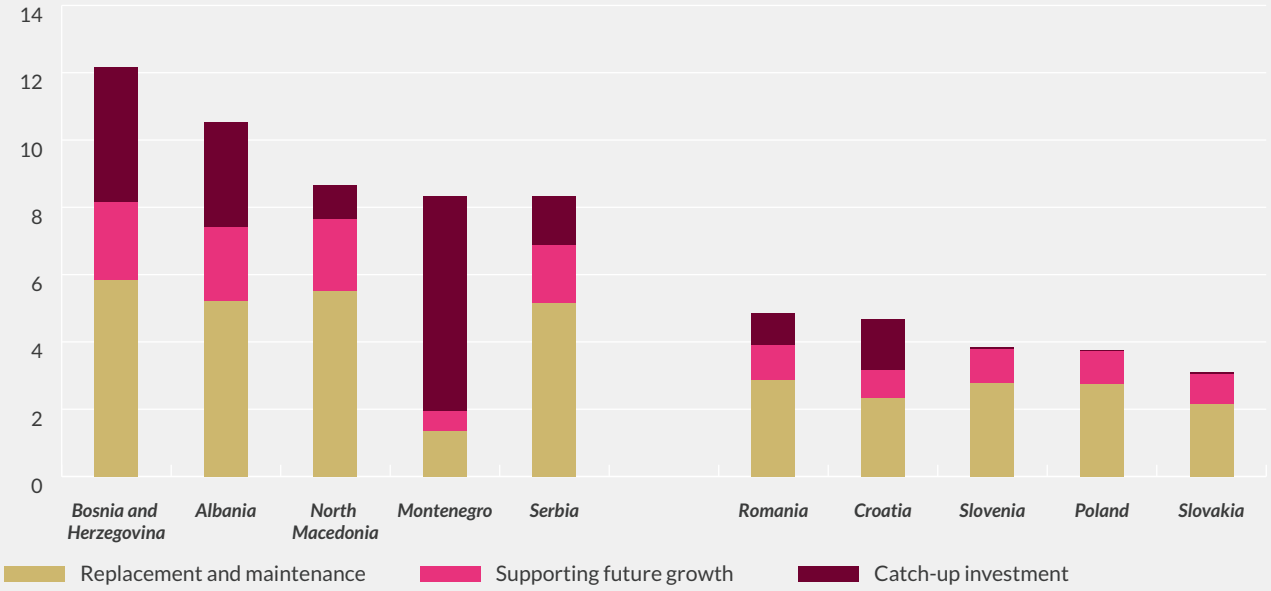
The indicators estimated by the IMF and EBRD highlight that the efforts of the last 20 years have been insufficient to converge to the levels of other CEE countries. Various areas of deficiency can be identified.

First, motorway densities[29] are still low, and existing road infrastructure is often of poor quality, which makes it a continued impediment to trade and participation in regional and global value chains. The EBRD estimates identified that more than half of the required investment is needed for maintenance and replacement. Thus, the establishment of comprehensive maintenance systems is a key issue that will need to be addressed.

Second, railway density and the quality of railway infrastructure is even more concerning than with roads. Figure V.7 shows that, on average, the quality of railways is the worst relative to that of other infrastructure. Albania, Bosnia and Herzegovina, and Serbia, in particular, lack well-

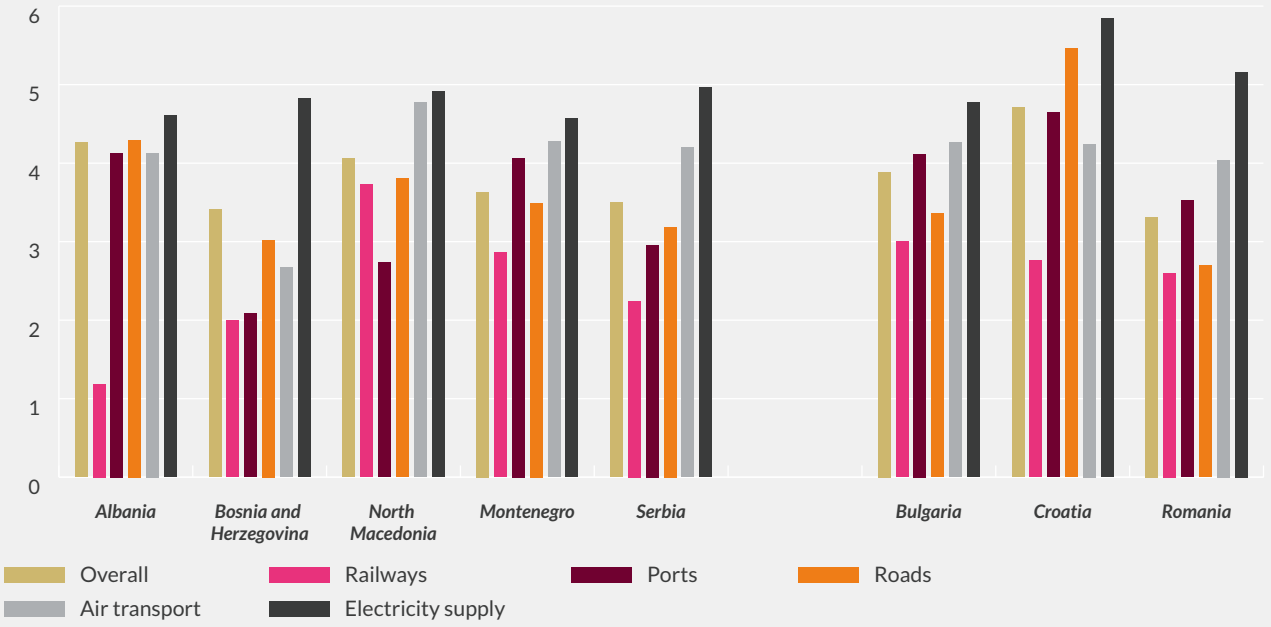
29 Details can be found in Cingolani, Berthomieu and Ri (2017), EBRD (2017), and Holzner and Grieveson (2018).

FIGURE V.6 **Infrastructure investment needs per year, as a percentage of GDP, 2018–2022**



Source: EBRD. | **© Bertelsmann Stiftung and wiiw.**

FIGURE V.7 **Quality of different infrastructure types, 2017–2018 (1 = worst; 7 = best)**



Source: World Economic Forum Global Competitiveness Index. | **© Bertelsmann Stiftung and wiiw.** | Note: Data for Kosovo are not available.

FIGURE V.8 **Distribution losses, as a percentage of gross electricity production, 2017**

Source: Eurostat. | **© Bertelsmann Stiftung and wiiw.**

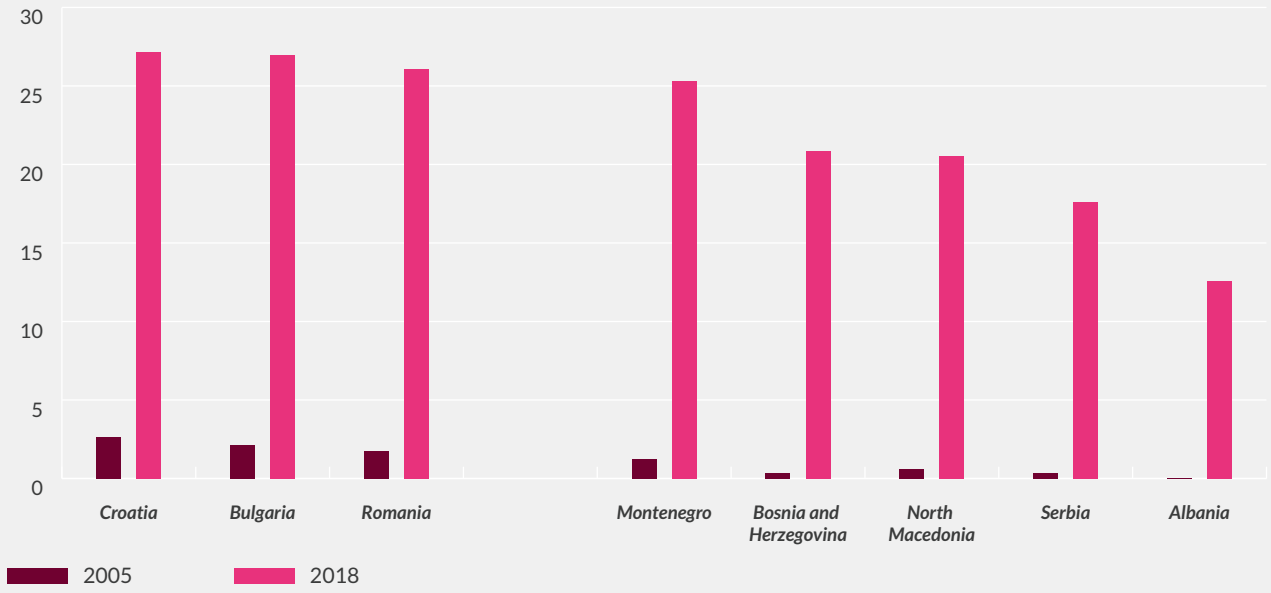
maintained railway infrastructures. This is not surprising given that public expenditure for such infrastructure barely exists. Moreover, the WBIF and Chinese investors have prioritised road infrastructure in the past and have only recently started to channel more resources towards this area. So far, the only exception is Serbia, whose investments in its rail infrastructure have increased substantially since 2014.[30] However, in the last few years, large rail projects along the Orient/East-Med Corridor and the Mediterranean Corridor have been signed in all countries. Thus, investment in railway infrastructure is expected to pick up significantly in the region.

Third, although significant progress has been made in developing electricity-transmission infrastructure, outages and electricity loss due to poor distribution infrastructure (and theft) remain prevalent, particularly in Albania and Kosovo (Figure V.8). Despite the commonly agreed objective to form a regional electricity market, the weak implementation of institutional and regulatory reforms inhibits fast progress. The Energy Community noted in its Annual Implementation Report (2018: 8) that "many important elements of the acquis have been superficially implemented in some Contracting Parties at best". Bechev, Ejdus and Taleski (2015) argue that publically owned businesses in the energy sector and price regulations, which often serve as a social policy measure, slow down or inhibit necessary reforms to forge a functioning regional electricity market.

Fourth, the region faces some serious challenges in transitioning to cleaner energy. This matters not only in terms of reducing coal dependency for environmental reasons, but also in terms of decentralising the electricity grid in order to enable such a transition to renewable energies. Coal-fired power plants account for more than half of the production in Bosnia and

30 No data are available for Bosnia and Herzegovina, Kosovo and North Macedonia.

FIGURE V.9 **Fixed broadband subscriptions per 100 inhabitants**



Source: International Telecommunications Union (ITU). | **© Bertelsmann Stiftung and wiiw.**

Herzegovina, Kosovo and Serbia, and projects in Kosovo and Serbia are expected to increase coal dependency. Meanwhile, the Energy Community Secretariat's annual implementation report (Energy Community 2018) also points out that decentralised generation and consumption patterns based on renewable energy sources are likely to replace the current centralised architecture. Thus, new investment in the energy sector should be compatible with low-emission objectives and developments in the renewable energy sector.

Finally, investment in the region's ICT infrastructure has so far been mostly neglected. The EU's Digital Agenda was only signed in 2018 and, to date, only EUR 30 million has been provided through the WBIF for technical assistance. Fixed broadband subscriptions are generally lower than in EU member states in SEE (Figure V.9). This may limit companies' business opportunities and hold back the e-commerce activities of both companies and individuals.

Tackling these issues is easier said than done. The reasons for the persistent deficiencies are complex, and there are no easy solutions in many cases. Below, we outline three key priority areas to be tackled.

First, the general problem of financing remains. Even allowing for the Connectivity Agenda, grants available for Western Balkan infrastructure investment appear set to remain quite limited compared with those available to EU members from structural funds.

Second, corruption is a challenge. As Bechev, Ejdus and Taleski (2015) highlight, there have already been high-profile cases of corruption. The contract for the 'Patriotic Highway' linking Tirana and Pristina, which was awarded to a consortium of Bechtel and Turkey's ENKA, received criticism for failing to comply with tendering regulations. In addition, China's arrival brings significant additional risk of corruption. Such cases could limit any benefits arising from improved connectivity.

Third, physical infrastructure investment needs to be coordinated in tandem with 'soft measures'. Moïsé and Le Bris (2013) conclude that high-quality physical infrastructure has only limited effects on transport costs in the absence of efficient and competitive logistics services. The lack of competition might even be a bigger constraint for developing countries than physical infrastructure when it comes to achieving lower prices. Similarly, the creation and functioning of a regional energy market will only be successful if countries implement the regulatory and institutional reforms suggested by the Energy Community. Unfortunately, the implementation of such reforms is currently far from being fulfilled. The Energy Community Secretariat's annual implementation report (Energy Community 2018) suggests that corruption and publicly owned businesses lead to delays and poor implementation. Thus, to reap the full benefits of infrastructure, incentives need to be created to implement 'soft measures'.

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VI. Taking stock: The state of play in 2020

Chapter V highlighted many successes in terms of driving trade, investment and infrastructure integration in the Western Balkans. Although one can admittedly identify many gaps and areas in need of improvement, it cannot be said that nothing has come out of this strategy in economic terms over the past two decades. Nevertheless, as outlined in the introduction to this paper, the point of this strategy has not just been to drive regional economic integration for its own sake, but also to use this increased connectivity and (hopefully) rising prosperity to have a direct and positive impact on the normalisation of political relations in the region.

In this chapter, we want to assess the situation in 2020 and to ask to what extent the implementation of the EU's regional cooperation strategy has fundamentally addressed the most important challenges that the region has and continues to face. We will do this in the context of the political, institutional and economic obstacles to regional cooperation set out in Chapter IV, asking to what extent these obstacles have been overcome.

Specifically, in this chapter we will address the following questions:

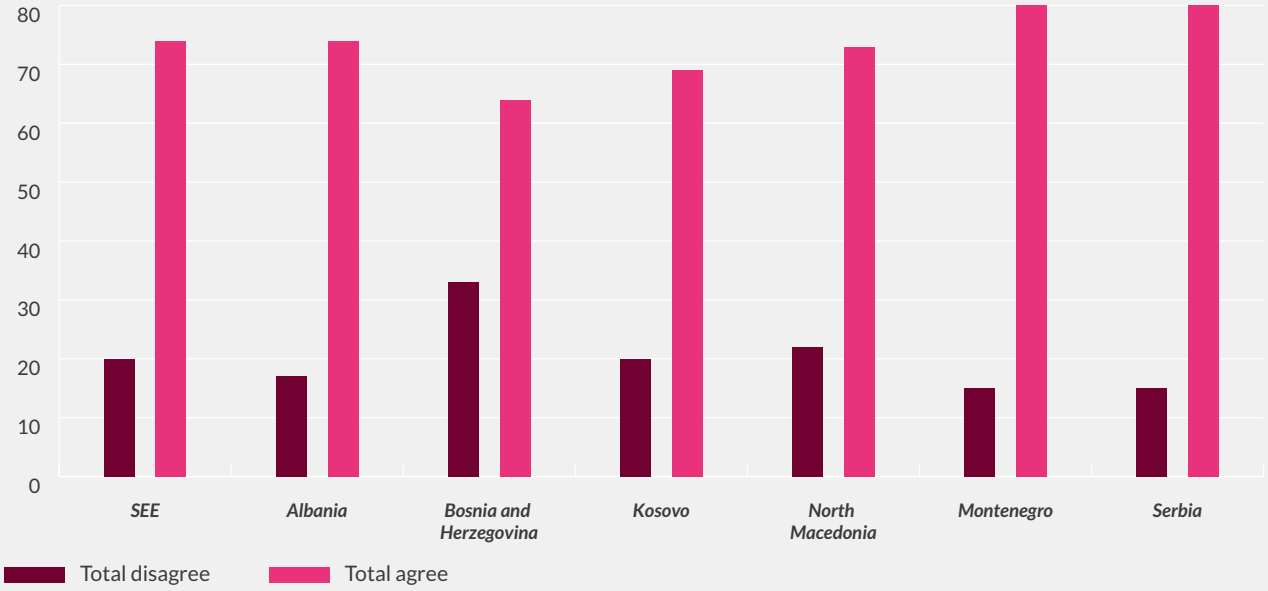
- Has the 'geography of animosity' been broken over the past 20 years?
- Are the incentives for the Western Balkan countries to cooperate more aligned than they used to be?
- Have governance challenges been overcome?
- What is the role of outside actors now?
- What are the next steps for regional cooperation in an economic sense?
- When it comes to greater regional economic integration, are the potential economic upsides greater and the barriers lower than they were before?
- How big are the demographic challenges that the region faces?

Has the 'geography of animosity' been broken over the past 20 years?

In part owing to the sense of drift in the EU accession process identified in the introduction to this study, local Western Balkan initiatives have become more important in the past decade. This can be seen in many important initiatives, including the Regional Cooperation Council, the Western Balkans Six, the Multi-annual Action Plan for a Regional Economic Area, and the 'mini-Schengen' idea.

As local ownership of the process has increased, citizens have become more engaged, and the level of support for regional cooperation in the Western Balkans has grown among citizens. In the Balkan Barometer 2019, the share of respondents who either 'totally agree' or 'tend to

FIGURE VI.1 **"Do you agree that regional cooperation can contribute to the political, economic or security situation of your society?" Percent of respondents**



Source: Balkan Barometer 2019. | **© Bertelsmann Stiftung and wiiw.** | Note: 'Total disagree' = sum of those answering 'totally disagree' and 'tend to disagree'. 'Total agree' = sum of those answering 'totally agree' and 'tend to agree'. Note SEE = Southeast Europe average

agree' that regional cooperation can contribute to the political, economic or security situation of their society was 74 percent for the Western Balkans as a whole versus 20 percent who disagreed (Figure VI.1). The share of respondents in agreement ranged from 64 percent in Bosnia and Herzegovina to 80 percent in both Serbia and Montenegro.

Of course, this single question could obscure a multitude of understandings and motivations among respondents. For example, it does not probe what respondents would be willing to give up in return for enhanced regional cooperation. However, one thing appears clear: Citizens in the region support regional cooperation as a goal in itself rather than just as a way to secure EU membership. In fact, in the Western Balkans as a whole, the share of respondents who support regional cooperation is significantly higher than the share of those who support EU membership. At the country level, only Albanians appear to be more supportive of EU membership than of regional cooperation.

The same survey also implied that citizens in the region would like to see regional cooperation go even further. For example, 53 percent of Western Balkan respondents wanted commercial and trade links in Southeast Europe to be improved, while only 6 percent said they are already too strong. However, the survey also showed that 52 percent felt 'not informed at all' about CEFTA, while only 13 percent said they were mostly or completely informed about it.

Interregional connectivity in terms of the movement of people appears to be fairly strong. Citizens seem to travel around the region (Table VI.1) and to feel comfortable visiting other Western Balkan countries, although more trips continue to be made to ethnically and

TABLE VI.1 **"Did you travel anywhere in the region in the past 12 months?" Percentage of respondents answering 'yes' by destination**

	Albania	Bosnia and Herzegovina	Kosovo	Montenegro	North Macedonia	Serbia
Albania		3	14	7	7	3
Bosnia and Herzegovina	1		1	9	2	14
Kosovo	32	1		12	5	7
Montenegro	7	13	5		5	32
North Macedonia	15	3	13	10		13
Serbia	1	8	2	16	3	

Source: Balkan Barometer 2019. | **© Bertelsmann Stiftung and wiiw.**

linguistically similar countries. The most common trips involve Kosovans going to Albania and Montenegrins heading to Serbia (in both cases, 32 percent of respondents from Kosovo and Montenegro had made these trips in the past year). On the other hand, the trips that hardly anyone makes are Bosnians to Albania or Kosovo and Kosovans to Bosnia.

Meanwhile, among most respondents to the survey who travel to other cities in the region, more people feel comfortable everywhere rather than uncomfortable or only comfortable in some places (Figure VI.2). Only in Serbia was this not the case, as only 36 percent of respondents had positive feelings about people from other parts of the region coming to work in their economy, compared with 19 percent who reported having negative feelings.

However, despite this reasonably positive picture, the impression from the actions of elites in the region is quite different. For many politicians in the Western Balkans, the geography of animosity is still present and manifests itself in territorial disputes and constitutional questions.

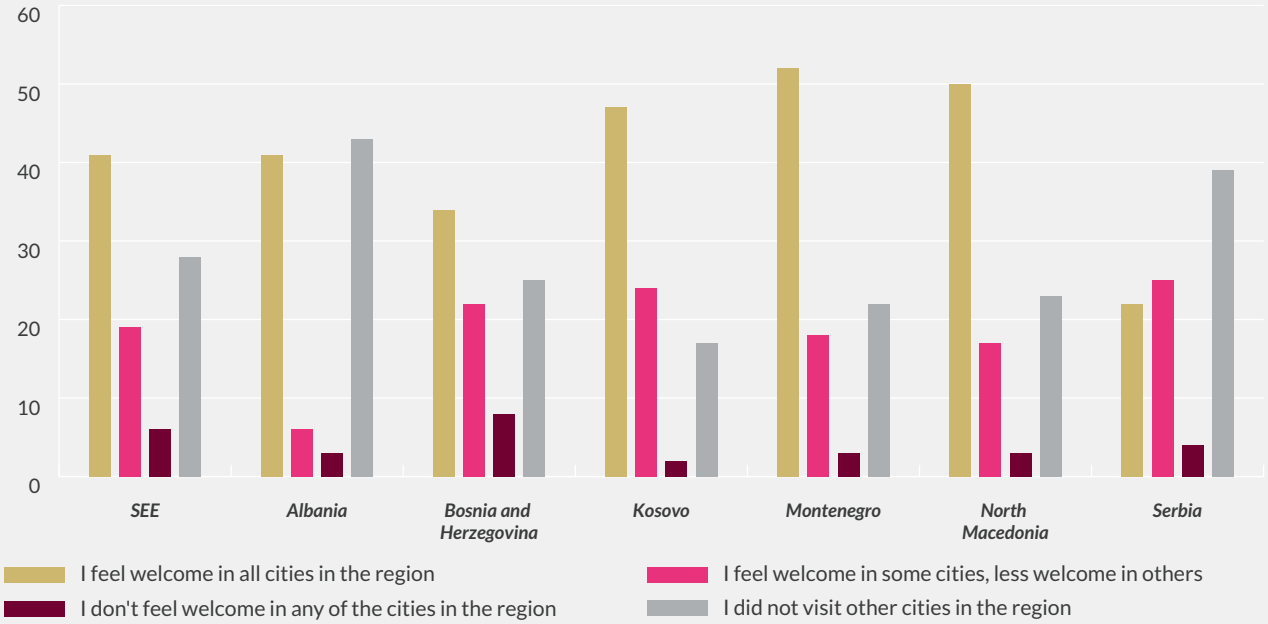
A key example of this has been discussions in recent years regarding border changes between Serbia and Kosovo. These represent a major challenge to regional cooperation. The idea of border changes reflects the territorial disputes at the core of the geography of animosity.

In August 2018, Serbian President Aleksandar Vucić and his Kosovan counterpart, Hashim Thaçi, announced that they were considering border changes as part of an agreement on the normalisation of relations. Influential international media sources, including the New York Times (Kupchan 2018) and the Financial Times (2018), added their support.

In practical terms, the idea of a territorial swap between Serbia and Kosovo is highly complex. First, this is because most ethnic Serbs in Kosovo live in the south of the country rather than in the north, which puts them farther away from Serbia. Therefore, even if the part of Kosovo directly adjacent to Serbia could be transferred from the former to the latter, this would not resolve the issue for the majority of Kosovan Serbs. If anything, this could further exacerbate the problem for these people (Joseph 2018). Second, the issue isn't even straightforward for Serbs in northern Kosovo. As the ESI (2019) lays out, installing a new border through Mitrovica is highly impractical, as this is the most multi-ethnic urban part of Kosovo.

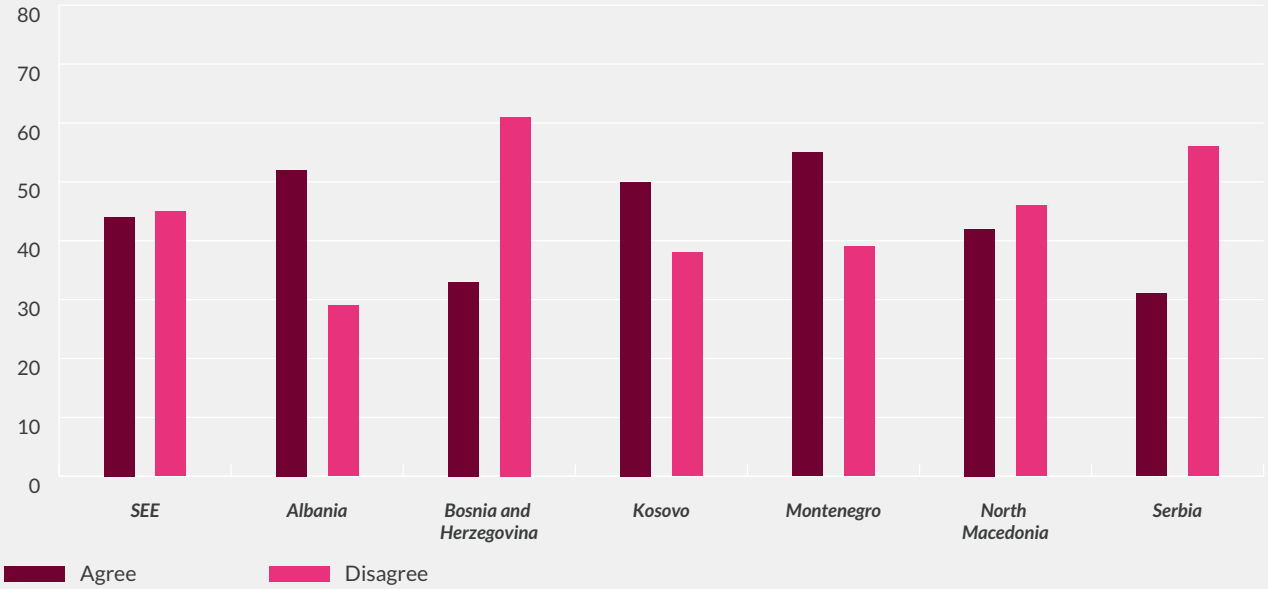
These factors have not been lost on citizens in the region. Despite the positive aspects of regional

FIGURE VI.2 **"Do you feel welcome abroad when traveling to other cities in the Southeast Europe region for business or leisure?" Percentage of total**



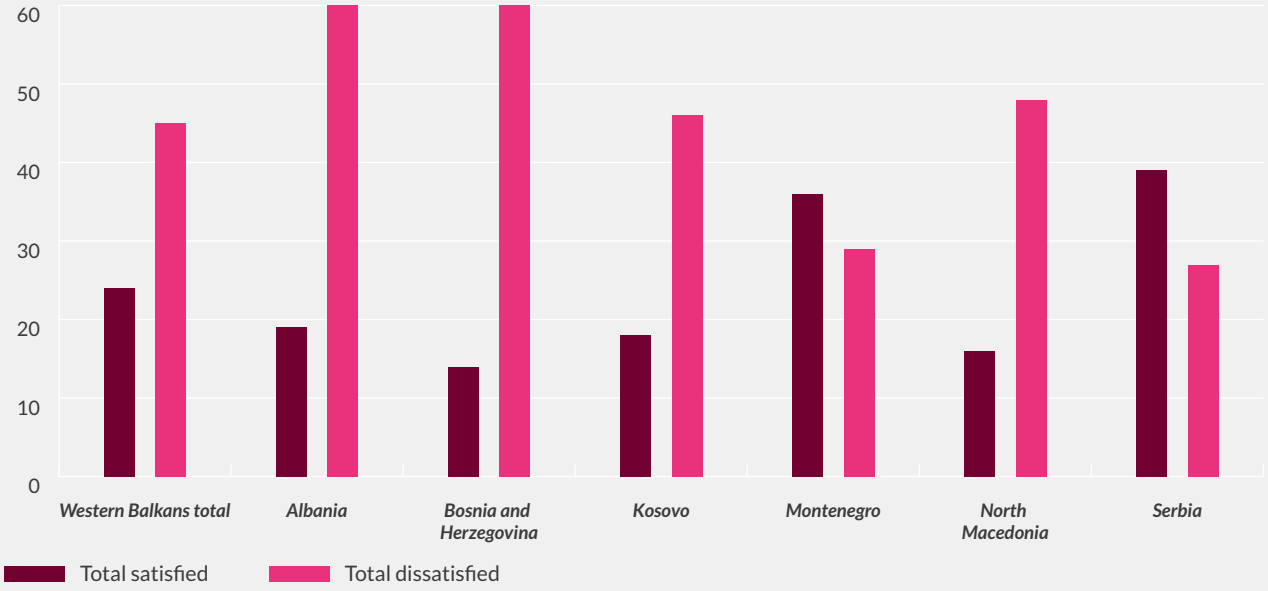
Source: Balkan Barometer 2019. | **© Bertelsmann Stiftung and wiiw.** | Note SEE = average for Southeast Europe.

FIGURE VI.3 **"Do you agree that regional relations in SEE are better than 12 months ago?" Percentage of total**



Source: Balkan Barometer 2019. | **© Bertelsmann Stiftung and wiiw.** | Note SEE = average for Southeast Europe.

FIGURE VI.4 **"How satisfied are you with the overall security situation in your economy?" Percentage of total**



Source: Balkan Barometer 2019. The survey takes into account crime, terrorism, uncontrolled migration and violent conflicts. | **© Bertelsmann Stiftung and wiiw.** | Note: 'Total satisfied' = sum of 'I'm completely satisfied' and 'I'm mostly satisfied'. 'Total dissatisfied' = sum of 'I'm completely dissatisfied' and 'I'm mostly dissatisfied'.

connectivity outlined in the previous section, survey data suggests that the inhabitants of the Western Balkans are aware of and concerned about high-level political tensions. The Balkan Barometer survey for 2019 found that those who felt that regional relations were going in the wrong direction slightly outnumbered those who thought the opposite (Figure VI.3). This appears to have been strongly felt at the country level, especially in Serbia and Bosnia and Herzegovina.

Moreover, according to the Balkan Barometer, those dissatisfied with the security situation clearly outnumber those who are satisfied in four of the Western Baltic Six countries as well as in the region as a whole (Figure VI.4). In Albania and Bosnia and Herzegovina, the share of people either mostly or completely unsatisfied stands at 60 percent. Interestingly, Serbia is one of only two countries with net positive responses to the question.

Are the incentives for the Western Balkan countries to cooperate more aligned than they used to be?

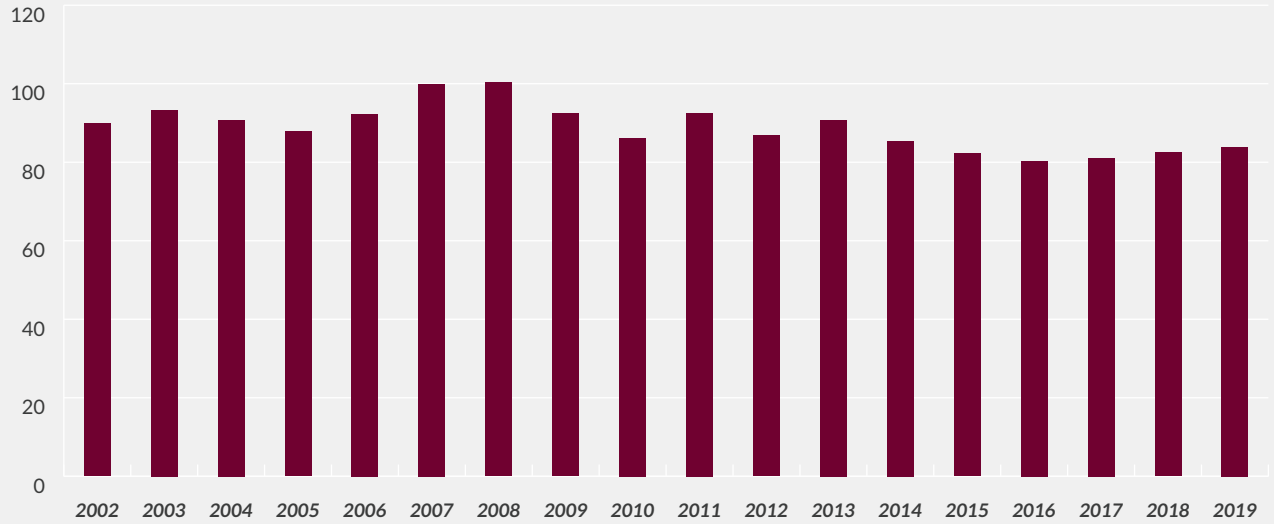
For two reasons, it is hard to make the case that all the Western Balkan countries have the same incentives to cooperate. First, two countries – Montenegro and North Macedonia – are not strongly involved in the geography of animosity. In theory, therefore, these two countries have a much quicker route to EU accession than the rest of the region. The Commission could help to prepare them for membership in the way it did for Bulgaria and Romania. Montenegro was moving closer to accession before facing internal turmoil in recent years, and North Macedonia was well on track to EU accession in the early 2000s before its name became a major issue. With serious EU support, both may now be able to get back on that track.

The second key difference in terms of incentives, and the one that is more complicated, is the particular role of Serbia. As outlined in Chapters IV and V, the size of Serbia relative to the other Western Balkan countries, as well as its greater ability to forge economic and financial relationships outside the region, means that its incentives to engage in economic regional cooperation are not the same as for the others. It has more options than the other Western Balkan countries, and this is reflected in the fact that Serbia has integrated ever more strongly with the EU (but also with China and Russia) in recent years, often at the expense of integration with its fellow states in the region. Serbia's share of the nominal GDP of the Western Balkan Six countries has not changed significantly over time (Figure VI.5). Over the past two decades, it has fluctuated between 80 and 100 percent of the combined GDP of the other five Western Balkan Six countries.

This matters a lot given Serbia's central position in the geography of animosity. Much of the EU's strategy has been centred on getting Serbia to change its strategic commitments and prioritise Europeanisation over its territorial problems. However, Serbia's leadership and populace are probably less interested in the EU now than at any time in the last 20 or so years. In fact, less than one-third of Serbia's population thinks EU accession would be a 'good thing' (Figure VI.6), which makes Serbia quite an outlier on this issue in the region.

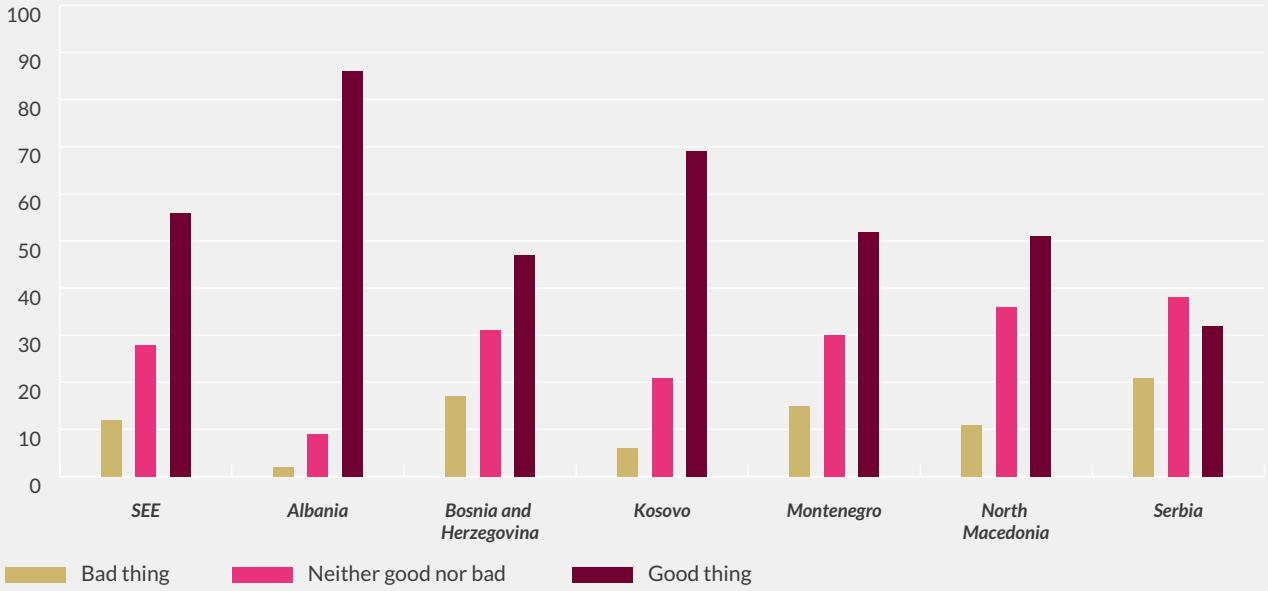
From the political point of view of Serbians, and especially of political elites, EU membership can be seen as bringing more responsibilities and constraints than new benefits. This is certainly the case when taking into account the concessions that the EU would expect Serbia to make on Kosovo and Bosnia and Herzegovina. Serbia does not necessarily have an interest in fully committing to EU membership before its potential regional gains are exhausted or have proved to be illusory. Especially considering the fact that the EU (but also Russia and China) regard Serbia as the key to the region, Serbia

FIGURE VI.5 **Serbia's nominal GDP, as a percentage of that of the other five Western Balkan Six countries combined**



Source: wiiw. | **© Bertelsmann Stiftung and wiiw.**

FIGURE VI.6 **"Do you think EU membership would be a good thing, a bad thing, or neither a good nor bad thing for your economy?" Percentage of total**



Source: Balkan Barometer 2019. | **© Bertelsmann Stiftung and wiiw.** | Note SEE = average for Southeast Europe.

does not want to give up on Republika Srpska, Kosovo or even Montenegro. Therefore, Serbia does not have very strong incentives to engage in regional cooperation in order to secure EU membership. Meanwhile, as time goes on and Serbia becomes more economically entangled with China and Russia, its ability to meet the terms of the acquis and eventually join the EU will be negatively affected.

From the EU perspective, the question is how to change Serbia's calculation of its incentives and, specifically, how to make Serbia an offer that is attractive enough to prompt a compromise on Kosovo, settle other disputes in the region, and prioritise European integration. First, there is the issue of access to EU labour markets, but visa liberalisation and special migration arrangements in countries like Austria and Germany have already made access to EU labour markets relative easy for Serbian citizens in any case. Second, transfers from the EU budget are attractive, but those would have to be advertised quite specifically in order to elicit interest among affected stakeholders. It is not clear that this would be attractive enough, nor that an expansion of the EU budget to fully include the Western Balkans would be politically feasible from the EU side.

In this context, support for deeper EU integration in Serbia might have the best chances of emerging from the business community. The increased economic openness of the economies of the region in general and of Serbia in particular, and the fact that this has been achieved via integration with the EU, was supposed to encourage business interests to push strongly for EU integration. In turn, this was supposed to stimulate the political interests to adjust. But this has not happened yet.

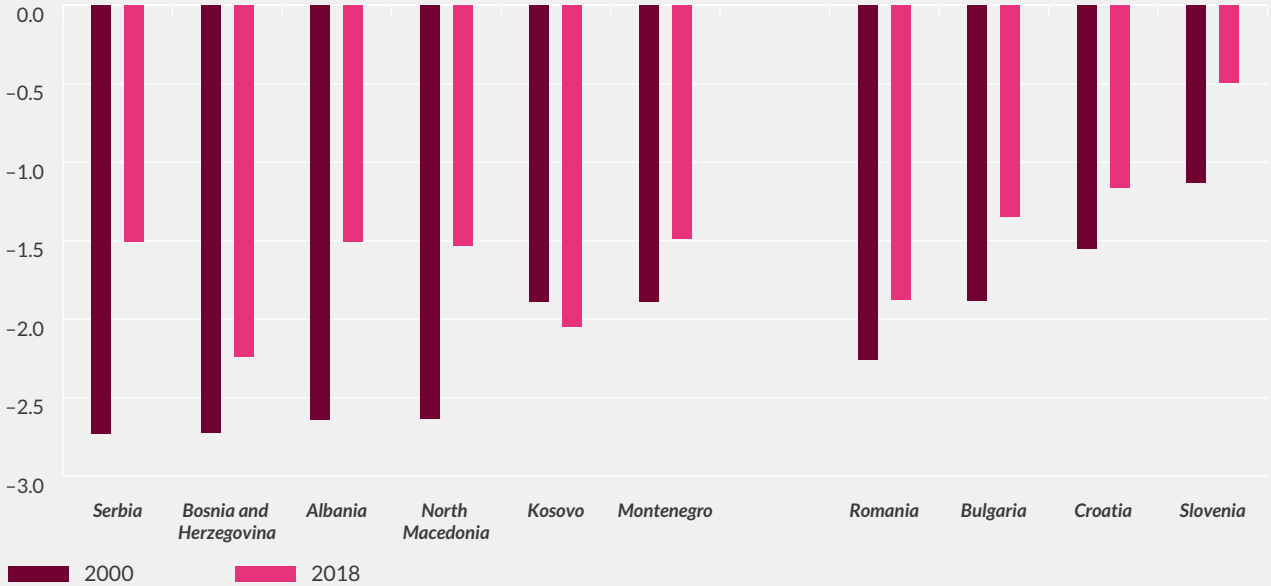
Have governance challenges been overcome?

Governance standards have generally improved in the Western Balkans over the past two decades (Figure VI.7). According to the World Bank's Worldwide Governance Indicators (WGI) score for government effectiveness, most Western Balkan countries are 1.5 to 2 points below Germany (with scores ranging from +2.5 to -2.5). Apart from Kosovo, all countries improved relative to Germany between 2000 and 2018, and substantially so in the cases of Albania, North Macedonia and Serbia. All else being equal, this should make regional cooperation easier.

However, recent events suggest that there is reason for caution here. First, animosity between and within countries – which, as we have shown, has increased in recent years – can provide a positive boost for autocrats. Second, the Covid-19 pandemic has allowed emergency legislation to be introduced in many countries and, in general, led to a rapid expansion in the role of the state, which could also play into the hands of authoritarian rulers.

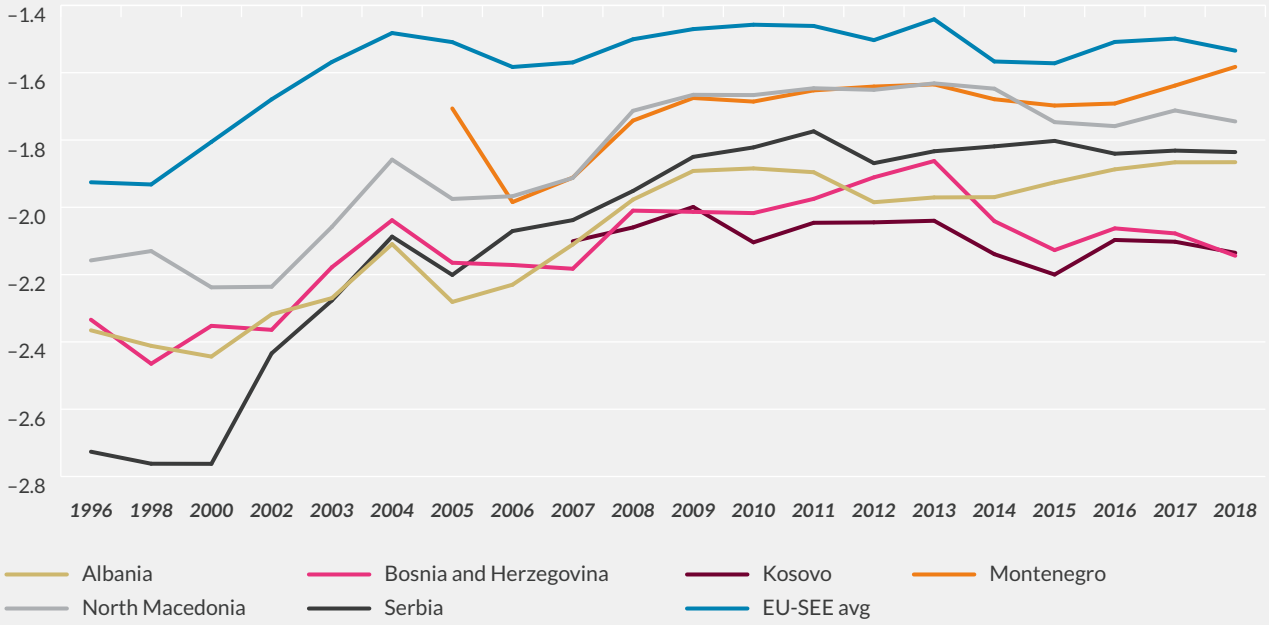
In addition, we find that, over the past decade, improvements in governance in the Western Balkans have generally stalled or even gone into reverse relative to those in Western Europe. Using a simple average of four WGI scores – government effectiveness, rule of law, control of corruption, and regulatory quality – we see almost no improvement via-à-vis the German benchmark since 2008 (Figure VI.8). Over this period, we observe minor improvements in Albania, Montenegro and Serbia and minor declines in Bosnia and Herzegovina, Kosovo and North Macedonia. It should be said that this has largely been a CEE-wide phenomenon since the global financial crisis, most famously in Hungary and Poland among the EU countries. However, given the generally lower absolute levels for the Western Balkans than for the EU member states in CEE, it is more of an issue.

FIGURE VI.7 **Worldwide Governance Indicators, government effectiveness score, distance to Germany, in points**



Source: World Bank. | **© Bertelsmann Stiftung and wiiw.** | Note: Outright scores on a scale of 2.5 (best) to −2.5 (worst).

FIGURE VI.8 **Average of four Worldwide Governance Indicator scores, differential vis-à-vis Germany, in points**



Source: World Bank. | **© Bertelsmann Stiftung and wiiw.**
Note: Outright scores on a scale of 2.5 (best) to −2.5 (worst). EU-SEE = simple average of Bulgaria, Croatia and Romania.

What is the role of outside actors now?

More than 20 years after the end of the war in Kosovo, the EU and US roles in the Western Balkans remain central. Both have accumulated huge responsibilities over these years. A great deal of governance in the region depends on the almost daily involvement of the EU, US and NATO. Bosnia and Herzegovina and Kosovo, in particular, cannot be run without the persistent involvement of these external actors and, in both cases, this naturally also means that there is intense interaction with Serbia. Basic stability – in not only a security sense, but also economic and financial senses – is more or less underpinned by the EU and the US.

Other important external actors are also active in the Western Balkans. We have shown that the economic role of China has increased over recent years, and while this has some potential positive spillovers (such as with respect to regional connectivity), China's involvement also creates risks. Russia's role is also important, at least with respect to Serbia, where it can exert influence via, for example, the oil company NIS.

The influence of Russia and China in the region does not necessarily hamstring regional cooperation efforts. However, the economic presence of both, and especially China's growing role, create the potential for conflict with the EU acquis, as we outlined in Chapter V. Over time, this could have negative knock-on effects for the EU accession prospects of the Western Balkan Six countries.

What are the next steps for regional cooperation in an economic sense?

The two key initiatives related to deepening regional cooperation in an economic sense are the Regional Economic Area and 'mini-Schengen' outlined in Chapter IV. In both cases, the question of overlapping priorities in terms of economic development and the scope for policy coordination becomes more important. Taking economic integration to the next level, as envisaged in these plans, will require much closer coordination of economic policy than in the past.

Two concrete aspects of this tighter economic integration are a customs union and a single market in the Western Balkans. Both are worth considering in terms of the different incentives and priorities for economic development that the Western Balkan countries have and the potential contributions that a deeper form of regional cooperation can make to reconciliation.

There are numerous potential advantages to a customs union. First, a customs union can increase cross-border trade. It can significantly cut costs and time lost at borders between the parties to the agreement, lower prices and increase choice for consumers, translate into lower business costs for firms, and lead to higher competitiveness for participating countries.

Second, a customs union can increase FDI inflows. By increasing the size of the region in which goods could move more freely than under a simple FTA (e.g. by reducing or eliminating border checks and the costs to moving goods across a border), a region can become more attractive to foreign investors. In the case of the Western Balkans, in terms of population, the region is roughly the size of Romania, but with a lot of internal borders. This has especially proved to be a problem for infrastructure investments, which in turn has stood in the way of large-scale investments in manufacturing and energy, in particular. A customs union could help eliminate these obstacles.

A third advantage is increased market power. Members of a customs union can combine their market size and thereby increase their power in relation to third parties. They can use this to support a domestic industry.

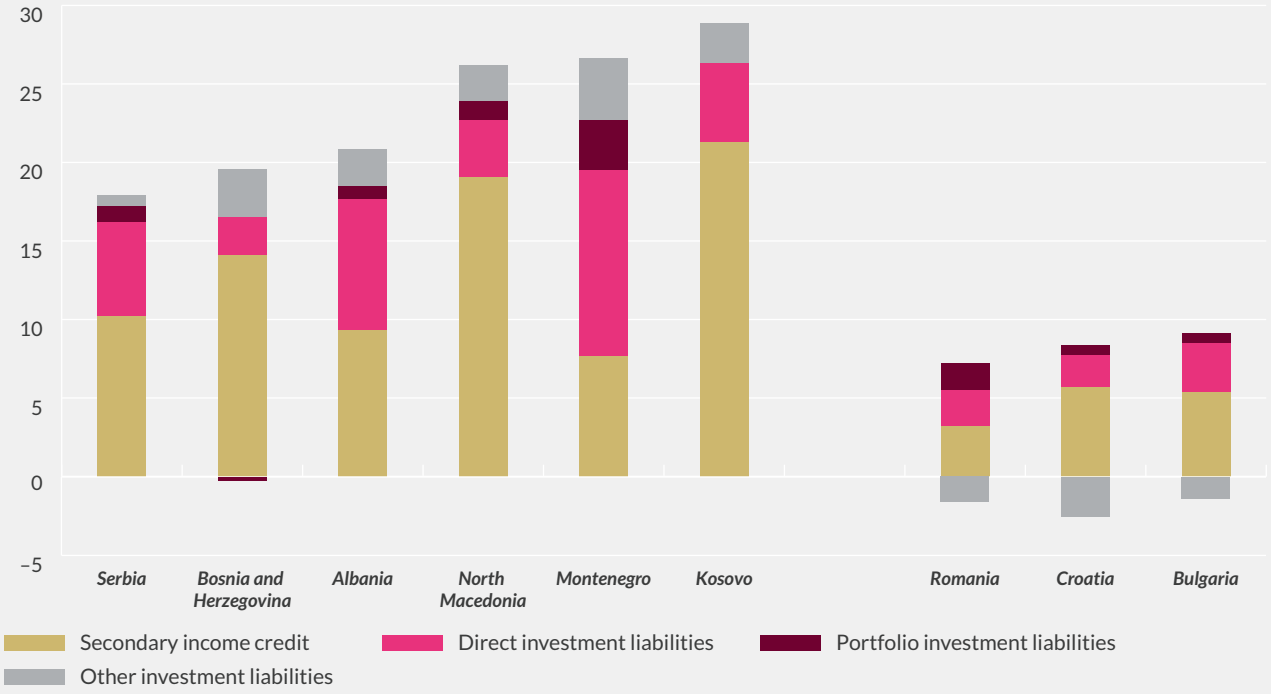
Fourth, customs unions can help to dilute the influence of powerful and entrenched interest groups by removing country-specific protections and forcing firms to compete in a more open market (Panagariya and Findlay 1996). This could be relevant for the Western Balkans, where powerful interest groups are often entrenched and able to rent seek (see e.g. Bechev 2012 and van Ham 2014).

Meanwhile, a single market would go much further than a free trade agreement or customs union by adding services, capital and labour. It can also do much more than a customs union in terms of reducing border delays and costs. In addition, a single market including capital markets and digital integration could have important positive spillovers. There are currently quite underdeveloped areas in the region. In theory, the creation of a single larger market in these areas could provide a significant boost to economic development.

Relative to the size of their economies, the Western Balkan countries are very reliant on foreign capital inflows (Figure VI.9). This is particularly the case in terms of secondary income credit (a rough proxy for remittances). FDI inflows have also been more significant, at least for Albania and Montenegro. Portfolio flows, meanwhile, play a very small role in the overall external financing profile, reflecting underdeveloped regional capital markets and a lack of instruments to interest international investors.

Underdeveloped regional capital markets are a serious barrier to growth (Moder and Bonifai 2017). In general, the region faces substantially higher real interest rates compared with both

FIGURE VI.9 **Selected capital inflows, as a percentage of GDP, 2010–2019 average**



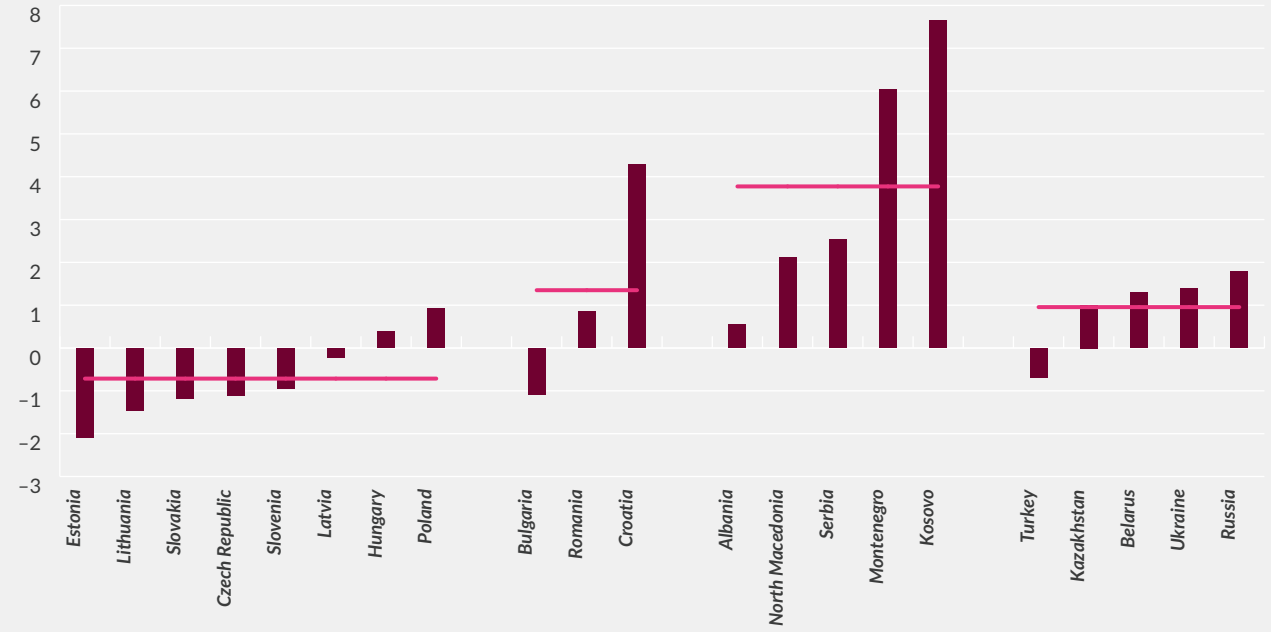
Source: wiiw. | **© Bertelsmann Stiftung and wiiw.**

EU-CEE countries (including the 2007 joiners) and other non-EU CEE countries (Figure VI.10). Most small and medium-sized enterprises (SMEs) in the Western Balkans – and especially the more innovative SMEs with significant growth potential – have very limited access to financing (ibid.). Their sole option, in effect, is commercial banks. However, the fact that many of the most innovative companies are in the ICT sector means that most of their assets are 'intangible'. In other words, they cannot post significant collateral, which is a big problem for traditional banks (Haskel and Westlake 2017). On the other hand, private equity firms, which are an important source of capital for these kinds of firms in the US and parts of Western Europe, still have a very limited presence in the Western Balkans.

One of the issues for the Western Balkans in this regard is simply scale, as none of the countries is really big enough to attract the interest of private equity firms. A capital markets union in the region could be important in this regard. The EBRD, OECD and others have recommended regional cooperation in order to support SME development, including in terms of access to financing. Scaling-up the market could significantly increase the interest of non-FDI foreign capital in the region, which would be helpful for smaller firms.

Policymakers around the world have become more focused on digitalisation in recent years. It is clear that digital topics will be increasingly important in the future, not least in the Western Balkans. Having recognised this, the European Commission launched its Digital Agenda for the Western Balkans in 2018. Digital integration in the Western Balkans is a key focus of the Regional Cooperation Council. Digitalisation in the economy in general is

FIGURE VI.10 **Real interest rates, CPI-adjusted, in percent; average for January 2010 – March 2020**



Source: wiiw. | **© Bertelsmann Stiftung and wiiw.**

likely to get a significant push from the Covid-19 pandemic and its fallout.

In theory, digital integration can proceed more easily than, say, energy or infrastructure integration. Since it does not require as much physical infrastructure, it may offer an opportunity for less developed economies to catch up more quickly. In the case of the Western Balkans, progress on regional digitalisation could act as a driver of economic and social convergence with the EU (Barbić et al. 2018).

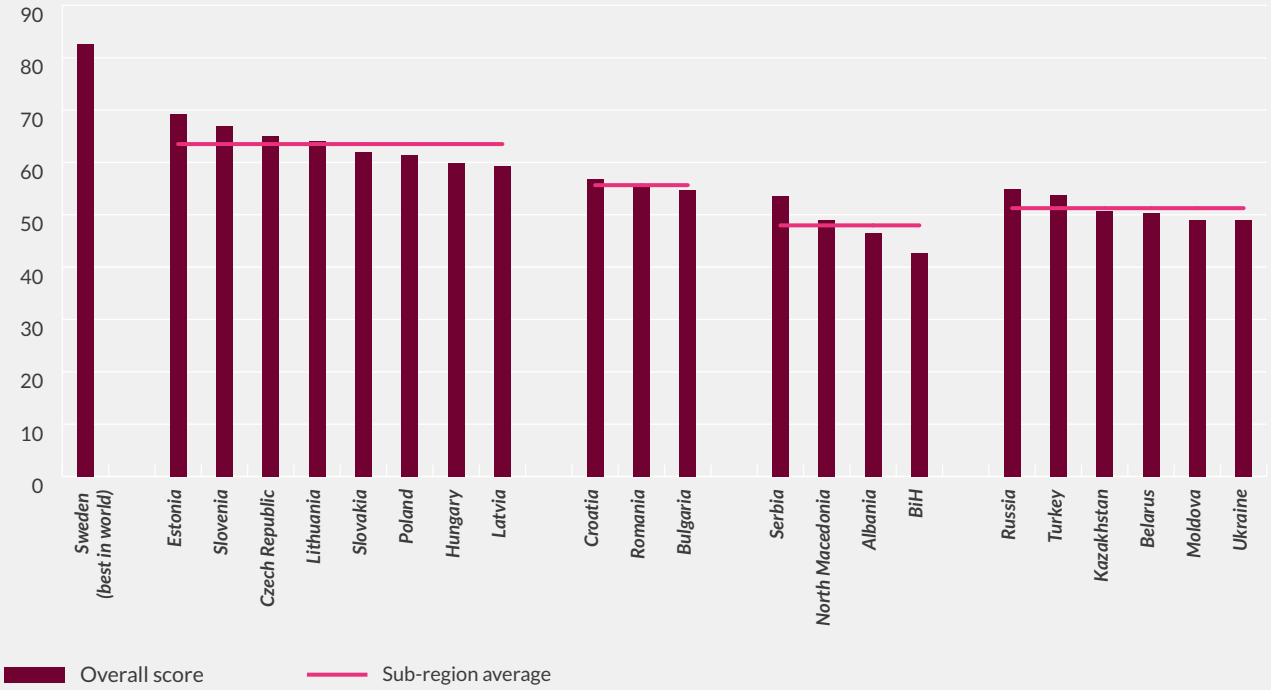
However, the 2019 update of the Network Readiness Index[31] suggests that the Western Balkans are already quite far behind most of their peers in CEE in terms of preparing for the digital economy of the future (Figure VI.11). The average score for the Western Balkan countries is considerably lower than that of the 2004 EU joiners in CEE as well as below the averages for the 2007–2013 EU joiners, the CIS, Turkey and Ukraine.[32]

Significant progress on digitalisation could have important and positive impacts on regional integration (ibid.). Directly, this could involve cross-border e-governance cooperation and facilitate cross-border business clusters. If pursued successfully, these developments could also have important spillovers for regional cooperation more generally, such as improving contacts among citizens of different Western Balkan countries.

31 The Network Readiness Index 2019 ranked 121 countries on their ability to use information and communication technology to achieve inclusive and sustainable growth, competitiveness and well-being. It assesses countries based on four main criteria: technology, people, governance and impact.

32 Kosovo and Montenegro are not included in the survey.

FIGURE VI.11 **Network Readiness Index 2019, score (1–100)**



Source: Network Readiness Index 2019. | **© Bertelsmann Stiftung and wiiw.**

When it comes to greater regional economic integration, are the potential economic upsides greater and the barriers lower than they were before?

Despite the potential positives outlined above, the creation of a customs union and/or single market in the Western Balkans is likely to run into the familiar practical difficulties and challenges of economic integration of the past. These challenges can be split into six key areas.

First, the economic upside of region cooperation remains very limited. As of 2018 (the last year for which fully comparable data are available), the combined nominal GDP of the Western Balkan Six was 2.8 percent of that of Germany and 0.6 percent of that of the EU28. As of 2018, none of the Western Balkan Six countries had risen above 40 percent of the German level on this basis. The old problem remains: These are small, relatively poor economies right next to a huge and very wealthy economic bloc. Despite a multitude of initiatives outlined in Chapter VI, most Western Balkan countries still do the vast majority of their trade outside the region. The economic relationship with the EU has largely remained in a 'hub and spoke' model.

A second challenge is connectivity, which is important for increased regional trade and investment flows. As shown in the previous chapter, the current state of regional transport and energy connectivity is better than it was 20 years ago, but it still has some major shortcomings. Various initiatives of recent years have the potential to improve this, but there isn't any game changer in sight.

Third, the Covid-19 pandemic and its economic fallout will also represent a rather severe challenge to the economies of the Western Balkans, and the global economic backdrop is extremely challenging. The IMF expects that 2020 will be the worst year for the global economy since the 1930s, and that certain countries which are particularly important to the Western Balkan countries (e.g. Croatia and Italy) will be particularly badly affected.

Fourth, further steps towards regional economic integration will require a greater harmonisation of legislation and regulations as well as more policy coordination. This will be difficult to achieve in light of the low level of trust between the partners and the low government standards outlined in Chapter IV. The challenges to policy coordination outlined in Chapter V are still in place.

Fifth, there would be the challenge of reaching agreement on a common external tariff for the regional customs union. At present, Western Balkan countries' tariffs with the rest of the world differ, which necessitates border controls within the region. Even though intra-CEFTA trade in goods and (increasingly) services is tariff-free and liberalised in most other respects, border checks are still necessary in order to implement rules of origin, which causes the border delays mentioned above.

Moreover, as outlined in Chapter V, the size, sophistication and international integration of Serbia's export sector (and particularly those of the automotive sector) dwarf anything else in the region. In this sector, Serbia mostly trades with the EU rather than the rest of the region, and very little of a regional value chain has developed. At the opposite end of the scale, Montenegro has almost no manufacturing industry to speak of; it accounts for just 4 percent of GDP compared with around 15 percent for Serbia. This means that Serbia would have quite different incentives in terms of setting a common external tariff related to automotive supply chains than most or all other countries in the Western Balkans.

Sixth, Western Balkan countries have existing FTAs with partners outside the region (Table VI.1). The most problematic of these would probably be Serbia's FTA with Russia, which has been in place since 2000. Serbia recently expanded this by signing a deal with the whole of the Eurasian Economic Union. Serbia's strong political relationship with Russia would make this

TABLE VI.2 **Western Balkan countries' FTAs**

Partner	Albania	Bosnia and Herzegovina	Kosovo	Montenegro	North Macedonia	Serbia
CEFTA	x	x	x	x	x	x
EU	x	x	x	x	x	x
Russia				x		x
US	x	x	x	x	x	x
Turkey	x	x	x	x	x	x
EFTA	x	x		x		x
Kazakhstan						x
Belarus						x
Ukraine				x	x	

Sources: National sources. | **© Bertelsmann Stiftung and wiiw.**

difficult to give up. Of course, it may well do this eventually to join the EU, but probably not for the sake of a Western Balkans customs union.

How big are the demographic challenges that the region faces?

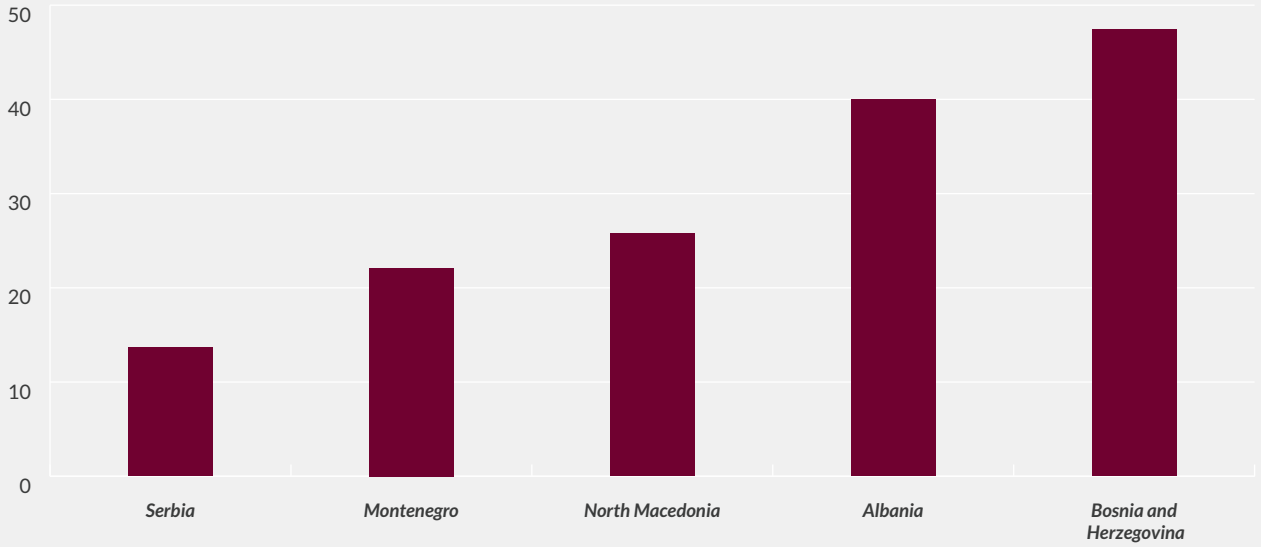
As alluded to in the introduction to this study, the macroeconomic performance of the Western Balkan countries over the last two decades has been far from impressive. The region's economies have generally recorded the weakest rates of per capita GDP convergence with Germany in the whole of CEE over the last 20 years. This is despite the fact that the Western Balkan countries started out in 2000 much poorer than almost all of the countries in the region that have subsequently joined the EU.

Negative demographic trends have been both a cause and a consequence of this disappointing economic performance. In some countries – especially Bosnia and Herzegovina, but also North Macedonia and Serbia to a certain extent – negative demographic trends can be partly explained by low birthrates. However, a key factor for all Western Balkan countries is a high rate of outward migration (Mara 2020).

Although outward migration from most of the Western Balkan countries was strong before 1989, it has grown even stronger over the last three decades. An estimated 1.6 million Bosnians lived abroad in 2017, or almost half of the country's population. However, for all Western Balkan countries for which such data are available, the number of people who have left is a significant share of the total population (Figure VI.12).

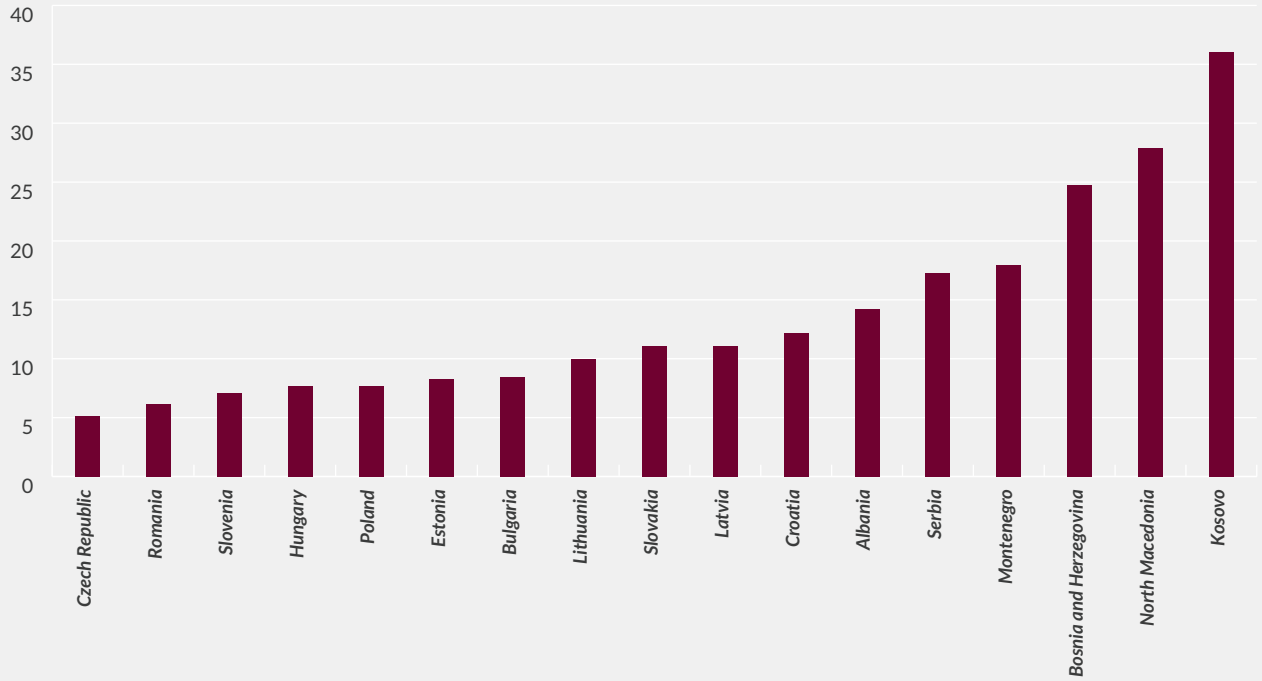
The high rates of outward migration can be interpreted as a reaction to various factors, including the quality of public services, governance standards and perceptions regarding corruption and nepotism (Judah 2019). However, it is likely that weak economic performance and

FIGURE VI.12 **Total emigrants as a share of current population, in percent**



Source: Own calculations, based on United Nations, Department of Economic and Social Affairs, Population Division (2017). World Population Prospects: The 2017 Revision, DVD Edition. | **© Bertelsmann Stiftung and wiiw.** | Note: Data on Kosovo are not available.

FIGURE VI.13 **Unemployment rate, in percent, 2007–2019 average, Labour Force Survey (LFS) data**



Sources: National sources, Eurostat. | **© Bertelsmann Stiftung and wiiw.**

poor job prospects also play an important role. Since 2007, the average unemployment rate in Western Balkan countries has been considerably higher than in the EU member states in CEE (Figure VI.13).

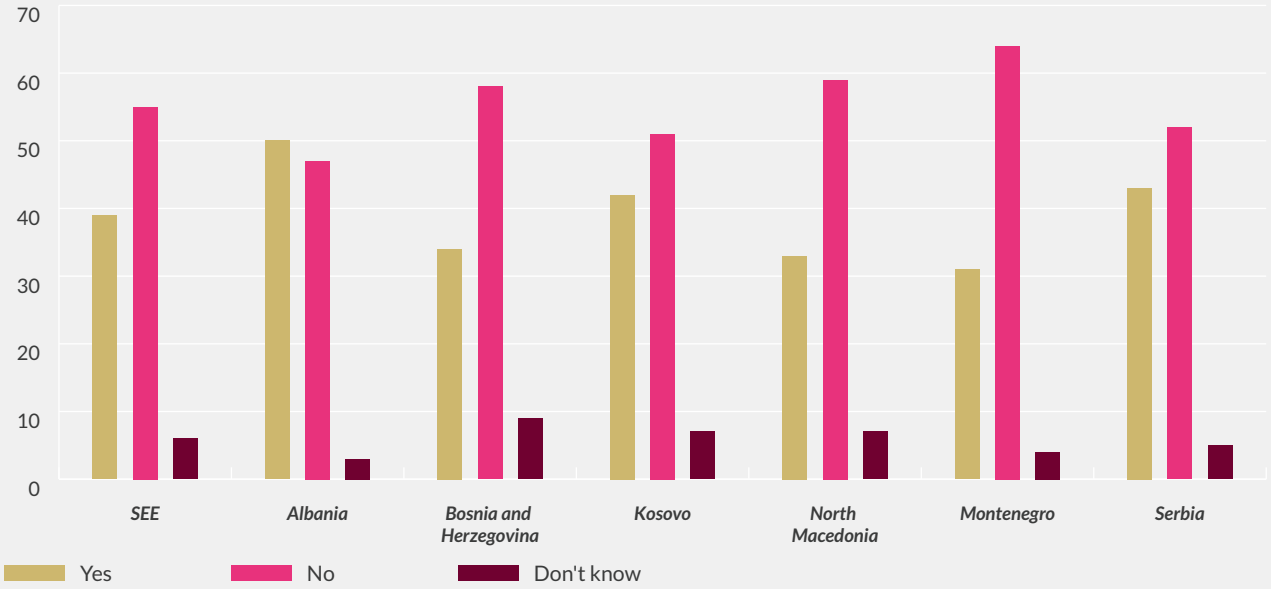
Available survey data indicate that high rates of outward migration are likely to continue. The Balkan Barometer in 2019 showed that 39 percent of people in the Western Balkans would consider living and working abroad (Figure VI.14). Country-specific responses ranged from 31 percent in Montenegro to 50 percent in Albania. Among those considering moving abroad, 25 percent were 'actively getting informed about possibilities' and a further 12 percent were already at a more advanced stage.[33]

Over the coming years and decades, the demographic challenges faced by the Western Balkans are only likely to increase. Moreover, it is likely to be younger and more educated people, in particular, who leave since they have the best opportunities to find work in Western Europe. This will create special challenges for the economies of the region, especially in sectors in which there are already severe shortages in some countries, such as in healthcare. In its 'constant natural population development' scenario,[34] the UN projects that the working-age population of the Western Balkan countries will decline by 15 to 35 percent by 2050, depending on the country (Figure VI.15). Even in a (quite unrealistic) 'zero migration' scenario, the decline would still be notable across the board.

33 This is a combination of those reviewing and applying for jobs (6%), those already with concrete plans to move (4%), and those who knew the exact date of departure (2%).

34 This scenario assumes that current fertility, mortality and net migration rates will continue. For a full explanation, see Mara (2020).

FIGURE VI.14 **"Would you consider living and working abroad?" Percentage of total**



Source: Balkan Barometer 2019. | **© Bertelsmann Stiftung and wiiw.** | Note SEE = average for Southeast Europe.

FIGURE VI.15 **UN working-age population projections, 2015–2050 changes, in percent**

Source: Own calculations based on United Nations, Department of Economic and Social Affairs, Population Division (2017). World Population Prospects: The 2017 Revision, DVD Edition. | **© Bertelsmann Stiftung and wiiw.** | Note: Data on Kosovo are not available.

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VII. Another way? 'EU integration max'

If the potential for further intraregional trade and investment is low and will additionally require the expenditure of a lot of political capital, perhaps it would instead be better to focus on greater integration with the EU, as was suggested by some two decades ago. The most obvious point to make here is that the potential upside of further economic integration with the EU – in terms of trade and investment – dwarfs even the most optimistic expectations about what greater regional integration could potentially achieve. The combined GDP of the Western Balkans is roughly equal to that of Slovakia, or less than 1 percent of that of the EU28. The disparity in size means that even a limited amount of further integration with the EU would surely be much more powerful in economic terms than a substantial increase in regional economic integration.

In this section, we will look at the example of the CEE countries that joined the EU in 2004 and how this impacted their economic integration. We will also look at various existing examples of deeper economic integration with the EU and ask to what extent these would be both feasible and desirable steps for the Western Balkans.

The example of the 2004 EU joiners

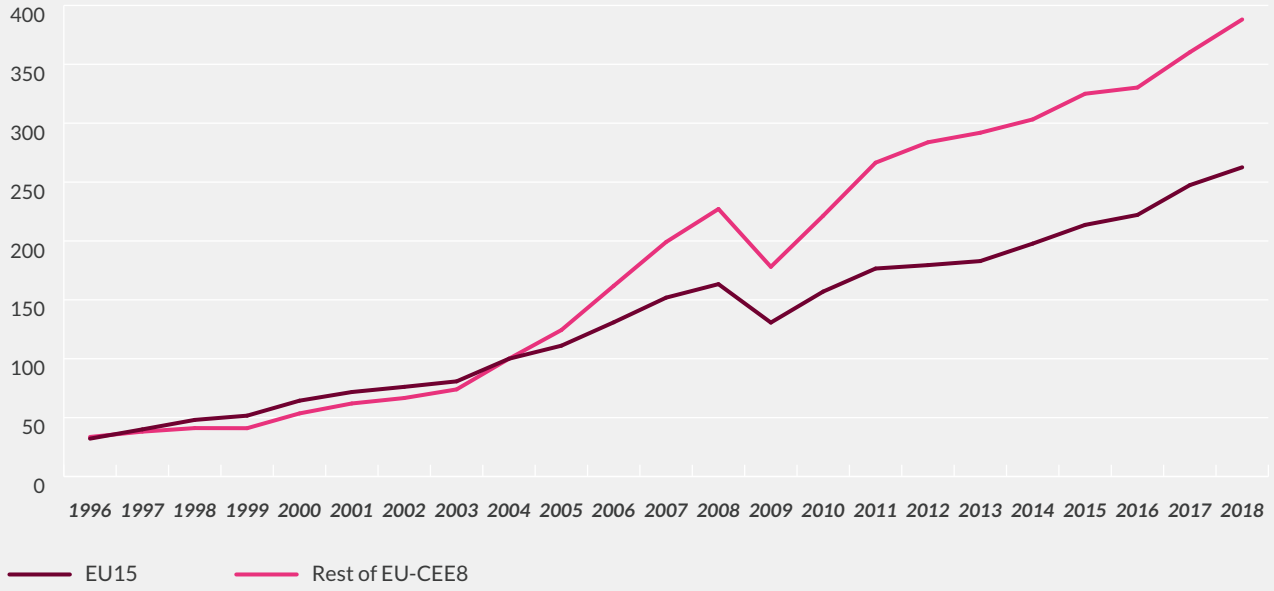
For CEE countries that joined the EU in 2004 (EU-CEE8),[35] we find that their trade integration with each other actually increased quite significantly after EU accession. Moreover, and interestingly, we find that the EU-CEE8 countries integrated more with each other after EU accession than with the EU15; in fact, 2004 marked quite a significant change in this trend (Figure VII.1). This is perhaps a surprising finding, as one could expect that the entry into the EU Customs Union and single market, combined with the fact that the EU15 was a much bigger and wealthier market, would mean that the opposite would occur.

We attribute this to two linked factors, both of which are highly relevant to the Western Balkans. First, EU accession brought about truly 'frictionless' trade. Second, EU accession introduced a significant positive demand shock in the EU-CEE8 economies. Although much of this was reflected in increased export demand, Figure VII.1 indicates that this was not the only thing going on, as a great deal of the extra demand came in the form of capital flows. These capital inflows came from various sources, but most significantly from FDI and EU budget inflows.

Beginning in around 1998 (which was roughly the start of EU accession negotiations for the EU-CEE8 countries), FDI started to flood into the

35 Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia and Slovenia.

FIGURE VII.1 **External trade of EU-CEE8 countries, 2004 = 100**



Source: wiiw. | **© Bertelsmann Stiftung and wiiw.**

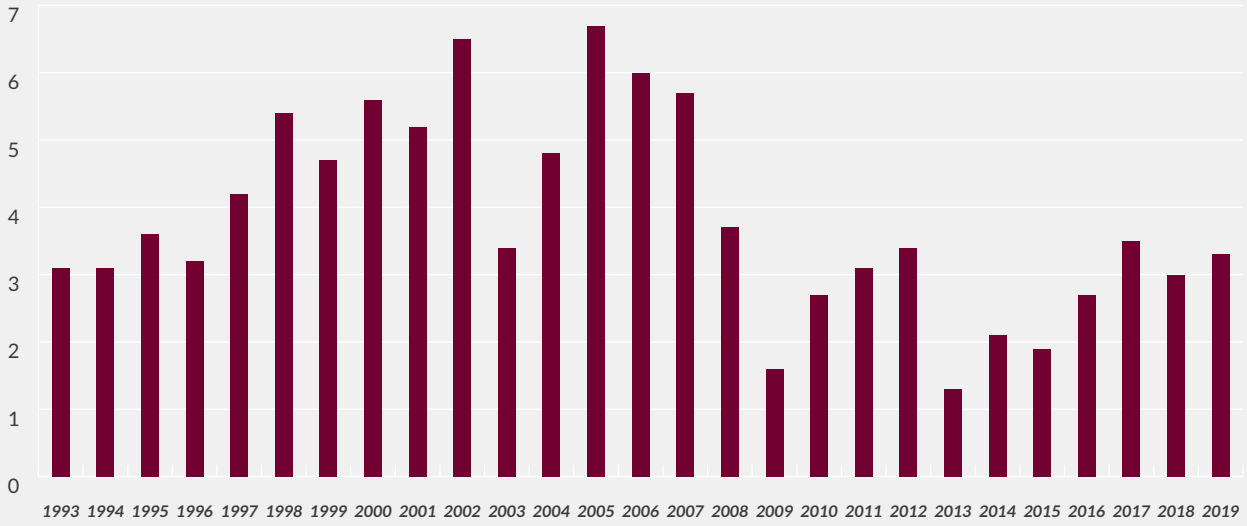
region (Figure VII.2). On average across the eight countries, net FDI inflows averaged 5.4 percent of GDP between 1998 and 2007. The share coming from the EU15 was, on average, consistently around three-quarters during this time, ranging from about half in Latvia to almost 85 percent in the Czech Republic and Estonia (averages for the 2000–2007 period). It is reasonable to expect that these inflows were greatly influenced by two things: first, expectations of future frictionless trade between the EU-CEE8 countries and the home markets of FDI, such as Austria, Germany and Italy (Buch and Piazolo 2000);[36] and, second, the strong and credible reform anchor of the EU and NATO accession processes (which is something very important to foreign investors).

Meanwhile, the EU-CEE8 countries were also given access to the EU budget. From 2004 to 2008, net inflows from the budget were equivalent to around 1 percent of gross national income on average in the eight countries (and increased significantly after that; see Figure IV.6 above). As well as being positive for aggregate demand in general, this was (and continues to be) important for infrastructure investment, in particular. In fact, EU funds have financed the majority of public infrastructure in these countries since 2004. This, in turn, has created a positive feedback loop, as better infrastructure enables the EU-CEE8 to develop increasingly sophisticated economic structures (e.g. 'just-in-time' manufacturing) and acts as a powerful incentive for foreign investors to put their money in these countries.

It is true that the Western Balkans already have a high level of economic integration with the EU. The SAAs already provide for free trade in goods as well as quite liberalised conditions for investment. Nevertheless, there are more steps that could be taken to integrate the region with the EU market. This, in turn, could be an important driver of regional cooperation.

36 One important caveat is that this was quite a special time for the global economy, and one that is not likely to be repeated.

FIGURE VII.2 **Inward FDI inflows, as a percentage of GDP, EU-CEE8 average**



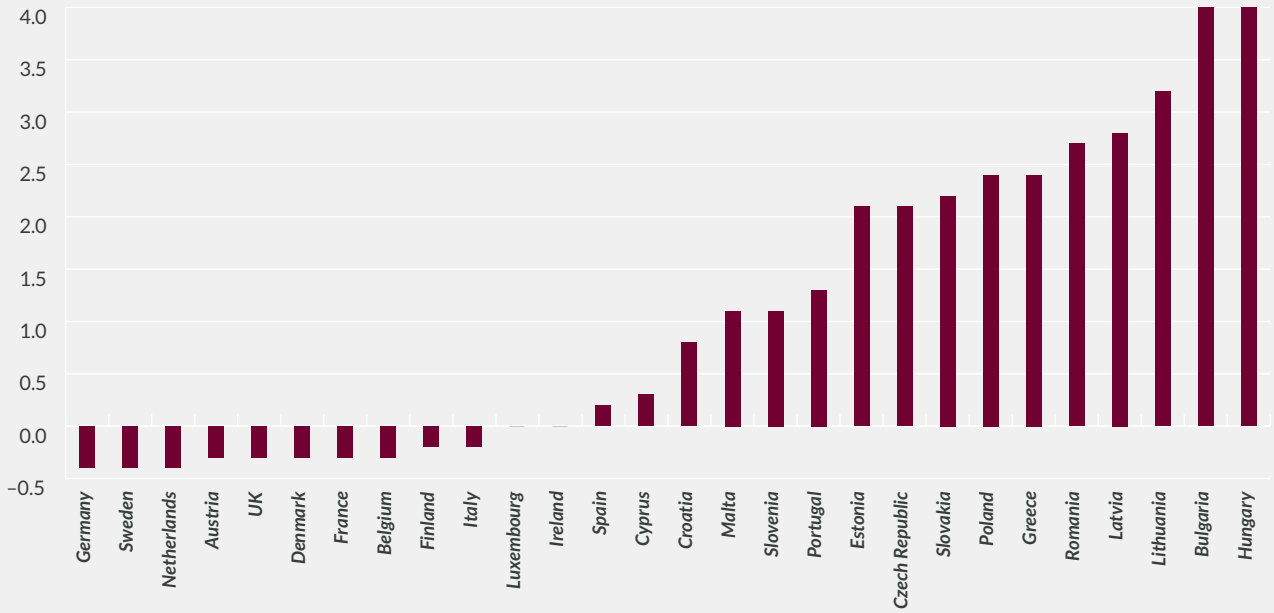
Source: wiiw FDI Database. | **© Bertelsmann Stiftung and wiiw.** | Note: EU-CEE8 = Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia, Slovenia.

Access to the EU budget

For the Western Balkan countries, full involvement in the EU budget would be hugely beneficial. For most of EU-CEE, EU funds are equivalent to 2 to 5 percent of gross national income (GNI) per year (Figure VII.3). Between 2014 and 2018, Hungary and Bulgaria received on average the equivalent of 4 percent of GNI per year in net terms, while the analogous Figures were 3.2 percent for Lithuania, 2.8 percent for Latvia, and 2.7 percent for Romania. Compounded over time, this has been something of a game changer for the infrastructure of these countries. EU funds tend to account for the majority of public infrastructure investment in the EU-CEE in addition to being a major reason (and probably the major reason) why EU-CEE countries tend to have significantly better infrastructure than Western Balkan countries. Although one could argue that weak governance would reduce the effectiveness of EU funds, this does not seem to have been decisive in the case of Hungary, despite evidence of corruption there (Gebrekidan, Apuzzo and Novak 2019).

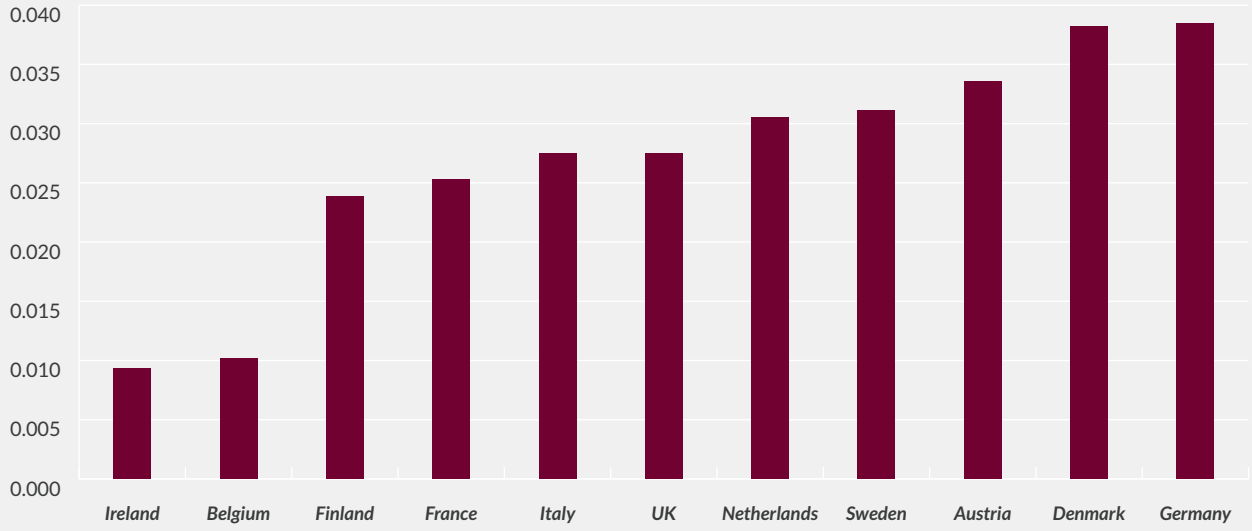
In addition to being a game changer in the region, including the Western Balkans in the EU budget would also hardly register (fiscally) in the EU itself. Using 2018 data, we come up with a rough estimate of what full Western Balkan participation in the EU budget would cost. Assuming the highest-possible rate of net income from the budget (Hungary's level of 4 percent of GNI on average over the most recent five years for which data are available), we find that the impact on the net contributors to the EU budget would be almost imperceptible (Figure VII.4), ranging from 0.009 percent of 2017 GNI in Ireland to 0.04 percent in Germany.

FIGURE VII.3 **Net operating balance with EU budget, as a percentage of GNI, 2014–2018 average**



Source: European Commission (https://ec.europa.eu/budget/graphs/revenue_expediture.html). | **© Bertelsmann Stiftung and wiiw.**

FIGURE VII.4 **Estimated costs of full Western Balkan participation in the EU budget, as a percentage of each net contributor member state's 2018 GDP**



Source: European Commission, Eurostat, wiiw, own calculations. | **© Bertelsmann Stiftung and wiiw.**

Partial entry into other parts of the EU Customs Union and single market

Membership in the EU Customs Union would be an important deepening of the economic relationship between the bloc and the Western Balkans. If the Western Balkans entered the EU Customs Union, this would mean two main things:

First, they would adopt the customs regime of the EU, including its external tariffs. Among other things, this would resolve the problem of the Western Balkan countries' arguing over external tariffs, as they would simply adopt those of the EU. Accession to the EU Customs Union would therefore prove to be a powerful driver of regional economic integration.

Second, membership in the EU Customs Union would mean the removal of non-tariff barriers to trade with the EU. Although Turkey's membership in the customs union for goods traded with the EU has not faced many practical difficulties in this respect (Hakura 2018), there are some important differences compared to the Western Balkans. First, the Western Balkan countries are on their way to eventual EU membership, which Turkey is not. This would make any Western Balkan participation in the EU Customs Union smoother than has been the case for Turkey (especially in the case of Montenegro and Serbia, which are already in the accession process). Second, size is also important. Both in terms of population and economic output, the Western Balkans region is small compared with Turkey, so it would be much easier for the EU to integrate. Third, Turkey faces (and will continue to face) visa barriers, whereas all Western Balkan countries except Kosovo already have visa-free access to the Schengen Area.[37]

37 At the time of writing, this is still the case for Kosovo.

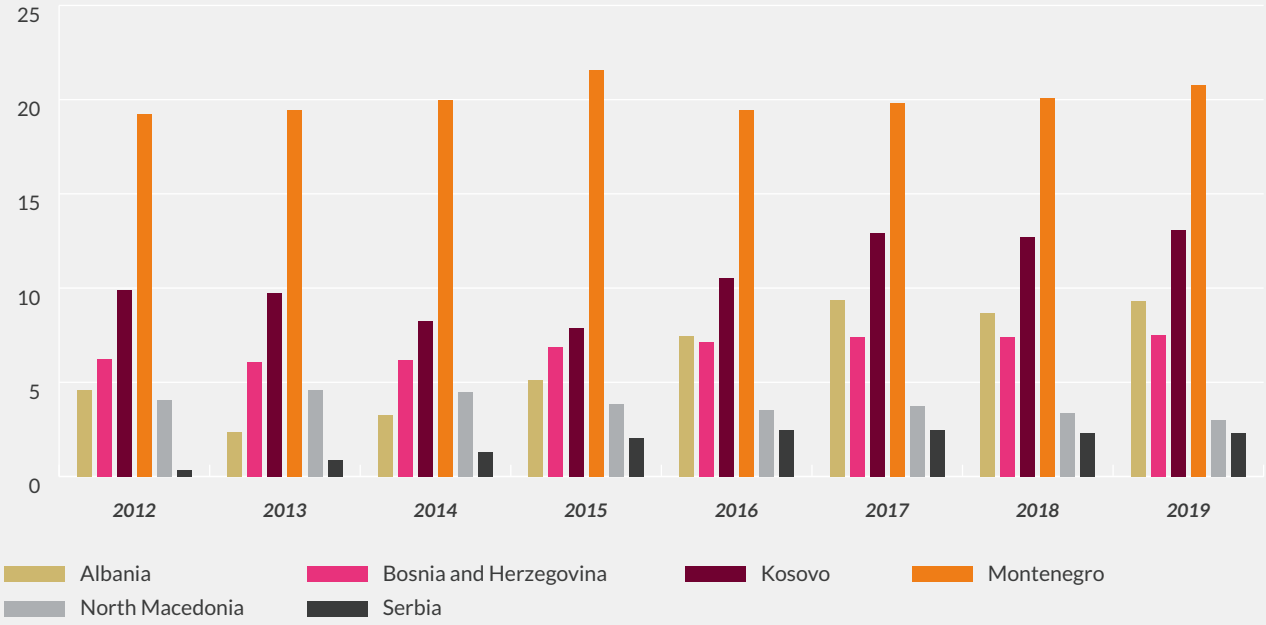
Deeper services and labour integration

Services are an important part of all Western Balkan economies and a key generator of foreign currency. All six countries run services surpluses, and these have generally increased relative to the size of their economies over the past decade (Figure VII.5). Montenegro's (and, to a lesser extent, Albania's) specialism in tourism is well known, but the service sector in the region is much broader than this, including and increasingly in IT and digital services.

Expanding the current SAAs to include services could be feasible and possibly not present huge obstacles. In this case, the Deep and Comprehensive Free Trade Agreement (DCFTA) with Ukraine is an instructive example (Adarov and Havlik 2016). This currently offers the highest level of integration with the EU apart from the EEA and EFTA (discussed below). DCFTAs provide for a high level of integration of goods, services and capital, although not of people (Emerson et al. 2017). Among other things, this indicates that the 'four freedoms' can be divisible in certain cases.

Introducing fully free movement of labour between the EU and the Western Balkans could be an altogether trickier issue, as one can assume that the population of many or most EU countries would be against it. In any case, this could be postponed for some time, as was the case during the enlargements of 2004, 2007 and 2013. However, in reality, opposition from the public in EU member states may not be as high as feared. For example, of the questions on EU policies asked by Eurobarometer, free movement receives the highest degree of support (Figure III.2 above). This does not include the Western Balkan countries, of course, but it is not obvious why EU citizens would be so supportive of free movement with, say, Romania and not with, say, Serbia. In fact, one could even expect to see quite strong business lobbying for this. Since 2015, citizens of the Western Balkans have been able to enter

FIGURE VII.5 **Services balance, as a percentage of GDP**



Source: wiiw. | **© Bertelsmann Stiftung and wiiw.**

Germany on working visas provided they have a concrete employment offer. More recently, amid labour shortages in Germany and other parts of Western Europe, there have been more initiatives to make it easier for people from the Western Balkans to work there.

Partial entry into the single market: The examples of Norway and Switzerland

Switzerland and Norway (along with Iceland and Lichtenstein) are members of the European Free Trade Association (EFTA), which gives them access to the single market. However, neither is a member of the EU Customs Union. Norway is a member of the European Economic Area (EEA), but Switzerland is not. One can view the EFTA as a kind of outer ring of the EU. This could be one possible route for the Western Balkans to integrate with the EU.

There are several important differences between what Norway or Switzerland have and full EU membership, with the most important being their non-membership in the EU Customs Union. Norway is also outside the Common Fisheries Policy and Common Agricultural Policy, which reflects the importance of these industries to its economy.

Both countries have had issues regarding their arrangements with the EU. Switzerland is a particularly tricky case because its membership is based on a large number of bilateral treaties, which creates a high level of complexity. This is certainly not something that will be offered to the Western Balkans. On the other hand, Norway's relationship with the EU is generally smoother, but the need to open its postal services and electricity companies has caused some friction. One could certainly anticipate similar issues in the Western Balkans. In both cases, unlimited immigration into the Schengen Area could be

an issue. However, in this regard, the case of the Western Balkans would be very different, as the region would be a source rather than recipient of migrants from the rest of the EU.

This links to a more general and fairly basic difference: While Norway and Switzerland do not want to be part of the EU, the Western Balkan countries do. This means that the exceptions of Norway and Switzerland, or deviation from full EU membership, are to suit the priorities of and placate public opinion in those countries rather than in the EU. In the case of the Western Balkans and the EU, the relationship would be the other way round. Just because there is opposition in some parts of the EU to allowing the Western Balkans full membership, this does not mean that there would be an automatic block to adding the region to parts of the single market.

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VIII. Conclusions and the way forward

As we have shown in Chapters V–VI, the challenges outlined at the start of this study remain largely the same 20 years on and, in some ways, the situation has become even more challenging:

- Intraregional trade and investment relationships within the Western Balkans have deepened in the last 20 years, and intraregional infrastructure connectivity has improved.
- However, this has not delivered much economic convergence with the rest of Europe, and the quality of infrastructure remains generally well below the levels of those in EU-CEE countries.
- For most countries in the Western Balkans, the key trading partner and sources of FDI is the EU.
- The efforts towards regional cooperation have not had any material impact on the most intractable aspects of the geography of animosity, and EU accession for the region still appears to be many years off.
- The economic upside of additional efforts towards regional cooperation is likely to be limited and not attractive enough to get leaders in the Western Balkans to fully embrace them.
- Current proposals for deepening regional cooperation in an economic sense are fine, but they will not fundamentally change the situation and are likely to run into the familiar obstacles of the past.
- Governance standards are very low and regressing in at least some cases, which in itself will hamper additional efforts towards regional cooperation and the EU accession process.
- Local ownership of the process of regional cooperation has increased, and citizens feel engaged. However, elites are less interested, and the territorial disputes and constitutional gridlock of 2020 is the same as that of 2000.
- The EU and the US underpin basic political, economic and financial stability in the Western Balkans.
- North Macedonia and Montenegro can feasibly join the EU in the coming years, but politics will prevent the remaining four countries in the Western Balkan Six from doing so. The sense of drift risks putting more roadblocks in the way of EU accession for these four countries.

By summarising in this way, we do not want to imply that regional cooperation in the economic sphere has been a waste of time. Rather, as we showed in Chapter VI, it has clearly had a positive impact on intraregional trade and investment as

well as on infrastructure connectivity. Moreover, our paper does not intend to challenge the political, social and youth aspects of regional cooperation, as it is undoubtedly good that there is youth cooperation, military/police contact, and a general normalisation of relations after what are still quite recent wars. Indeed, all of this should continue, and the increased local ownership of the process has undoubtedly been a positive step.

However, as we have also shown in this paper, these efforts alone are not enough to fundamentally drive stronger regional economic integration and development and, in turn, to change the geography of animosity. They may have been necessary, but they are far from sufficient. The two main challenges of the year 2000 – territorial/constitutional disputes and a low level of economic development relative to most of the rest of Europe – remain the challenges of 2020. This has been exacerbated by demographic challenges, with strong outward migration over many years causing shortages of skilled labour in key sectors, which further weighs on the economic outlook for the region. Survey data suggest that the strong outward migration and brain drain of the last few decades are set to continue in the future, and that the Western Balkan region faces quite an alarming decline in the size of its working-age population between now and 2050.

The question, then, is not whether regional cooperation has had a positive impact and will continue to; it has, and it will. A more important question is whether the gains have really justified the time and political capital spent on this initiative, and whether this approach is the best way to achieve what must still be the end goals: political normalisation within the Western Balkans and full EU accession for all countries.

Pushing further economic regional cooperation from this point is not without its merits. Reducing trade-related friction between the Western Balkan countries will bring positive benefits. Greater integration into capital markets and the digital sphere are very welcome, not least in the current environment, when the economic shock from the Covid-19 pandemic will put particular pressure on SMEs and lead to opportunities in the digital economy. All of this would surely increase the region's ability to attract bigger and higher-quality FDI projects, a form of economic development that has worked reasonably well for other parts of CEE. It would also increase the size and power of the business community pushing for EU accession.

However, these efforts alone are not going to overcome the fundamental barriers to economic integration, economic development, political normalisation and eventually EU accession for most of the countries of the Western Balkans. There is a clear risk that pushing hard for greater regional cooperation would be 'pushing on a string', so to speak. In other words, it could require major efforts and a large investment of political capital as well as create a lot of expectations, but then only result in a few tangible rewards as well as subsequent disappointment and frustration.

As outlined in Chapter V, a greater level of economic integration with the EU than the Western Balkan region currently has is both possible and desirable. The Western Balkan countries could get greater access to the EU budget without any significant increase in expenditure for any member state given the size and wealth level of the Western Balkan economies relative to those of the EU. This would particularly be important for public infrastructure funding, and have the added bonus of reducing the temptation for Western Balkan countries to turn to China. Moreover, by itself, greater integration with the EU market could actually spur regional integration, seeing that trade integration between the Visegrad countries increased substantially after EU accession.

In this sense, the phased integration approach being advocated by France could be engaged with constructively. For example, it would be better to have more access to the EU budget and other benefits of membership earlier in the accession process than to do all the hard work upfront and only receive rewards at the end.

However, economic aspects can ultimately only be part of the solution for the Western Balkans. As in the past, the political aspects are central and, in this sense, the old dilemma of the 'Balkan express' versus the 'Balkan regatta' is still there. In other words, is it better to bring the less 'problematic' countries in first? Or is it better to try to bring all countries into the EU at the same time? In both cases, regional cooperation and integration make up important elements, but they are far from sufficient by themselves.

There is a quicker route for Montenegro and North Macedonia into the EU than for the rest of the region. These two countries are not as strongly involved in the geography of animosity as the other four. With strong Commission support, as happened with Romania and Bulgaria, relatively swift EU accession for Montenegro and North Macedonia is feasible. In turn, it could be hoped that accession for these two countries could boost pro-EU forces in Serbia. This would be helped by the deepening of the regional market and higher FDI outlined above, which would increase the size and power of the business constituency that supports regional and European integration.

By contrast, bringing all of the Western Balkan Six countries into the EU at the same time is a much tougher proposition. Doing so would require a combination of strong pressure on and serious incentives to Serbia to make the required compromises regarding Kosovo in addition to a change in the stances of some current EU member states that oppose Kosovan independence. It would also mean a much harder push for improved governance standards across the region. If this does not happen, Serbia will be incentivised to continue to extract concessions from the EU and other external players, and the EU accession process for most of the region will be stalled.

IX. Acknowledgments

In the early 2000s, following the end of the Yugoslav Wars, the Bertelsmann Stiftung in cooperation with Germany's Federal Foreign Office explored strategies for regional reconciliation and peacebuilding within the framework of the so-called "Balkan Forums". Particular attention was paid to the opportunities for regional cooperation to bring peace to the Western Balkans. Twenty years later, while much progress has been made, the desired deepening of cooperation as an essential prerequisite for peaceful conflict resolution has not been fully achieved. The 25th anniversary of the genocide in Srebrenica in July 2020 served as a reminder not only of the violence of the 1990s, but also of the fact that most of these conflicts have been merely frozen rather than constructively dealt with through new forms of cooperation between the Western Balkan states.

The question therefore arose as to whether the EU strategy of regional cooperation for the Western Balkans was the right one at all, and what else could or should have been done to make more progress. In the Vienna Institute for International Economic Studies (wiiw), we found an excellent partner for examining the economic aspect of regional cooperation and whether the Western Balkans actually fulfilled the requirements for such a strategy.

During the initial scoping of this study, discussions took place in Brussels attended by representatives of DG TRADE, DG NEAR, the European Parliament, the European Political Strategy Centre (EPSC), EEAS and the German Institute for International and Security Affairs (SWP). The input and advice given during these discussions is gratefully acknowledged.

We present the results of the cooperation together with recommendations for a change of strategy in this report. wiiw has also summarised the extensive research and calculations it has carried out for this report in an extra study entitled "Regional Economic Cooperation in the Western Balkans: The Role of Stabilisation and Association Agreements, Bilateral Investment Treaties and Free Trade Agreements in Regional Investment and Trade Flows". We are publishing this in parallel to this report

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