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## Balkan End Game *By Vladimir Gligorov*

In the next couple of years, all of the most important decisions about the Balkans will be made. At the end of this year, the European Union will decide whether to accept the Commission's recommendation to begin membership negotiations with Turkey early in 2005, when it will also start negotiating with Croatia. Bulgaria and Romania are set to join the EU on Jan. 1, 2007. A decision on the final status of Kosovo is expected next year, though the actual implementation will take several years, while Serbia and Montenegro will choose either to prolong or terminate their state union. Finally, next year decisions are needed on the EU candidacy of Macedonia and changing the character of the international military and political presence in Bosnia and Herzegovina. If all these decisions flow as expected, practically all the outstanding problems will have been solved by early 2007, and the irreversible Europeanization of the whole of the Balkans will have been set in motion.

But will those interested in continuing Balkanization give up so easily? This past Sunday, the parliamentary elections in Kosovo were boycotted by the Serbian minority. In Macedonia, a referendum on the repeal of a new law on local government, set for Nov. 7, likely will be boycotted by the Albanian minority. In Bosnia and Herzegovina, Serbs are signing a petition for the independence of the Serbian Republic, one of the country's two political entities, in the event that Kosovo becomes independent.

Finally, Serbia is even less ready now than ever to cooperate with the Hague Tribunal, thus risking an imposition of sanctions and further postponement of its international integration, especially with the EU and the U.S. In view of the growing awareness of the massacre of about 8,000 Muslims in Srebrenica in 1995, that becomes not only politically but morally unbearable. Cooperation with the Tribunal, not just in Serbia but overall, is not very high and some of the most notorious fugitives are still regarded as heroes.

Most probably enjoy state protection.

Which of the two forces is stronger: Europeanization or Balkanization? Once one is put against the other, the answer is unavoidable. Barring further discord between the EU and the U.S., the end to the whole Balkan mess is nearing -- almost irrespective of local political developments. For that to happen, it will be important for the EU and the U.S. to coordinate their Balkan policies. For the outcome within reach to come about, soft power of the EU should be strategically combined with the hard power of the U.S.

The hard power of the U.S. is still needed. Only America has the necessary authority with more or less all the Balkan nations, especially with those that are still locked up in deep animosity. In particular, Albanians in Kosovo and Macedonia, and perhaps everywhere, will listen only to the U.S. Similarly, the U.S. can speak with authority to Serbs, Croats and Bosnians. This authority is not a moral one but the consequence of U.S. military interventions in the Balkans in the last decade or so.

By contrast, the EU does not have much hard authority in the Balkans, but it does command an increasing amount of soft power, based mainly on its financial aid and institutional development. But they become really important only when connected with the credible prospect of EU integration. Just throwing money at the Balkans, for reconstruction or appeasement, does not lead to any fundamental changes either in belief or

in behavior. It is only when the prospect of EU integration becomes an operational possibility that the EU starts playing a modernizing role in the region.

This is the reason that countries like Bulgaria and Romania, perhaps surprisingly, have been able to stay out of the post-Cold War Balkan mess. The early promise of EU membership has anchored these countries in the process of democratization, reform and economic integration. Though they have lagged behind the more successful Central European countries, they will still manage to transform enough to join the EU in 2007 or thereabout. Similarly, the prospect of EU membership has changed the public discourse in Croatia, though much work remains in the area of respect for human and minority rights. The same promise is held in Turkey's possible EU convergence and accession.

Unfortunately, when it comes to the other Balkan countries the EU has only recently begun to develop a clear strategy. The list of mistakes and miscalculations is long. But recently it looks as if the EU is moving in the right direction. In the next couple of years it will have to support the independence of Kosovo, the peaceful dissolution of the state union of Serbia and Montenegro, and constitutional reform in Bosnia and Herzegovina. At the same time, it should start to negotiate with Macedonia for its early EU accession. If these decisions are taken, and if the U.S. helps persuade the local actors that those are in their interest,

then the Balkan problem will have been solved.

These political developments will be helped by the improving economic conditions in the region. This is a developing region with high unemployment rates, significant macroeconomic imbalances and pervasive corruption and criminality. There is nothing more urgent than sustained growth. In the last few years, the growth rates throughout the region have been high. On average, the region has been growing by 5% or more. There are pockets of recession, mainly around the last areas of latent conflict, but those are shrinking. Clearly, investments are of crucial importance and will have to come from abroad. Also, the Balkans do not export very much, partly because of their internal disintegration and subsequent low market access. The same problems sap the region's tourism industry. The Balkans are beautiful and interesting, and both the coasts and the mountains will be very attractive once politics are normalized and infrastructure is upgraded. Already the seas around this peninsula are attracting ever larger numbers of tourists.

What then should be done? The EU should speed up and strengthen the process of bringing the Balkans into Europe with a view to eventual membership. The decisions already taken, including the most recent one on Turkey, will make the integration of the whole peninsula unavoidable. But it cannot be led by the region itself. Left to itself, the region will revert to Balkanization, however short-

sighted and harmful. Also, the EU should recognize that aid and budget support are neither sufficient nor paramount. Banks in EU nations own most of the Balkans' banking and financial sector, and the Union should push them to spur foreign investment in the region. Also, the EU should foster regional cooperation in trade, investments and policy coordination. In the case of the latter, the positive experiences of the Central European countries in the transition from communism to market should serve as guidelines, rather than more orthodox policy approaches of the IMF and the World Bank that have not proved successful in this region.

The U.S. can support these developments and use its authority to discourage further territorial disintegration. One way to do that is to speed up the accession of the remaining countries of the region into NATO. Currently, Bosnia and Herzegovina and Serbia and Montenegro are

outside the security structures of NATO, even its Partnership for Peace program. There are reasons for that, namely that the most notorious war criminals are still at large, but there are also reasons to speed up the process of NATO accession. Security is still the key problem of the region, and there is no other umbrella organization that could supply it. Additionally there is still insufficient control over some military and paramilitary forces, and only the prospect of NATO integration could induce local politicians to speed up the transformation of local armies and the dismantling of paramilitary forces. That would also contribute to a sharp decrease of criminal activities, as those are mainly run or supported by the military and other security services.

What is in a way strange and fascinating about the Balkans is the lack of internal support for change and entrenched resistance to modernization. That leads so many people to think

that the Balkans are different and their problems intractable and unsolvable. Still, country by country, party by party, ethnicity by ethnicity, intellectual by intellectual, defections are increasing. The disbelief that the world has indeed changed is weakening, as is the belief that wars are solutions rather than problems. The year 1999 of the war in Kosovo was for the Balkans the equivalent of 1989 for eastern Europe, only it will take a few more years for some people in the region and indeed outside of it to realize that.

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## Political and Economic Effects of Unilateral Euroization in Albania, Macedonia, and Serbia

By *Altin Ilirjani*

This article discusses the effects of unilateral Euroization on trade and national incomes of Albania, Macedonia, and Serbia.

Western Balkans, with the exception of Croatia, remains the poorest region in Europe in terms of GDP per capita and levels of poverty. Ethnic conflicts of the past decade worsened their economic situation and widened the gap between them and other post-

communist societies. Since the end of Kosovo war, Western Balkans has seen high economic growth rates. The average growth rate for the entire region in 2003 was 4.2 percent, and it is projected to increase to 4.3 percent in 2004 and 4.6 percent in 2005. Albania is the only country in the region that has reached a level of GDP above that of 1989. With respect to public finances, the average government deficit of the

region decreased to 4 percent of GDP in 2003, ranging from about 1.5 percent of GDP in Macedonia to 5.5 percent of GDP in Albania. Collection of tax revenue has been on a downward trend since 1989, and the large informal sectors, corruption and organized crime remain serious problems. In addition, political instability continues to pose considerable risks for the near future.

Liberalization of intra-regional trade, as well as promotion of trade with the EU, has been an integral part of the EU policy in the region. The EU remains the most important trade partner for all these countries and this dependence is likely to increase in the future. The average share of trade with the EU for the entire region was about 55 percent of total trade. For 2003, individual country figures varied from about 92 percent for Albania to 37 percent for Bosnia and Herzegovina, 48 percent for Macedonia, 54 percent for Croatia, and 42 percent for Serbia. Albania is more dependent on trade with the EU because historically it has not traded much with the other former Yugoslav republics.

Sovereign governments determine their exchange rate regimes in consideration of two interrelated sets of constraints, objectives of their economic and monetary policies, and the character of the international monetary system. Fixed exchange rate regimes have been the norm for most of the last century, especially for small and poor countries. The main attraction of such policies has been the elimination of the risk of devaluation of a country's exchange rate, a higher level of confidence among international investors, reduced fiscal costs, low inflation, and more investment and growth. The benefits have been significant enough to offset costs of these policies such as the loss of seigniorage, and of an independent monetary policy.

Conventional wisdom, since the publication of Robert

Mundell's seminal work in 1961, has maintained that when policymakers consider decisions to enter a currency union or dollarize, they should try to determine if the common currency area to which they will belong is an optimum currency area. Otherwise, according to the optimum currency area theories, costs of adopting the same currency would outweigh the benefits. Optimum currency area (OCA) theories stipulate that any two countries that react to an economic shock symmetrically, trade significant proportions of their GDP bilaterally or have diversified products are better off with a fixed exchange rate or a common currency. In addition, these theories say that reorganization of national currencies is feasible and the concept of optimum currency area has direct applicability only in areas where national sovereignty is being given up and member countries are participating in a political integration or cooperation process. Optimum currency area theories have attracted a lot of criticism, as well. They have been criticized for underestimating the advantages of sharing a common currency, and for lacking operational indicators for factor mobility, openness and diversification of products.

Recent studies have abandoned strict consideration of the optimum currency area criteria, and the gravity equation of international trade has been the model of choice. The idea behind these models is that certain factors create some kind of a gravity relationship on human behavior by pulling people or their economic,

political and social activities together. For example, political borders encourage trade between regions within a state; common currencies promote trade within the same currency area, as do free trade agreements.

Findings about the impact of common currency on bilateral trade are astonishing. According to Andrew Rose of UC Berkeley, who started this research project, there is sufficient proof that trade between countries with the same currency is substantially higher compared to countries with different currencies. Studies on the effect of common currency on trade, economic growth, and political integration converge on a few points. First, currency unions have a huge impact on bilateral trade between countries participating in the union. Estimates vary from 30 percent to 300 percent. In any case, this is a potentially significant increase to deserve special policy attention. Second, increase in bilateral trade does not come at the expense of existing trade with other countries which do not share the same currency. Third, countries which enter into a currency union have greater chances of satisfying optimum currency area criteria *ex post*. Fourth, membership in a currency union fosters economic integration which in combination with a political integration process can deliver even stronger trade increase. Fifth, currency unions can have a significant positive effect on per capita income, and six, the best candidates for unilateral currency unions are poor, small, and open economies

that have a large share of trade with a rich country or countries of the anchor currency. However, there is a lot of disagreement over statistical techniques best suited to estimate the exponential gravity equation, and the best sample selection methods.

In my own research, I argue that the Poisson Pseudo-Maximum Likelihood Regression (PMLE) model is better suited than the traditional log-linearized ordinary least square regression (OLS) model to estimate the gravity equation with respect to the effect of currency union on trade. The data set used in my study come from World Trade Database for 1995, and the 2002 trade data of Western Balkan countries.

Estimates of the Poisson PMLE regression are much smaller than the OLS estimates. With respect to the geographical distance, the OLS coefficients indicate that for every one percent increase in the distance between two trading partners, their trade will decrease by less than one percent (OLS estimates are taken from Frankel and Rose 2002). Poisson estimates, on the other hand, indicate that for every one percent increase in the distance, trade will decrease by only 10 percent of one percent or about 8 times less. OLS results for GDP per capita indicate that rich countries trade disproportionately more than other countries. For every one percent increase in income, trade increases by almost 1 percent according to OLS results. Poisson estimates retain the disproportionality but indicate that the gap is

not as wide as suggested by OLS results. For every one percent increase in per capita income, trade will increase by 10 percent of one percent according to Poisson estimates. Both regression models maintain the fact that countries which share the same language, history, or which are connected to each other through some sort of political union trade more than other countries.

With respect to the effect of currency union on trade, OLS and Poisson PMLE regression models produce significantly different estimates. Both indicate that being in a currency union has a positive impact on bilateral trade between two countries. OLS results show that being in a currency union increases trade by a rate of 189 percent in the augmented model. The Poisson estimates indicate that the average expected increase in bilateral trade between two countries which adopt the same currency is only 12 percent for the augmented model (and 20 percent for the simple gravity model). In other words, the Poisson regression estimates are about 16 times smaller than the OLS results. These results are also supported by empirical studies on the impact of Euro on bilateral trade among the Eurozone member countries, which show that bilateral trade between participating countries has increased by about 6-10 percent since 2001. An important advantage of the Poisson regression model over OLS is that its estimates can be generalized. It is one of the properties of the Poisson distribution to capture the features of

the so-called laws of rare events.

Below, I have calculated the potential economic effects of Euroization on bilateral trade with the EU using three parameters: the Poisson PMLE, the parameter of a meta study of 30 different OLS studies, and the parameter of the original study by Andrew Rose in 2000.

Calculations with the Poisson PMLE estimate show that trade between Albania and the Eurozone would increase by about 11 percent in the event that Euro becomes legal tender in Albania. Over seven percent of that would be due to an increase in her bilateral trade with Italy and Greece. For Serbia and Macedonia, total trade is expected to increase by 5 percent and 5.5 percent respectively. In US dollar terms, Euroization is expected to increase trade by over 175 millions for Albania, about 330 millions for Serbia, and about 140 millions for Macedonia. With respect to real GDP, results are very conservative. For Albania and Macedonia real GDP is expected to increase by about 1.5 percent following Euroization, while for Serbia the effect is estimated to be below one percent.

When using the coefficient of the Meta study, estimates predict that unilateral Euroization would increase total trade of Albania by about 80 percent whereas the predicted increase on trade as percentage of GDP is about 32 percent. Real GDP in the case of Albania is expected to increase by over 10 percent. For Serbia total trade is predicted to increase by

about 38 percent, total trade as percentage of GDP by about 21 percent, real GDP is predicted to see a growth of around 7 percent. In the case of Macedonia predictions are similar. Total trade would go up by about 48 percent, total trade as percentage of GDP by 34 percent, and real GDP up by 11 percent.

As expected, Rose's original coefficient predict much larger gains from Euroization. In the case of Albania, it is predicted that total trade will increase by 217 percent while the effect on trade as percentage of GDP would be 83 percent. Real GDP of Albania is expected to increase by 27 percent in case of Euroization, all other things equal. For Serbia total trade is expected to increase by 100 percent, total real GDP by 18 percent. Macedonian total trade is expected to increase by 110 percent and the GDP by 30 percent.

Obviously, predictions vary significantly. In the case of Albania, Euroization would have an effect anywhere between 11 to 216 percent on trade, depending on the coefficient of the estimate. With such a large variation in our results, can we arrive to a more reasonable conclusion about the potential impact of Euro on trade and GDP of Albania?

In comparison to other countries in Western Balkans, Albania is sort of an outlier. Her share of trade with the EU is almost two times larger than the regional average but her ratio of total trade to GDP is more than two times smaller than that of Macedonia or Bosnia and Herzegovina, Croatia or the EU candidate countries of Bul-

garia and Romania. If we exclude Albania from calculations, the average ratio of trade to GDP for the region is about 71 percent. This is a reasonable figure and we can expect that as political situation stabilizes and investments increase, Albania's ratio of total trade to GDP will reach that of other countries. As a result, when making long-term projections we should be able to use the 71 percent regional average instead of Albania's current ratio of 38 percent. In this case the estimations of Euro on real GDP increase from a minimal 3 percent to a maximum 50 percent.

However, any potential gains from trade that would result from Euroization may not materialize if problems of bad governance, corruption, and poor law enforcement in these countries are not addressed. Empirical studies suggest that higher national per capita incomes result from improving governance, the rule of law, and fighting corruption. Recent World Bank studies have found that countries that tackle corruption and improve their rule of law can increase their national incomes by as much as 400 percent in the long term.

Despite this, Euroization is a policy option worth being pursued. In addition to economic effects outlined above, Euroization can bring huge political gains, as well. Just like national currencies serve as symbols of national political identity, Euroization can serve as a symbol of commitment to the European project. It may invigorate the European project in these countries, identify their societies

stronger with the European Union, and thus increase domestic pressure on ruling elites to not waive from required reforms. In short, unilateral Euroization is a win-win policy, and worth being pursued by Albania, Macedonia, and Serbia.

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This article draws from the PhD dissertation of the author. The author can be contacted by email at [Altin@unc.edu](mailto:Altin@unc.edu)

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Table 1

## Estimates of the Impact of Currency Union on Trade

Study	Year	Estimated Parameter	Effect in Percent
Rose OLS model	2000	1.21	235%
Meta Study coefficient	2004	0.64	90%
Ilirjani Poisson PMLE	2004	0.11	12%

Table 2

## Economic effect of Euroization

using three different coefficients of the impact of common currency on trade and income  
(2002 trade data for Albania, Macedonia, and Serbia)

	Trade share (% of total trade)	Impact on Total Trade (% change)	Predicted In- crease in Total Trade (US\$ m)	Total Trade as % of GDP	Predicted Effect on Trade as % GDP	Predicted Effect on real GDP (%)	Predicted GDP growth (US\$ m)
<i>Calculation using the Poisson coefficient.</i>							
<b>Albania-Eurozone</b>	92.10	10.71	175.31	38.00	4.07	1.34	57.13
<b>Serbia-Eurozone</b>	42.10	4.90	328.67	55.00	2.69	0.89	102.85
<b>Macedonia-Eurozone</b>	47.02	5.47	139.30	80.00	4.37	1.44	49.60
<i>Calculations using the Meta Study coefficient.</i>							
<b>Albania-Eurozone</b>	92.10	82.57	1351.60	38.00	31.38	10.35	440.49
<b>Serbia-Eurozone</b>	42.10	37.74	2534.02	55.00	20.76	6.85	792.97
<b>Macedonia-Eurozone</b>	47.02	42.15	1073.96	80.00	33.72	11.13	382.44
<i>Calculations using Rose's original study coefficient.</i>							
<b>Albania-Eurozone</b>	92.10	216.76	3548.29	38.00	82.37	27.18	1,156.41
<b>Serbia-Eurozone</b>	42.10	99.08	6652.42	55.00	54.49	17.98	2,081.75
<b>Macedonia-Eurozone</b>	47.02	110.65	2819.42	80.00	88.52	29.21	1,004.01

## Southeast Europe: Areas of regional cooperation

By Vladimir Gligorov

It is assumed in this paper that, in general, when it comes to trade, investments and pretty much everything else, Southeast Europe (SEE) maintains a hub-and-spoke relationship with the European Union (EU). In other words, from the point of view of the countries in the region, bilateral relations with the EU are more important than the regional ones and even more important than the relations of the region as a whole with the EU. It is also assumed that there is low interest in regional cooperation if it is not connected with the process of EU integration. Thus, multilateral regional cooperation has to be supported by bilateral processes of EU integration.

The key areas of cooperation are reasonably easy to identify. Those are dominated by the need to develop and to grow. The agenda of development is also reasonably clear, especially when it comes to investments in infrastructure, institutions and human capital. I will put these issues aside.

Sustainable growth is a solution to almost every problem and there the issues of economic policy become paramount. Here regional cooperation may play a role especially when seen in the context of EU integration. Given the hub-and-spoke character of inter- and intra-regional relationship, the contribution of regional cooperation

to economic growth and development may happen to be indirect via the influence on regional stability and opportunities. Indeed, the developments so far have tentatively confirmed this observation as it is the normalisation and liberalisation that have been more important consequences of increased regional cooperation rather than growth of trade, investments or production. Still, in the future, regional cooperation can contribute to economic growth and development too. Already it can be observed that the regional business connections and activities are increasing especially in places where there are few if any political and constitutional problems. Thus, it could be argued that:

Liberalisation of trade and investments and economic policy cooperation have greater contribution to stabilisation and normalisation in the region while their importance may increase with the economic growth of the region and in the particular countries in the region.

With that in mind, the following general areas of regional cooperation should be contemplated.

### Trade

The choice is between multilateral free trade area or customs union with the EU. In a sense, the second is more in tune with the EU integration. In that sense, regional coordination of this

process could be the best institutional approach.

However, the process of EU integration is such that a customs union with the EU is hardly a feasible alternative. As in other cases, the bilateral approach of EU integration clashes with the multilateral approach of regional cooperation. This is even more so as the distance between various Balkan countries in respect to EU integration increases. Clearly, candidate countries or countries that hope to become candidates are more interested in their negotiations with the EU than in those with the other countries in one or the other regions or sub-regions in the Balkans.

In these circumstances, the multilateralisation of the bilateral free trade agreements may be the most that can be achieved though the added advantage that they bring cannot be expected to be all that great.

### Investment

There are advantages to the larger market when it comes to investments. Obviously, only some types of investments look for such markets. The Balkans produce small firms, but larger firms are a more difficult affair and those are often relying on government support either through subsidies or through a privileged position in the market. Outside firms adopt the same strategy as long as they have to deal with

often weak and corrupt governments. To detach firms from the budgets and budgets from the firms, a regional market with firms competing in those could be one possibility. Besides providing for the benefit from the economy of scale, there is also the benefit from increased competition.

The development of the regional financial market, however, is still far off. This is to an extent a consequence of the underdevelopment of domestic financial markets and of the significant role that states still play. Thus, even the firms coming outside of the region are yet to develop regional investment strategies. Two developments perhaps hold the key to further improvements in this area:

(i) improvement in the local business climate that depends on institutional and policy reforms in each particular country, and

(ii) normalisation of international financial relations in the sense that the countries in the region need to become normal participants in the international financial markets (a number of countries in the region are still cut off from the international debt and equity markets).

### **Exchange rate policy**

One characteristic of the Balkans is that it is, with the exception of Romania, mostly on fixed exchange rates. In some cases, euro is used as the official currency. Fixed exchange rates bring problems, however. Competitiveness is a problem, external balances are a problem, and fiscal sustainability is a problem. Though intra-regional trade

is relatively small, exchange rate misalignments and shocks, due to risks of devaluation, play some role in that. Thus, some regional cooperation in exchange rate policies could be useful. The usefulness will increase as the process of EU integration speeds up.

However, as argued above, the theory of OCAs suggests that fixed exchange rates will be more of a rule in the Balkans though none of these countries can be considered OCAs by themselves. Being small and increasingly open economies, they have difficulties implementing floating exchange rate regimes. If that is so, then there are two possibilities. One is to have an implicit coordination of exchange rate policies via a fixed exchange rate regime with the euro. The other is to take a harder look at the issue of the competitiveness of the Balkan economies and to try to coordinate the exchange rate regimes and policies accordingly. This alternative approach seems to me to be rather less than feasible.

Thus, some kind of an indirect exchange rate coordination using the euro as the anchor could be useful. In particular, a version of an ERM mechanism suited for this region could be contemplated.

### **Fiscal policy**

States in the Balkans tend to be weak in a number of ways, that of the fiscal sector being the most important one. There are a number of reasons that suggest cooperation in fiscal policies.

First, to support trade liberalisation. Lowering of tariffs can be reversed by the introduction of taxes. Thus, trade liberalisation may not be as effective as it could be. In order to avoid unnecessary tax competition, some co-operation on tax policies could be useful. This is not to be understood as a suggestion that fiscal harmonisation is to be looked for. Clearly, co-operation does not exclude competition. What this co-operation could accomplish is, first, the decrease in the shock element in local fiscal policies and, second, the decrease of the power of local business lobbies to influence the tax policy with the view of retaining the position of monopoly. This co-operation, as in the other areas of economic policy, could be supported by the process of EU integration and would probably have to be led by it.

Second, to decrease distortions and rent seeking by firms. Taxes can bring in significant distortions and subsidies can produce significant sources of rent-seeking. Both are especially powerful in cases where an arguments for support for exports are made. Given that the misallocation of resources in the Balkans is still quite significant, the simplicity and the transparency of the fiscal systems would be quite desirable. In that, regional co-operation can clearly play a significant role.

Third, to bring in the informal economy. In a number of cases, the informal economy is fuelled by the opportunities to exploit differences in fiscal systems in the region. Thus, if for

no other reason, then because of the need to diminish the presence of informal and even criminal activities, fiscal co-operation would certainly be useful.

### **Competition policy**

As competition policies are quite under-developed in the region, EU could play a significant role in this area too. Again, as the process of integration speeds up, EU competition policy could be extended to the region. It would especially prove important in the reform of the public sector, which is certainly the key issue of the process of transition. State monopolies as well as private monopolies are quite characteristic for the Balkan countries, especially those that are laggards in

transition. Internally, competition policy would be very difficult to implement. In the context of the EU integration that could indeed be much more efficient. Indeed, in some cases, the fact that a country is outside of the EU or of the process of EU integration has been used to grant monopoly rights to either domestic or foreign firms or banks, with some of the latter being from the EU countries. This has not only supported misallocation of resources but has led to the slowdown of the process of integration in so far that it would mean the introduction of anti-monopoly measures. To an extent, the transformation of the local judiciary system, certainly the weakest

link in the institutional set-up, has been impeded because of the strong influence of state and private monopolies or lobbies.

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## **Trade Flows in Southeast Europe**

*By Edward Christie*

The paper seeks to give an overview of the major issues connected to international trade for the countries of Southeast Europe. In its first part the paper discusses trade in goods. This part revisits the issues of bilateral trade patterns and trade composition in Southeast Europe and looks at recent developments in terms of trade agreements and trade facilitation within the region and between the region and the European Union. The second part of the paper deals with trade in services. A gravity model for trade is estimated on European bilateral services trade flows. The estimation results are then used to produce forecasts for bilateral services

trade flows for the countries of Southeast Europe.

### **Trade in Goods**

Trade patterns in Southeast Europe were heavily disrupted during the 1990s notably due to the military conflicts in former Yugoslavia. In the last few years the patterns have normalised to a new equilibrium where the European Union, and especially the Western European member states, acts as by far the most important trading partner both for imports and for exports for practically all the countries of the region. While some recovery of trade flows between countries formerly part of Yugoslavia has taken place, countries further from the geographical centre of South-

east Europe such as Albania and Romania trade very little with regional partners and very much with the EU. Trade between the EU-15 and especially Romania and Bulgaria has surged impressively over the last few years, although trade deficits are persistently large.

The countries of the region are progressively liberalising trade with one another through a series of bilateral trade agreements. Out of the 21 bilateral free trade agreements (FTAs) that are necessary to mimic a free trade area, all have been at least initialled (in terms of negotiations). Some have been signed and are awaiting ratification, and 17 were already in force as of 2 June 2004. These FTAs

stipulate gradual reductions in tariffs up to 2008, when trade in industrial goods should be fully liberalised. Around that time it is likely that Romania, Bulgaria and Croatia will have joined the EU. This will void the corresponding FTAs, which will be replaced by the bilateral relations between the EU as a whole and the remaining SEECs. As the EU itself has (unilaterally) already granted wide ranging trade concessions to the remaining countries, one may expect "almost free" trade across the region by that time, while the remaining trade impediments would probably only disappear once the whole region is in the EU.

What is striking about the whole process is how cumbersome and slow it has been, especially bearing in mind that all the countries of the region want to (and almost certainly will) join the EU anyway. For this and other reasons, one may wish to evaluate whether a customs union with the EU for the remaining countries of the region may be a preferable option.

On the issue of market access, there has been marked progress in terms of trade facilitation measures. Border waiting and clearance times have fallen quite significantly throughout the region, while progress is ongoing in terms of transport infrastructure, notably thanks to coordinated help from international bodies. Finally, the entry into the EU of Central European countries such as Slovenia and Hungary should also have

a positive impact on trade flows.

Further liberalisation, improved access to the EU market and quite strong GDP growth in the SEECs together imply that trade flows should continue to increase, both with the EU and within the region. However the overall pattern which will most likely remain for the region is that of a set of small peripheral economies with the EU-15 acting as a hub.

Concerning the composition of trade, the countries of Southeast Europe (SEECs) have large shares of their exports from basic manufacturing sectors (e.g. textiles, basic metals) which employ essentially lower skilled workers, which use rather low technologies, and which miss out on the higher value added available in other sectors. This is in clear contrast to the export structures of the Central European countries (CEECs) which have more technology-intensive and more human capital – intensive export compositions. In light of this, the current export structures of the SEECs seem neither sustainable nor desirable in the long run. If the SEECs were to evolve towards something like the current structures of the CEECs, one would need to see the emergence of more human capital intensive and technology intensive export sectors. The experience of the more advanced CEECs suggests, among other things, a need for more FDI.

#### **Trade in Services**

A gravity model for trade is estimated following the

Matyas specification using data from 1999 to 2002. The model finds a quite strong positive (and significant) effect associated with EU membership. The model is then used to produce forecasts for services trade flows up to 2009, assuming 2% p.a. real growth for EU-15 countries and 4.5% p.a. real growth for the Southeast European countries.

According to the model's forecasts, all the countries of the region have good prospects for increases in services trade. The forecasts indicate high potential for trade in services between Romania and Bulgaria (and to a lesser extent Croatia) on the one hand, and the large EU economies on the other hand, notably Germany, the UK and France. These larger forecasts are due in part to the latter countries' larger GDPs, but also to the model's assumption about the effect of EU membership. EU membership is modelled using a dummy variable. For the forecasts, this variable is set to one for Croatia, Romania and Bulgaria, which is equivalent to assuming that the effect of EU membership on those countries' links to the rest of the EU will be as strong by 2009 as it has been for trade links among the old EU-15 members.) Conversely, the forecasts for Serbia and Montenegro, Bosnia and Herzegovina, Macedonia and Albania are much lower, due to lower GDPs and to not being part of the EU. The underlying message is that there is quite a lot of potential for trade in services, but that releasing it requires strong integration

with the EU-15. Clearly, the EU membership dummy variable used in the model captures many different effects, some of which are not direct consequences of EU membership, or only partly so, for example infrastructure developments.

Many flows are currently still relatively low but, as the case of Croatia shows, tourism is a natural export service for many parts of the region and could be developed much further (assuming some infrastructure improvements) for example in Montenegro or Albania. The case of Croatia is certainly a success story as far as tourism is concerned. Tourist arrivals and tourism revenues have been growing strongly over the last few years. The current levels of growth will probably not continue as far as Austria and Germany are concerned, but there is still scope for growth from other source countries. On the other hand, other

types of services trade have stagnated.

Business services could develop much more than they have so far for all the countries of the region. This has already started to happen to some extent in the case of Romania. Services trade between Italy and Romania in particular is already quite high, but still below the report's 2009 forecast.

### Conclusions

The prospects for trade within the region and between the region and the EU have improved over the recent years. Key developments such as forthcoming EU membership for three countries of the region, the EU's unilateral trade concessions to the Western Balkan countries, the bilateral free trade agreements between the countries of the region, improvements in trade facilitation and in infrastructure and, overall, relatively good GDP growth prospects all point to further growth in trade

volumes, both in goods and in services. The overall picture is certainly much more positive than a few years ago, and all the main indicators are pointing in the right direction. Many challenges remain however. Regional trade liberalisation is happening more slowly than could have been the case, and infrastructure improvements require large investments and time.

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Summary of a paper presented at the IBEU Interim Meeting "Functional Borders and Sustainable Security: Integrating the Balkans in the European Union", Belgrade, October 1-2, 2004.

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## Illegal Trade in South East Europe

*By Mario Holzner and Vladimir Gligorov*

Based on the theoretical foundations as described in Bhagwati (1974)<sup>1</sup>, illegal trade can be defined to consist of faked invoicing on the one hand and smuggling on the other hand.

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<sup>1</sup> Bhagwati, J., (1974), 'Illegal Transactions in International Trade – Theory and Measurement', edited by Jagdish N. Bhagwati, North-Holland Publishing Company, Amsterdam, 1974.

While in the first case at least one of the trading partner countries has recorded a trade flow either as an export or as an import, in the latter case no official customs data is available. Smuggling is bypassing legal trade channels altogether. Therefore it is difficult to estimate the full magnitude of illegal trade with the help of one single method.

### Faked invoicing

Nevertheless, we try to give a crude estimate of the overall impact of faked invoicing in the Balkans. Therefore we use the available 2001 data on exports and imports by countries as provided for Albania, Croatia, Macedonia and Romania. In a first step we calculated shares of illegal trade volumes due to over- and underinvoicing of exports and imports respectively

country by country by summing up positive and negative entries of the 35 most important trade destinations, using the partner-country-data comparison technique. We could have done the same by products, however the implicit assumption is that a partner country has a similar trade regime for most of the product groups (i.e. rather restrictive or liberal trade policy). In a second step we calculated weighted shares and applied it to total 2003 export and import data of all the seven SEE countries (thus including intraregional trade flows). The results are the following.

We estimate about 11% of SEE-7 exports (or USD 3.8 bn) to be related to the underinvoicing from the side of the partner countries (or overinvoicing of domestic exports). Radically speaking this would imply that either partner country statistics are too low or official domestic export figures are too high. At the same time we estimate some 4% (or USD 1.4 bn) to be related to the overinvoicing from the side of the partner country (or underinvoicing of domestic exports).

Similarly we have calculated the shares for SEE-7 imports. Here, we found a share of approximately 12% of SEE-7 imports (or USD 7.9 bn) to be related to domestic underinvoicing (or overinvoicing of partner country exports) and about 10% of SEE imports (or USD 6.5 bn) to be related to domestic overinvoicing (or underinvoicing of partner country exports). The radical consequences would be that either local import statistics are too low or

partner country exports statistics are too high in the first case and vice versa in the second case. However, all these figures have to be treated with utmost caution as they are based on relatively strong assumptions. Ideally one would need data on each single trade flow by product and country to estimate 'correct' figures.

Looking at the detailed results country by country and just comparing the total discrepancy figures of the SEE countries with the figures for the total discrepancy on the world level we can try to assess whether and to which extent illegal trade due to faked invoicing is different in the Balkans. The aggregate picture shows that both Romanian exports and imports are close to the 4.6% world discrepancy level. Similarly, Albanian total imports fit the world average. However, Albanian, Croatian and Macedonian exports as well as Croatian and Macedonian imports display discrepancy figures that are either more than double the size of the world average and/or of a different sign. This would support the widespread belief that the Balkans are a stronghold of illegal trade. When it comes to single SEE product groups, the following can be identified as being traded illegally above the world average: textiles & footwear, petroleum, cars & trucks, ships, sugar, medicine and electronics.

### **Smuggling**

With the help of the partner-country-data technique it can be possible to detect a considerable part of the illegal trade due to faked

invoicing. However, this method will not help to detect the magnitude of smuggling trade as smuggling bypasses the legal trade channels altogether. This is also the reason why it is much more difficult to make any quantitative statements about the size of smuggling and its overall economic importance.

Most methods have to restrict to single goods using good specific data. Given the limitations of the methods for the estimation of smuggling in general we shall focus in this research on the smuggling trade in one good notoriously smuggled all across the Balkans – cigarettes. We therefore developed our own method to detect the volume of cigarette smuggling in South East Europe using quantity data of official production, exports and imports as well as information from national household surveys on the amount of cigarette consumption for the years 1995 and 2000 for each of the Balkan countries (see table 1).

Except for Albania in both years and Bosnia and Herzegovina in 1995, all the Balkan countries are illegal net exporters of cigarettes due to smuggling. Albania has almost no cigarette production at all and Bosnia and Herzegovina had to suffer war in 1995. In four countries illegal net exports increased over time. Albania reduced its illegal imports as official cigarette imports were recorded in 2000. In Bosnia and Herzegovina official trade figures didn't change a lot but post-war official production went up dramatically resulting in a shift from a illegal net importing coun-

try in 1995 to a illegal net exporting country in 2000. In fact the Bosnian net importer position in the 1990s is also supported by anecdotal evidence on the case of the so called 'Capljina cigarettes'. Cigarettes produced in the Croatian tobacco factories of Rovinj and Zagreb were smuggled to the Herzegovinian border town of Capljina and subsequently sold all over Bosnia and Herzegovina. However, this business was closed down in 2000 after the investigation of the financial police. It is estimated that Bosnia and Herzegovina lost tens of millions USD because of unpaid sales and excise taxes on 'Capljina cigarettes'.

In the period 1995-2000 Bulgaria more than doubled its illegal net export position. Both official production as well as official cigarette exports fell radically. However, official production fell by 64% while official exports even dropped by 93%. In Serbia and Montenegro illegal net export position even tripled though for other reasons. Here both official production and official imports increased over time. In Croatia, Macedonia and Romania the illegal trade balance of cigarettes deteriorated from 1995 to 2000. In the first two cases this was due to increased official cigarette exports. In the case of Romania the opposite holds true. Official imports dropped severely by 84%.

On the regional level the Balkans were in 2000 in total illegal net exporters of about 44 bn cigarette sticks due to smuggling. In the last row of table 1 an effort was done to transform the quantity data into money

values which is not a trivial task. This was done for each country separately using the 2001 retail price of the most popular cigarettes less excise and sales taxes. The resulting 2001 net domestic price differs quite substantially across the region (from USD cent 0.5 per cigarette stick in Macedonia to USD cent 2.4 per cigarette stick in Croatia). This is probably due to the differences in quality, taxation, exchange rate and purchasing power among the SEE countries. However adding up the sums for the single countries leads to a total SEE illegal net export position in cigarette smuggling of close to USD 500 mn<sup>2</sup> in 2000. Nevertheless, it should not be forgotten that the above calculations did not involve transit smuggling, which is most probably an even more important factor at least for some countries in the Balkans. The case of Montenegro is well known in this respect. Allegedly containers full of cigarettes were bought in the duty free zone of the Rotterdam harbour and smuggled via speedboats from Montenegro to the nearby Italian coast. In the 1990s, according to Italian sources Montenegro made up to 60% of its GDP from this 'transit business'.

### Conclusion

Liberalisation and political cooperation are the instruments of soft security which could contribute significantly to the decrease of illegal trading and other

activities. Those measures come under the heading of rewards rather than punishments. Of course, the increase of efficiency at the official borders and many other measures would be useful too. But the key cause of illegal trade and the attendant security problems come from the proliferation of borders and tariff and non-tariff barriers rather than from the lack of security services.

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*Mario Holzner and Vladimir Gligorov* are staff economists at the Vienna Institute for International Economic Studies.

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<sup>2</sup> Please remember that this is probably a lower bound estimate due to some non-observed unofficial cigarette production.

Table 1

### South East Europe: Cigarette Smuggling, 1995 & 2000

		Albania		Bosnia & Herz.		Bulgaria		Croatia		Macedonia		Romania		Serbia & Mont.	
		1995	2000	1995	2000	1995	2000	1995	2000	1995	2000	1995	2000	1995	2000
Total Consumption of Cigarettes (TCC) <sup>1)</sup>	mn sticks	3083	3228	3473	3559	7485	7977	4431	4211	1866	1923	21524	21291	10009	7917
Official Cigarette Production (OCP)	mn sticks	685	62	1500	4670	74603	26698	12110	13692	9664	9181	23000	33000	12686	14451
Official Cigarette Exports (OCE)	mn sticks	.	5	.	.	60900	4000	1627	6117	1483	5675	78	71	.	100
Official Cigarette Imports (OCI)	mn sticks	.	2260	.	25	200	200	12	34	218	130	22335	3474	100	2199
Illegal Trade Balance of Cigarettes (ITBC) less Unofficial Cigarette Production (UCP)	mn sticks	-2398	-911	-1973	1136	6418	14921	6064	3398	6533	1713	23733	15112	2777	8633
ITBC-UCP in 2001 domestic net prices <sup>2)</sup>	USD mn	-29.4	-11.2	-33.2	19.1	37.5	87.3	146.0	81.8	32.5	8.5	333.8	212.6	31.8	99.0

Source: Own calculations, National Statistical Offices, Tobacco Control Country Profiles 2nd Edition 2003.

Notes: 1) Calculated for Bulgaria under the assumption that 1 cigarette stick = 1g, using data from household surveys. Due to non-availability of similar data for the other countries, average daily per capita consumption of cigarettes in Bulgaria 1992-2001 (2.6) was used in order to calculate TCC for the other countries. -

2) Using the 2001 retail price of the Most Popular Price Category (MPPC) less excise and sales taxes.

## Infrastructural Needs & Economic Development in Southeastern Europe - The Case of Rail and Road Transport Infrastructure

By Mario Holzner, Edward Christie and Vladimir Gligorov

The theory of the 'Big Push' emphasises that coordinated investment and simultaneous industrialisation of many sectors could move economies from a bad to a good equilibrium. Shared infrastructure could help to make their industrialisation more likely. International empirical evidence on the relationship of infrastructure investment and economic growth is mixed. Although most studies reveal a positive relationship, it is still arguable whether infrastructure investment contributes directly to GDP growth or

by raising the productivity of investment in other type of capital. Moreover the question of reverse causality, with an increase in income leading to an increased demand for infrastructure, is still debatable. However a set of international empirical studies point out that, with respect to economic growth it might be more important how well countries use their infrastructure rather than how much of it they have. This underlines the importance of infrastructure quality and efficiency.

The analysis of the current state of the Southeast European rail and road transport infrastructure shows that while rail density is close to the European average, road density is significantly below the European average (see table 1 for a comparison of SEE road density in 2001 – the data is being compared to the averages of 8 Central and Eastern European CEE new EU member states, the three southern EU cohesion countries EU-S-3 and the remaining 12 more northern EU countries EU-N-12).

Table 1

### Road Density 2001

	Length of roads in km <sup>1) 2)</sup>	Density of roads km/'000km <sup>2</sup> area	Density of roads km/mn persons
Albania	18,000	626	5,743
Bosnia-Herzegovina	22,600	442	5,683
Bulgaria	37,296	336	4,692
Croatia	28,275	500	6,454
Macedonia	12,927	503	6,355
Moldova	12,657	375	3,478
Romania	198,603	833	8,852
Serbia-Montenegro	49,805	487	4,684
SEE-8 average	47,520	587	6,534
CEE-8 average	115,225	1,265	12,488
EU-S-3 average	283,899	1,169	14,319
EU-N-12 average	244,390	1,169	9,272
TOTAL AVERAGE	164,076	1,102	10,017

Notes: 1) Data on the length of roads for Moldova corresponds to the year 1999, for Albania, Austria, France, Germany, Greece, Italy, Netherlands, Portugal, Romania, Serbia and Montenegro, Spain and UK it corresponds to the year 2000 and for Bosnia and Herzegovina to the year 2003. 2) Data for Germany and Portugal is incomplete as there is no information on 'other roads' (besides motorways, national and regional roads) available.

Source: World Development Indicators 2003, EU Energy and Transport in Figures 2003, National Statistics, International Union of Railways and wiiw estimates.

Moreover rail and road transport infrastructure in the Balkans is of very poor quality compared to the other countries in Europe. Low levels of double track railway lines and only few motorways in the region constrain modern transportation services. The Southeast European countries' rail and road transport infrastructure has only low levels of efficiency. To sum up, these countries are poor countries with poor infrastructure.

In this respect the central question is whether the Southeast European countries have enough infrastructure capacity given their current stage of economic development and whether the poor level of transport infrastructure is a constraint for further economic growth. The results of our econometric analysis indicate that e.g. with regards to paved roads, SEE countries have, in comparison with other European countries, a smaller level of total length of paved roads per capita than their current GDP levels would imply. In the case of the railway network rather the opposite holds true.

Looking at the maps, one sees that most of the Balkan countries have better transport connections to the EU than with the other countries of the region. This is also a legacy of the cold war and the breakup of former Yugoslavia. Nevertheless the European Union and the International Financial Organisations are engaged in help-

ing the countries of the region to establish a core transport network. International and regional cooperation could help to overcome the inherited infrastructure patterns from decades of regional disintegration.

### **Infrastructure and Borders**

The argument for "big push" via investments in infrastructure apply perhaps better to longer distances than to shorter ones. This is because these are partly investments in public goods, i.e., in goods with large fixed costs. The longer the distance, the higher the fixed costs. Consequently, higher is the element of the public good and of externalities. Therefore, in a region with small countries, development is sapped to the extent that border impede large infrastructure projects. Conversely, investments in infrastructure lead to significant cross-border cooperation and can lead to increased economic and political integration.

This is even more the case with a transit region. Southeast Europe is such a region. Current infrastructure partly testifies to that. With the other part, it testifies to the long history of disintegration due to political reasons. It is this interplay of geography with politics that is of such an importance in the development or lack thereof in this region. With these two statements – that this is a transit region and that its infrastructure is distorted – it would then fol-

low that investments in infrastructure would have positive effects for development and will also have to cut across borders.

How would it contribute to development? If it is true that the inherited infrastructure is distorted because of the history of political disintegration, then political normalisation should lead to reallocation of infrastructure that would by itself, without the added "big push" effects, lead to high growth. In addition, if it is true that this is a transit area, then "big push" effects could be expected to exist because, by assumption, lack of adequate infrastructure leads to the existence of unexploited opportunities for trade, investment and production of goods and services.

Here, the key problem issue is how to cross borders? The history of disintegration and conflicts has worked for the support for hard borders. Though they may in fact be porous for private businesses, they often prove to be quite hard for public agencies. The recent experience of the Stability Pact, which has been especially active in procuring infrastructure projects, testifies to the fact that those that are regional have hard time being put together and realised. The political economy of this is not simple because it involves three types of actors: private businesses, public budget centres and international (or multilateral) bodies. In a decentralised setting of decision-making,

it may be difficult to come up with workable cooperation.

Thus, unlike the classical case of institutional failure inherent in the working of the market that was analysed by the theory of the "big push", there is an institutional failure due to political disintegration that has to be overcome. Clearly, once it is realised that cross-border infrastructure development is beneficial to all involved, these investments will in turn have beneficial effects on regional security and on the rationalisation of the behaviour of the local public agents, i.e., states and other political entities.

One reason that inter-state cooperation may be difficult to engineer is the effect that cross-border investments may have on the budgets. Not only some direct sources of public revenues may be lost – e.g., tariffs – but the reallocation of businesses may present various budget centres with a changing tax base. This may be temporary, but still important enough to make it difficult if not impossible for local public authorities to cooperate on common projects. For that reason, the public failure is perhaps more difficult to deal with than the market one, because there is, by assumption, no market solution to this problem.

In that circumstance, an outside agent, either private or public, could play a useful role in moving the various local governments to cooperate on common infrastructure projects. The same logic would work for the outside push for faster and more compre-

hensive reform in the sector of infrastructure services. It is indeed in this sector that public and private partnership (P&PP) play such a crucial role if that partnership is well organised and carried out.

The idea beside the P&PP is that public interest should be applied to the investment in the public good while private interest should be relied on to efficiently supply the private goods. For this partnership to work, it is important that proper procedures for competition are put in place. For that to be the case across border, it is necessary to liberalise the services sector in the whole region. In addition, the presence of an international or multilateral actor should induce the local public agents to cooperate not only in infrastructure projects but in the liberalisation of the services sector across borders also.

Infrastructure development may have far-reaching consequences for regional and inter-regional cooperation too. Common infrastructure leads to economic and political inter-dependencies. Those, in turn, work for regional investments, which eventually lead to policy inter-dependency. Those would then lead not only to the diminishing significance of the official borders, but also of the policy borders and so-called invisible borders too.

### Conclusions

Investments in infrastructure should have significant effects on the efficient allocation of resources in Southeast

Europe. They should also contribute to the high growth rate and faster convergence with the EU.

The more important ones cross borders, thus contributing to regional development and security. In addition, they make countries in the region inter-dependent and thus more prone to cooperate.

With that, the policy and invisible borders get to play a diminishing role. All that, however, cannot be expected to be generated from within the region alone, an outside push, primarily from the EU, is indispensable to overcome the consequences of the long history of political disintegration.

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