# Assessing regional integration and business potential in the Western Balkans

Sklias, Pantelis and Tsampra, Maria

University of Peloponnese, University of Western Greece

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**TITLE**

# Assessing Regional Integration and Business Potential in the Western Balkans

**Pantelis Sklias**
Dept. of Political Science & International Relations, University of Peloponnese
E-mail: psklias@hotmail.com

**Maria Tsampra**
Dept. of Business Administration of Food and Agricultural Enterprises,
University of Western Greece
E-mail: mtsampra@cc.uoi.gr

## ABSTRACT

This paper extrapolates the patterns and volume of business development within the Western Balkans region. This is a war-torn area with social, cultural, religious and political specificities. Despite noticeable institutional and growth progress of the individual countries, regional business is still lagging as persistent state rigidities create trade distortions. We argue that intra-regional business clusters, embedded in shared socio-cultural characteristics, can be the alternative to underdevelopment. Political willingness is the prerequisite, as market forces in transitional areas seem to be of secondary importance to regional business development and integration. New analytical approaches are needed to capture the complex reality.

## KEYWORDS

Regional Development, Business Clusters, Transition Economies, Western Balkans.

## JEL CLASSIFICATION CODES

F59, G01

## Assessing Regional Integration and Business Potential in the Western Balkans

### 1. Introduction

During the last 20 years, the region of the Western Balkans has witnessed enormous political, economic and social changes. Thousands of pages have been written and excellent scientific work has been done in order to assess the progress of the transition states. Many socio-political and economic developments have taken place as new states have emerged, newborn democracies have been established, and market-economy structures are now in function. In other words, a new different world has been now formed in the region, consisting of eastern nation-states with western-oriented patterns of development.

In the paper we argue that despite the crucial and astonishing developments that have taken place, business development at the regional level is still pending and is far from being accomplished, as well as regional integration. Regional integration is defined here as the institutional unification of independent national economies to bigger economic entities. Research on regional integration mainly concerns the conditions for the effective use of regional resources on the basis of barriers elimination for goods and factors mobility; but it also concerns the creation of efficient markets and institutions supporting the integration (Grupe and Kušić, 2005).

Neoclassical economic theories set a number of prerequisites and variables to be fulfilled in order to presume a successful path and accomplishment of regional cooperation and business development. Among those, a series of political and economic criteria are also set. We will demonstrate however, that although economic growth and FDI have considerably contributed to the well-being of the people in the newborn states under consideration, political development has not followed the same path. This has led to inconsistencies and gaps which impede intra-regional trade flows and regional business development and do not allow for regional growth projects to be visualized, nor accomplished.

The paper substantiates that business development at the regional level still has a very limited scope in the Western Balkans, while growth conditions are not so promising. Although a series of economic steps have been realized, the political requirements for such an achievement have not yet been met. In other words, a stronger political will and strategic orientation is now required towards this direction. Finally, we conclude with certain policy recommendations - in specific, the development of inter-country/intra-regional business clusters based on geographical proximity and cultural coherence.

### 2. Theoretical Considerations - Regional trade patterns and business development

A very large amount of literature has been developed over time, in order to assess the roots and causes of regional business development. The issue of regional trade is central in this literature, in the sense of selective trade partnerships among countries and the patterns of their trade relations. According to the classical and neoclassical theory, the differentiated production factors of countries form their ‘comparative advantages’; so, in the context of international division of labor, national economies specialize in products capitalizing these comparative advantages. Through free trade, the factor costs for labour and capital adjust and the resources of different countries complement each other. In these theories, returns to scale are assumed as constant, markets as perfect and complete, and transport costs as nonexistent.

Research of the last decades encompasses Johnston's (1976) approach to the geographical patterns of trade and their relation to broader geopolitical trends (Michalak and Gibb, 1997; Poon et al., 2000). Trade flows between countries are explained by the 'gravity model' (Johnston, 1976), which shows that trade correlates positively with the size of the national economy but negatively with distance. On this ground, economies with high GDP export and import more; less distance and a favorable natural environment mean more trade (Schiff and Winters, 2003, p. 40). However, Krugman and Obstfeld (2003) more recently argued that absolute convergence will only occur if the structural conditions between trade partners are similar. In other words, the traditional theoretical model suffers from severe shortcomings, which have been taken into account by the New Trade Theory (NTT). This 'new' theory of international trade shows that profits can emerge independently of the existence of comparative advantages.

The elimination of internal barriers has been the major reason why intra-block trade has substantially increased within the (then) EEC and EFTA countries (Aitken, 1973; Bayoumi and Eichengreen, 1997). This has been also the result of the association agreements on the development of mutual trade relations between the EC and 18 African countries (Aitken and Obutelewicz, 1976). It is also interesting that the more the intra-block trade increases, the more the extra-block trade (with the rest of the world) decreases. In other words, trade agreements lead to trade distortion (Frankel, Stein and Wei, 1997); and this has been the case of eight Regional Integration Agreements (RIAs) for the period 1970-1992. Furthermore, the study by Soloaga and Winters (2001) has demonstrated that trade within the EU (intra-block trade) has considerably increased during 1980-1996, while at the same time extra-block trade was decreased. This was eminent for Portugal and Spain when they joined the EU.

On the other hand, regional integration agreements (RIAs) between developing countries were not so effective. Their fundamental characteristics were extra-regional liberalizations, which advanced the integration of those countries in the world economy - but not their intra-regional integration. Although overall trade increased, intra-regional trade was less than extra-regional trade. This indication points to the fact that RIAs have differentiated impact on industrial location, specialization and consequently, inequality among partner-countries. Venables (2003) suggested an influential explanatory framework, claiming that integration between low-income countries tends to lead to divergence, while agreements between high-income countries lead to convergence. On this basis, it's been sustained that developing countries are likely to be better served by 'north-south' than by 'south-south' agreements.

However, at the same time that income convergence in the European Union ('north-north' integration) is documented (Ben-David 1993, 1996), other research substantiates lack of convergence, or even divergence in such integration (Karras, 1997). Moreover, Carmignani's research (2007) on the extent of per-capita income convergence in RIAs, demonstrates convergence in 'south-south' integrations. This research, covering a total of more than 100 countries, shows that convergence of per capita income is not necessarily a privilege of 'north-north' integration. Needless to point out that the integration process of the less developed economies of Eastern and Southern Europe in the EU - as a typical example of 'north-south' integration - has not resulted to income convergence at all.

The conclusion of this analysis is that 'south-south' integration does not necessarily imply widening intra-regional disparities. Although it might lead to bottom-convergence – i.e. to regional average income, which is lower than richer countries' income (Carmignani, 2007) - 'south-south' integration can provide dynamic welfare for its partner-countries. This can be achieved by enhancing efficiency through mutual learning, by enabling economies of scale and scope, by increasing FDI attractiveness and securing better bargaining positions. However, market size is a crucial determinant of 'south-south' successful integration, as is adequate transport and technology infrastructure, harmonized business regulation, appropriate institutions and policy instruments as well.

The important outcome of the discussion on the impact of RIAs is that their existence alone does not determine the scale and orientation of bilateral FDI flows; but rather the socio-economic, political and institutional characteristics of both investing and host countries. Namely, it is arguable whether membership in a RIA – e.g. the EU – alone, can enable the attraction of FDI and endogenous business growth if other 'locational' advantages are absent. Such advantages include region-specific specialization, accumulated knowledge, labour wages and skills, business milieu, etc. (Balasubramanyam et al, 2002). Even in the case of neighboring countries, which are empirically more prone to go ahead with RIA, the essential precondition is political willingness and determination to replace past tensions with an institutional framework that promotes cooperation and nondiscriminatory liberalizations among them.

Traditional theoretical approaches, as previously argued, consider a perfect economic environment where the principle of comparative advantage is well functioning and overwhelming. But the real world is imperfect and far from being complete. This is the reason for the formation of enriched economic approaches which encompass additional variables when addressing the issue of regionalism. In order to articulate regional economies with international trade, spatial dispersion (related to comparative advantage) and spatial concentration (related to scale economies) of globalized trade, is attributed to regional specialization and integration (Boschma and Iammarino, 2009). The historical path of places is also a defining factor, as pre-existing 'locational' patterns form strong external economies, or capacities (Storper et al 2002). Different industrialization histories are the case in Europe, where trade has developed under protectionism, language barriers and state support. Industrial dispersion is high, thus specialization of regional and national economies is low (compared to the US). As a result, intra-industry trade (rather, than inter-industry or inter-sectoral trade) is increasing across nearly all sectors in the EU (Storper et al 2002).

Even the dominance of multinational corporations (MNCs) is a clear indication of imperfect competition, as their existence is attributed to firm-specific advantages. The so called 'new' New Trade Theory (NNTT, as launched by Melitz in 2003) stresses the importance of firms rather than sectors in regard with the challenges and opportunities faced by countries in the context of globalization. Uneven spatial distribution of economic activities is related with the heterogeneity in firm performance within the very same industry. Some firms fail to cope with international competition while others of the same industry, succeed. In conclusion, intra-industry reallocations are much more pronounced, than inter-industry reallocations driven by comparative advantage (Melitz and Ottaviano, 2008; Ottaviano, 2011).

Additionally, institutional and regulatory frameworks - including political processes and mechanisms - have also been addressed in the regional analysis framework (Olson, 1996, p.7). The institutional 'dimension' of economies has been particularly stressed in recent research (Hall and Jones, 1999; Sokoloff and Engerman, 2000) and it has been broadly sustained that a country's institutions are invariably significant for cross-country differences in GDP per capita. The institutional framework has a fundamental role in explaining growth since it forms the environment within which the various actors operate. Moreover, institutions in neighboring countries are significant as well; good institutions may be ineffective when a country is surrounded by neighbors of poor institutional structures. The latter increase the chance of armed conflict, political turmoil and refugee flows; they may also obstruct trade, not only among neighbors but with other countries as well. This fact points to the significance of harmonized regional development policies and mutual efforts to upgrade institutional standards across neighboring countries.

Attention has been also put on the role of knowledge in regional convergence and development; information links and flows, knowledge accumulation and innovation prove to be more important than comparative advantages of physical capital and natural resources (Torstensson, Henrekson and Torstensson, 1996). Production networks do not exist in a vacuum, as every element of them – firm, or function – is grounded in specific locations of both tangible (fixed production assets) and intangible (localized social relationships, distinctive institutions and cultural practices) features (Coe et al., 2008). Hence, they are defined by the socio-political, institutional and cultural attributes of the places within which they are 'embedded', through complex relationships (Dicken and Malmberg, 2001). The contemporary context of the proliferation of preferential trading arrangements among states creates a dramatically changed economic and political landscape and new structures for the regional organization of industries (Dicken, 2007).

Porter's diamond model (1990) encompasses much of the richness of the aforementioned theoretical approaches; the figure of five forces provides a comprehensible explanation of what makes an industry, or a cluster of firms, competitive in a particular location, considering the patterns of comparative advantage in different industrialized nations. In his cluster theory, Porter (1998) underlines the particular importance of the interlinkages between geographically proximate partners – other companies, specialized suppliers, and institutions like universities or trade associations – in achieving competitiveness.

Firm location within a cluster enables better and cost-effective access to specialized inputs (e.g., human resources, scientific and technological infrastructure), information and knowledge. Proximate and sophisticated customers apply pressure on firms to constantly innovate. Close collaboration with local customers in the product development phase enable firms to gain a competitive advantage over competitors. Moreover, competitors exert pressure on firms to constantly innovate towards differentiation, cost savings or quality improvements. The relationships between firms and suppliers (related and supporting industries) play a decisive role in the value chain that is crucial for innovation and improvement processes. In close collaboration, local suppliers assist firms to establish new methods and technologies. Productivity enhancement occurs also by facilitating complementarities between the activities of cluster participants (Porter 1990, 1998 and 2003).

In Porter's diamond model, government interventions (at the local, regional, national or supranational level) influence the supply conditions of key production factors, demand conditions in the home market, and competition between firms. While, chance events are also important because they create discontinuities in which some gain competitive positions and some lose. However, although theory goes beyond traditional neo-classical stereotypes and offers a substantive scope for evaluating competitiveness, it still lacks a comprehensive approach when trying to assess why a location is favorable for creating competitive business in a given time. Qualitative variations and parameters - such as: perceptions, norms and culture - have not been adequately addressed by mainstream economics. This fact entails the risk of omitting important aspects of the regional agglomeration and integration phenomenon. This is often the case in complex situations such as the Western Balkans war-torn economies.

## 3. The Framework of Analysis

Low exports are at the heart of the problem of competitiveness and sustainable growth in most South-Eastern European (SEE) countries. As evidenced by World Bank data (Kathuria, 2008), exports from SEE have been growing especially in services. Nevertheless, low exports in manufactured goods are related to unemployment. In overall, export levels still fall significantly short of potential and needs: Albania, Bosnia and Herzegovina, Serbia and Montenegro are lagging in almost all fields; Bulgaria and Croatia are strong performers; while Romania, the largest country by far, has lower export intensity than Bulgaria and Croatia, although faster growing than either of them. Trade in the region has been influenced by exogenous forces such as (Kathuria, 2008): (i) the intense trade relations among the states of the former SFRY – with the exception of Serbia and Croatia; (ii) the Stabilization and Association Agreements (SAAs) enhancing trade between SEE and EU countries; and (iii) the Stability Pact-induced Free Trade Agreements (FTAs), which concluded in the CEFTA (2006), encouraging trade within SEE.

Related analysis however, shows that trade patterns in the region are unfavorable: exports mainly consist of unskilled-labor-, or natural-resource-intensive products. This pattern makes most countries vulnerable to low-wage competition from Asia and other regions. Moreover, buyer-driven trade is dominant while producer-driven trade is slowly emerging (with exception of Romania). During the 1990s, all countries of the Western Balkans region experienced a period of transition and ethnic conflict, along with a decline in the standards of living and the impediment of economic growth. World Bank experts underline poverty, unemployment, social cohesion and inadequate governance as the common challenges for all countries of the region (The World Bank Policy Research Working Paper, http://www.wds.worldbank.org). Nonetheless, the status and 'distance' from the European Union is differentiated across Western Balkan countries, along with their level of democratization and economic recovery. Thus, the deterioration of inter-ethnic relations and the absence of multicultural policies have been a major obstacle for stability and prosperity in the region (Petričušić, 2005).

As previously theoretically considered, from the neoclassical point of view, low trade in the region is the result of overlapping comparative advantages among its countries – i.e. dominance of raw-materials- and labour-intensive products (Grupe and Kušić, 2005; data of Comtrade of UNSD, ITC 2002) – which lead to similar trade structures with little complementarities, given the small size of the regional market (Vlahinić-Dizdarević and Kušić, 2004). Moreover, regional trade structure reflects inter-industry specialization patterns typical for developing countries in their exchanges with developed ones, as capital intensive products account for more than one-third of imports (von Hagen and Traistaru, 2003). So, in order to develop competitive production structures, the Western Balkans economies need to turn away from low-factor-costs production, move up their skills and technology to sustain rising wages and greater economies of scale and scope, and develop products for customers in the increasing SEE market (UNCTAD, 2002).

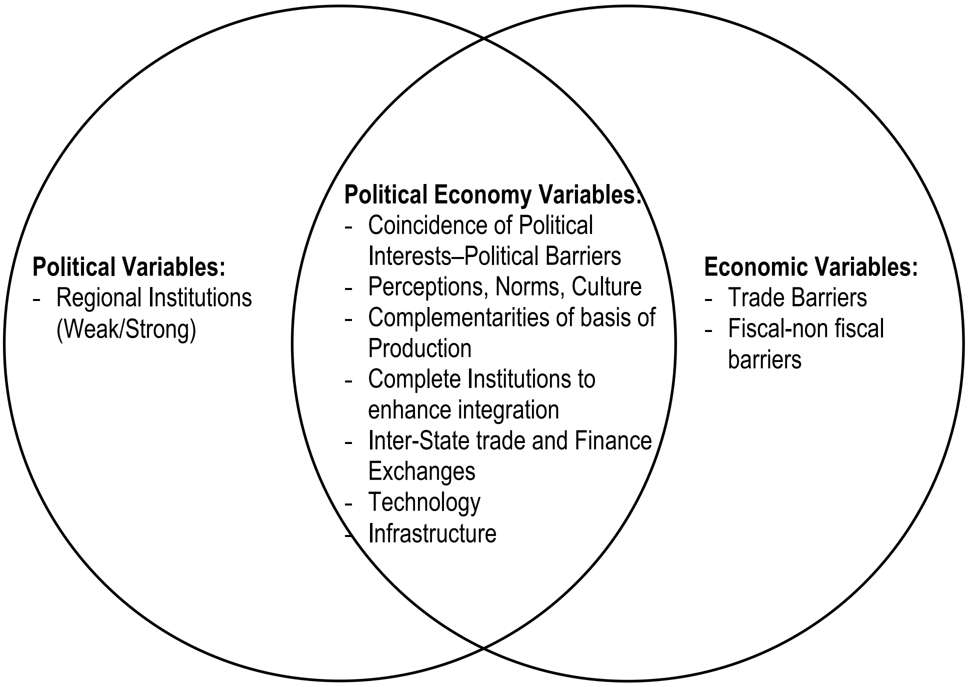
Political support so far promotes the region's integration to the EU rather, than intra-regional integration. Regional cooperation in the Balkans has been mainly hindered by political barriers. National economists tend to underestimate the importance of intra-regional trade, claiming that neighboring countries are too poor to be of interest for investment, or that they constitute economic competitors. It has even been argued that the SEE countries should not be considered as a region in economic terms, because of the low-level of intra-regional trade in Western Balkans (Gligorov, 2004; Christie, 2002). Undoubtedly, discrepancies in the economies of the Western Balkans are indeed considerable, as a result of the breakdown of the region's common market in the beginning of the 1990s which terminated long-established trade relations. Moreover, trade liberalization between the SEE countries and the EU proceeds faster, than among the countries in the region (Bartlett and Samardžija, 2000).

Contrary to prevailing perceptions, Barrett (2009) advocates intra-regional trade and claims that cross-border business links would enhance economic gains "through higher levels of entrepreneurial activity and increased foreign investment". In order to achieve regional economic integration, it is necessary to establish cross-country cooperation on the microeconomic level (of the firm) – such as cross-border business clusters; to undertake joint competition efforts and collaborate in R&D to enhance innovation (Grupe and Kušić, 2005). Geography and physical proximity of the Western Balkans countries are factors conducive to regional integration, along with the common heritage of socialism, culture, partly language and social and economic cohesion – shared endowment that has been partly offset by the turbulence of the 1990s. The gains from regional integration are progressively understood by entrepreneurs, who cooperate to revive old distribution channels in the region. Such intra-regional trade relations should be further promoted and supported by economic policy. Supporting regional initiatives on the business level requires the establishment of trust and confidence relations in the business community, as well as relations between economic actors and the state, across all countries.

Our framework of analysis uses the notions of culture and politics in order to capture regional business development and integration dynamics. The impact of culture on processes, practices and dynamics has already been explored by scholars (Koutsoukis, Sklias, Roukanas, 2011).

We previously demonstrated that merely economic criteria are inadequate for the assessment of regional integration processes. Social and political elements play their own role and many cases overweigh the neoclassical economic prerequisites. Abolition of trade, fiscal and other barriers of pure economic nature is one aspect of the whole picture. However, the perceptions on national interest, identities and norms, security notions, as well as dependency paths play their own role in the success or failure of regional integration. Thus, political willingness and determination still remains the big issue. Such an analytical approach may be figured as follows:

**Figure 1.** Capturing Regional Economic Integration (Sklias, 2011).




Applying the above analytical framework for capturing regional economic integration and measuring the aforementioned variables in a complex, war-torn region such as the Western Balkans, led us to the conclusions demonstrated in Table 1:

**Table 1.** Political Economy of Regional Economic Integration Variables in the Western Balkans Level of Accomplishment/Intensity

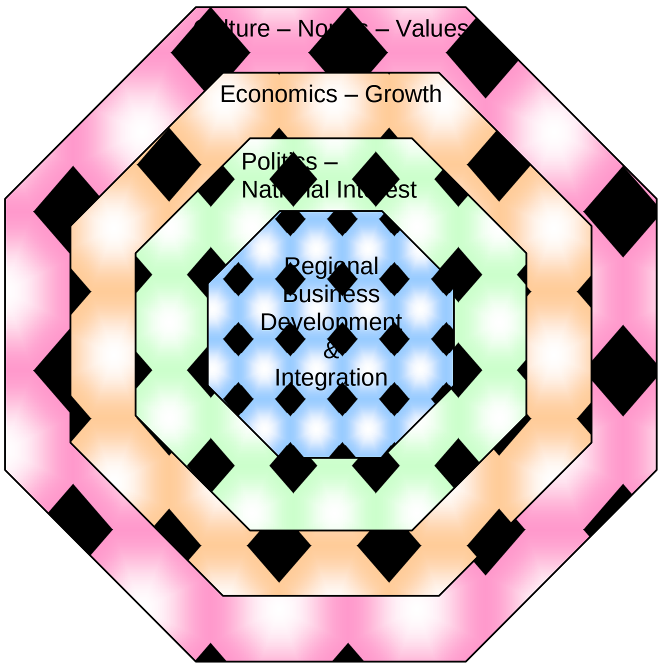
| Variable | Level of Accomplishment - Intensity | |
|---|---|---|
| | Low | High |
| Coincidence of national interest and political barriers | √ (for coincidence of national interest) | √ (for political barriers) |
| Common Perceptions on Norms, Principles, Culture | √ | |
| Complementarity of Productive Basis | √ | |
| Complete and Mature Institutions | √ | |
| Inter-State Trade and Finance Transactions | √ | |
| Technology | √ | |
| Infrastructure | √ | |

Source: Sklias (2011).

The variables denoting regional economic integration prospects among the Western Balkans economies show a remarkably negative tendency. More precisely, the level of accomplishment/intensity of the institutional, cultural, political and economic (IPE) variables used to assess the level of regional integration is low. For example, let us focus on the level of coincidence of national interests among the countries of the region, which is estimated as very low. This finding indicates cross-boundary disagreements – over political barriers, conflicting declarations and public statements, ethnic minorities rights issues raised, separatist aspirations within states, perceptions on potential armed conflict. The case is similar when we assess the level of accomplishment of the remaining variables. When measuring all these variables, they all prove a limited level of intensity/accomplishment and negative tendencies. We may assume that this situation creates a rather weak background for founding integration efforts in the region (Sklias, 2011). This is a satisfactory justification of why existing attempts have had limited success, while prospects for the future seem to be also dim. It additionally justifies why an enriched framework of analysis is necessary when addressing business development within regions where cultural, religious and social differences and political clashes prevail over the willingness to cooperate and integrate.

This framework of analysis can be figured as follows:

**Figure 2:** Capturing Regional Business Integration in Complex Regions




Culture, economics and politics create an integrated framework within which regional business development takes place. Thus, when assessing the roots and causes of success or failure of regional business development endeavors and initiatives, one sided analytical approaches may result into misleading conclusions and, accordingly, wrong policy recommendations. A comprehensive view of the appraisal of regional business development in complex areas such as the one of the Western Balkans should by no means neglect the mechanisms, processes and dynamics resulting from the interconnections of the three main cycles of politics, economics and culture.

In the above figure, the different components are not separated but interlinked, thus creating the conditions for a dynamic framework of business development. Politics and national interests play a crucial role in this analysis. However, economic policies targeted at increased growth rates still remain the objective. Nonetheless, the anticipated dynamics emerge in a specific cultural and social context of certain norms, values and principles, as well as the people's own perceptions for their reality and future. The particularities of this context form variations which should be taken into consideration when analyzing the prospects of regional business cooperation in complex regions.

This analytical framework will be accordingly applied in order to evaluate regional integration and business development potential in Western Balkans.

## 4. The case of the Western Balkans – Assessing regional business potential

Available statistical data derived from the respective Central Banks of the countries in the region, their Statistical offices as well as IOs prove that the majority of individual states in Western Balkans have demonstrated considerable performance, both in terms of growth rates as well as institutional reforms. More precisely, GDP annual growth accounts at least for 4-6% in the post 2008 economic crisis era (Table 2).

**Table 2.** GDP Growth in Western Balkans Countries

| Country | 2006 | 2007 | 2008 | 2009 |
|---|---|---|---|---|
| Albania | 5,4 | 6 | 7,8 | 4,9 (est.) |
| Kosovo | 4 | 5 | 5,4 | 3,8 |
| B&H | 6 | 6,2 | 5,7 | -3 |
| Serbia | 5,2 | 6,9 | 5,5 | -3 |

Data derived from Central Banks and Statistical Offices of the States concerned

Considering the pace of noticeable institutional reforms achieved, we address specific references in the World Bank Doing Business Reports. In particular, in terms of facilitating business start-ups in 2009/10 and in which way, the World Bank Report states the following:

*"Cut or simplified post registration procedures (tax registration, social security registration, licensing) Brazil, Cape Verde, Arab Republic of Egypt,* ***Montenegro,*** *Mozambique, Peru, Philippines, Taiwan (China)…Created or improved one-stop shop Cameroon,* ***FYR Macedonia****, Mexico, Peru, Slovenia, Tajikistan, Vietnam…(Doing Business Database, p.19)…In Portugal****,*** ***Serbia*** *and Ukraine the registry can now publish information about the company registration, so companies no longer have to arrange with a newspaper to advertise it…(p.20)…Putting procedures online Cape Verde, FYR Macedonia, Maldives, New Zealand, Puerto Rico, Saudi Arabia, Singapore (p. 21)."*

The above mentioned institutional reforms, although signifying considerable improvements, do not necessarily make the region a paradise for doing business. On the contrary, it still remains an area for development and improvement with considerable obstacles and complexities. Table 3 explicitly demonstrates the situation in terms of the extent to which the regulatory environment in a given country of the region is more or less conducive to the start-up of a local firm – in regard with variables such as "dealing with construction permits", "registering a property", "getting credit", "protecting investors", "paying taxes", "trading across borders", "enforcing contracts" and "closing-down a business". Ranked from 1 (the easiest country to do business) to 183 (the most difficult country to do business) the countries of the region rank as follows:

**Table 3:** Ranking on the ease of doing business

| Country | Rate 2011 | Rate 2010 |
|---|---|---|
| FYROM | 38 | 36 |
| Bulgaria | 51 | 51 |
| Romania | 56 | 54 |
| Montenegro | 66 | 65 |
| Albania | 82 | 81 |
| Serbia | 89 | 90 |
| Greece | 109 | 97 |
| B&H | 110 | 110 |
| Kosovo | 119 | 118 |

Source, World Bank, *Doing Business Database,* p.4, 2011

International institutional organizations realize the poor business environment in the region. The following references are characteristic:

*"Albania has made significant progress in transition reforms in recent years but significant challenges remain. Business environment suffers from a high level of corruption, serious shortcomings in the judiciary, and very weak institutional and law enforcement capacities. Despite sizeable investments in recent years, infrastructure is far from being adequate for private sector development, including substandard road network, lack of reliable power supply, and limited regard paid to environmental consequences of rapidly expanding economic activity. Poverty is also a significant issue, particularly outside the main Tirana – Durres area"* (Machacova and Elke, 2008, p.4 for Albania).

Or in the case of Bosnia & Herzegovina:

*"In Bosnia and Herzegovina (BiH) enterprise policy is largely established at entity level. The country lacks a SME strategy, as well as policy design and implementation capability at state level. There are growing disparities in approach and level of development among the two entities and the District of Brčko. Some critical elements for establishing a level playing field across the country are still not in place (e.g. harmonization of corporate tax, a national company register). There is a need to establish a system allowing regular information exchange, and to create synergies among locally managed programs at state level... BiH appears to lag behind significantly in the entire business establishment process, due in particular to problems of agreement and co-ordination between different levels of government* (Machacova and Elke, 2008, p. 4 for B&H).

Based on the above, we note the fact that we face a situation in which EU member states such as Greece - an OECD developed economy - is in a much worse situation compared to new EU entries such as Bulgaria and Romania, or non-EU member states of the region such as FYROM. Overall, the countries of the region have a long way to go before they are considered to be attractive for business and investments.

The same picture appears when assessing the 2011 Index of Economic Freedom, as well as the 2010-2011 Global Competitiveness Index (GCI) as Tables 4 and 5 demonstrate.

The Index of Economic Freedom ranks from 0-100 the level in given economies of individuals' freedom to work, produce, consume, and invest in any way they please - freedom both protected by the state and unconstrained by the state; as well as the level to which governments allow labor, capital and goods to move freely, and refrain from coercion or constraint of liberty beyond the extent necessary to protect and maintain liberty itself. The following components of economic freedom are measured: business freedom, trade freedom, fiscal freedom, government spending, monetary freedom, investment freedom, financial freedom, property rights, freedom from corruption, labor freedom.

**Table 4.** Index of Economic Freedom, 2011

| Country | World Rank | Freedom Score | Change from previous |
|---|---|---|---|
| Germany | 23 | 71,8 | +0,7 |
| FYROM | 55 | 66 | +0,3 |
| Bulgaria | 60 | 64,9 | +2,6 |
| Romania | 63 | 64,7 | +0,5 |
| Albania | 70 | 64 | -2 |
| Montengero | 76 | 62,5 | -1,1 |
| Greece | 88 | 60,3 | -2,4 |
| Serbia | 101 | 58 | +1,1 |
| B&H | 104 | 57,5 | +1,3 |

100-80; Free
79,9-70: Mostly Free
69,9-60: Moderately Free
59,9-50: Mostly Not free
49,9-0: Repressed
Source: Index of Economic Freedom World Rankings, available at:
http://www.heritage.org/Index/ranking

The Global Competitiveness Index is based on 12 pillars of competitiveness, providing a comprehensive picture of the competitiveness landscape in countries around the world at all stages of development. The pillars are: institutions, infrastructure, macroeconomic environment, health and primary education, higher education and training, goods market efficiency, labor market efficiency, financial market development, technological readiness, market size, business sophistication, and innovation.

**Table 5.** Global Competitiveness Index, 2010-2011

| Country | World Rank | GCI Score | Rank 2009-2010 |
|---|---|---|---|
| Germany | 5 | 5.39 | 7 |
| Montenegro | 49 | 4.36 | 62 |
| Romania | 67 | 4.16 | 64 |
| Bulgaria | 71 | 4.13 | 76 |
| FYROM | 79 | 4.02 | 84 |
| Greece | 83 | 3.99 | 71 |
| Albania | 88 | 3.94 | 96 |
| Serbia | 96 | 3.84 | 93 |
| B&H | 102 | 3.70 | 109 |

Source: The Global Competitiveness Report 2010-2011, 2010 World Economic Forum

Intra-regional trade is limited due to non-tariff barriers as well. This is related to similar trade structures and little complementarities, which are also demonstrated to a large extent from the greatly overlapping comparative advantages as Table 6 presents, showing the revealed comparative advantages of the region in 2002.

**Table 6.** Revealed Competitive Advantages, 2002

| | ALBANIA | B&H | CROATIA | FYROM |
|---|---|---|---|---|
| Basic manufactures | 0,76 | 3,38 | 1,24 | 3,67 |
| Transport equipment | | 0,06 | 1,12 | 0,14 |
| Clothing | 11,08 | 3,85 | 3 | 8,81 |
| Leather products | 24,03 | 8,35 | 2,8 | 2,46 |
| Wood products | 1,03 | 4,59 | 2,12 | 0,34 |
| Non-electronic machinery | 0,17 | 0,46 | 0,55 | |
| Miscellaneous manufacturing | 0,36 | 1,31 | 0,82 | 0,17 |
| Fresh food | 1,75 | 1,06 | 0,79 | 1,92 |
| Minerals | 0,28 | 0,64 | 0,93 | 0,2 |
| Processed Food | 0,24 | 0,79 | 2,07 | 2,55 |
| Textiles | | 0,58 | 0,64 | 1,24 |
| Electronic components | | 0,12 | 0,68 | 0,47 |
| Chemicals | | 0,13 | 0,91 | 0,5 |
| IT an consumer electronics | | | 0,24 | |

Source: Calculations based on Comtrade of UNSD, ITC 2002 as stated in Grupe and Kusic (2005).

The fact that intra-regional trade is of a limited scope is also demonstrated by the following data which mainly relates to import and export of goods by countries:

**Table 7.** FYROM: Import and Export of Goods By countries (in million euros)

| Germany | 1991 | | 2000 | | 2005 | | 2010 | |
|---|---|---|---|---|---|---|---|---|
| Country | Imports | Exports | Imports | Exports | Imports | Exports | Imports | Exports |
| Germany | 243 | 225 | 253 | 257 | 336 | 364 | 610 | 692 |
| Albania | 5,1 | 5 | 3 | 12 | 9 | 27 | 22,8 | 72 |
| Serbia | | | | | | | 418 | 271 |
| Bulgaria | 68 | 48 | 97 | 27 | 234 | 76 | 301 | 294 |
| Romania | 10,6 | 9 | 14 | 1 | 64,3 | 4 | 126,2 | 54 |
| Montenegro | | | | | | | 1,44 | 27 |
| Greece | 85 | 62 | 200 | 84 | 297 | 313 | 448 | 245 |
| S&M | | 69 | 190 | 335 | 264 | 459 | | |
| B&H | 2 | 55 | 5,3 | 23 | 23,5 | 50 | 49,1 | 184 |
| Turkey | 28 | 18 | 52 | 10 | 113 | 45 | 260 | 50 |
| Russia | 339 | 255 | 191 | 10 | 425 | 21 | 552 | 26 |
| Total | 1274 | 1095 | 2093 | 1322 | 3232 | 2042 | 5450 | 3301 |

Source: National Bank of FYROM

EU countries and Serbia have the largest share in the trade volume in FYROM. We also note that, comparing to other Western Balkan countries, the country appears to a have more balanced trade relations as a result of related institutional reforms. Additionally, the strong Albanian minority in the population has not been adequate to give impetus to trade with Albania, although historical ties, traditional economic links and complementarily could justify for it.

**Table 8:** Kosovo Imports and Exports by Country (in thousands euros)

| | Exports | | | | Imports | | | |
|---|---|---|---|---|---|---|---|---|
| Country | 2009 | | 2010 | | 2009 | | 2010 | |
| | February | | February | | February | | February | |
| | Value | % | Value | % | Value | % | Value | % |
| Romania | 4 | 0.0 | 564 | 2,2 | 995 | 0,8 | 2080 | 1,4 |
| Bulgaria | 342 | 2,2 | 79 | 0,3 | 1590 | 1,2 | 2240 | 1,5 |
| EU 27 | 9194 | 58,6 | 16835 | 65,5 | 50381 | 39,5 | 57366 | 38,5 |
| Albania | 1568 | 10 | 2300 | 8,9 | 2696 | 2,1 | 3334 | 2,2 |
| FYROM | 1498 | 9,6 | 2365 | 9,2 | 16218 | 12,7 | 19303 | 13 |
| Montenegro | 147 | 0,9 | 337 | 1,3 | 332 | 0,3 | 300 | 0,2 |
| Serbia | 272 | 1,7 | 518 | 2 | 15129 | 11,9 | 19152 | 12,9 |
| Turkey | 447 | 2,9 | 291 | 1,1 | 8001 | 6,3 | 9232 | 6,2 |
| B&H | 241 | 1,5 | 10 | 0 | 3,393 | 2,7 | 3398 | 2,3 |
| Total | 15681 | 100 | 25714 | 100 | 127493 | 100 | 148993 | 100 |

Source: Statistical Office of Kosovo, 2011.

The share of the EU in the pattern and volume of Kosovar trade increases. We can also notice the comparatively big share of Albania and FYROM in Kosovar trade, both in terms of imports and exports. This can be justified by the fact that the three areas are neighboring and there are strong political, social and religious ties among them. The considerable share of Serbia in the imports volume can be justified not only by the real consumer needs of the Kosovar population, but also by the presence of a Serbian minority in the region, which is fully dependent on Serbia.

**Table 9.** Albania: Imports by Trading Partners, 2005-2009

| **Country** | **2005** | **2006** | **2007** | **2008** | **2009** | **2009/2008 (%)** |
|---|---|---|---|---|---|---|
| EU Countries of which: | 1401 | 1580 | 1820 | 2168 | 2088 | -3,7 |
| Italy | 611 | 677 | 826 | 946 | 850 | -10,1 |
| Greece | 346 | 381 | 444 | 524 | 505 | -3,6 |
| Germany | 113 | 136 | 167 | 216 | 209 | -3,2 |
| Bulgaria | 59 | 66 | 54 | 69 | 61 | -11,6 |
| Non EU countries | 683 | 831 | 1244 | 1402 | 1161 | -17,2 |
| China | 140 | 145 | 203 | 266 | 236 | -11,3 |
| Turkey | 140 | 145 | 203 | 266 | 236 | -1,9 |
| FYROM | 26 | 39 | 59 | 79 | 60 | -24,1 |
| Russia | 85 | 99 | 125 | 157 | 87 | -44,6 |
| TOTAL | 2084 | 2411 | 3045 | 3570 | 3249 | -9 |

Source: Bank of Albania

Albania’s trade in goods with the rest of the world preserved its previous years’ geographical pattern. About 60% of imports originate from EU countries, among which Italy continues to share the main weight accounting for 26% of total imports and 40% of imports originating from EU countries. Greece is ranked second with 15% of total imports and 25% of imports originating from EU countries. Imports from Albania’s main trading partners declined since 2008. Imports from EU countries dropped by 4%, while imports from Italy dropped by 10%. Imports originating from outside the EU fell as well in 2009 (Table 9). China and Turkey have the largest share in this group of countries, accounting for 7% and 6% of total imports, respectively. But imports from China dropped by 11%. The decline of exports to Italy by 14% (Table 9) provided the largest contribution to the narrowing of the country's total exports by 14%. In 2009, Italy was the destination of 60% of Albania's total exports and 80% of exports to EU. Exports to countries outside the EU declined as well. Albania's exports to Balkan countries were EUR 50 million, or 60% lower than in 2008. Exports to Kosovo, Turkey and Montenegro declined substantially during 2009 (Bank of Albania, 2011).

**Table 10.** Montenegro: Imports and Exports by Trading Partners, 2006-2009

| **Imports** in TEUR | **2006** | **2007** | **2008** | **2009** |
|---|---|---|---|---|
| Bosnia & Herzegovina | 40.937 | 117.166 | 164.810 | 1.149.882 |
| Slovenia | 52.841 | 149.019 | 161.297 | 1.148.161 |
| Serbia | 402.153 | 705.041 | 839.179 | 599.232 |
| Slovakia | 201.899 | 166.449 | 24 835 | 191.998 |
| Croatia | 60.408 | 133.610 | 169.665 | 126.477 |
| Italy | 141.088 | 163.687 | 193.195 | 108.577 |
| Germany | 154.495 | 95.987 | 136.849 | 63.215 |
| Switzerland | 51.430 | 110.801 | 120.519 | 56.742 |
| Hungary | 16.490 | 48.578 | 54.710 | 31.433 |
| FYROM | 15.596 | 22.342 | 29.878 | 21.347 |
| Czech Republic | 21.754 | 30.131 | 29.800 | 14.532 |
| Romania | 27.207 | 15.311 | 21.191 | 12.560 |
| Russia | 38.300 | 9.836 | 3.042 | 10.158 |
| Bulgaria | 6.262 | 10.238 | 11.915 | 8.694 |
| **Exports** in TEUR | **2006** | **2007** | **2008** | **2009** |
| Serbia | 172.016 | 106.726 | 107.811 | 79.606 |
| Slovakia | 63.277 | 46.847 | 62.135 | 60.877 |
| Italy | 239.231 | 145.286 | 130.563 | 34.218 |
| Slovenia | 23.046 | 28.556 | 37.355 | 24.095 |
| Bosnia & Herzegovina | 28.548 | 26.022 | 22.089 | 18.882 |
| Belarus | 12.299 | 8.019 | 17.462 | 16.811 |
| Hungary | 44.245 | 63.338 | 9.248 | 11.683 |
| Croatia | 8.797 | 10.987 | 6.620 | 9.829 |
| Lithuania | 4.797 | 8.930 | 8.091 | 7.733 |
| Germany | 5.682 | 9.188 | 16.218 | 6.792 |
| Latvia | 3.248 | 5.562 | 5.589 | 3.938 |
| Estonia | 2.630 | 1.040 | 2.339 | 1.912 |
| Russia | 869 | 585 | 1.041 | 1.513 |
| FYROM | 2.036 | 794 | 902 | 1.439 |
| Czech Republic | 1.476 | 2.836 | 4.425 | 1.058 |
| Romania | 1.337 | 119 | 995 | 689 |
| Bulgaria | 66 | 434 | 122 | 130 |
| EU | 617.492 | 483.175 | 428.980 | 276.611 |

Source: Montenegrin Statistical Office, 2011.

In the case of Montenegro, the main foreign trade partners are: Serbia (EUR 74.9.million), Greece (EUR 56.4 million) and Italy (EUR 48.8 million). In import, the main foreign trade partners are: Serbia (EUR 432.6million), Bosnia and Herzegovina (EUR 432.6 million) and Germany (EUR 117.1 million). Foreign trade exchange was biggest with the countries subscribers of CEFTA agreement and European Union.

**Table 11:** Serbia: Exports and Imports by selected countries, March 2011 (in USD millions)

| | Exports | | Imports | | % Exports | | % Imports | |
|---|---|---|---|---|---|---|---|---|
| **Country** | **2010** | **2011** | **2010** | **2011** | **2010** | **2011** | **2010** | **2011** |
| Total | 2030 | 2683 | 3812 | 4627 | 100.0 | 100.0 | 100.0 | 100.0 |
| Europe | 1951 | 2594 | 3149 | 3803 | 96.1 | 96.7 | 82.6 | 82.2 |
| Russia | 96,6 | 157,7 | 525,5 | 674,8 | 4.8 | 5.9 | 13.8 | 14.6 |
| Germany | 229,6 | 306 | 394 | 424 | 11.3 | 11.4 | 10.3 | 9.2 |
| Italy | 249,8 | 349 | 338 | 368 | 12.3 | 13 | 8.9 | 8 |
| Romania | 103 | 222 | 131 | 239 | 5.1 | 8.3 | 3.4 | 5.2 |
| B&H | 220 | 235 | 115 | 145 | 10.9 | 8.8 | 3 | 3.1 |
| Montenegro | 181 | 170 | 53 | 46 | 7.5 | 6.3 | 1.4 | 1 |
| FYROM | 100 | 118 | 44,8 | 55,7 | 5 | 4.4 | 1.2 | 1.2 |
| Greece | 37,2 | 50 | 53 | 66 | 1.8 | 1.9 | 1,4 | 1.4 |

Statistical Office of the Republic of Serbia, 2011.

From the above we can notice that the major foreign trade partners in exports in the reference period (January-March 2011) were: Italy (USD 349.4 million), Germany (USD 306.0 million) and Bosnia and Herzegovina (USD 235.4 million). The major foreign trade partners in imports in the reference period were: the Russian Federation (USD 674.8 million), Germany (USD 424.9 million) and Italy (USD 368.5 million). The external trade in the reference period noted the highest level with the countries with which Serbia has signed agreements on free trade. European Union member countries account for more than 50% of the total external trade. Serbia's second major partner refers to the CEFTA countries, since the gained surplus in external trade amounted to USD 279.4 million, resulting mainly from the exports of agricultural products (cereals and produces thereof and various sorts of drinks), as well as from exports of iron and steel.

The statistical data presented in Tables 7,8,9,10,11 also demonstrate that:

- The volume of trade increases with those partners with which Free Trade Agreements have been signed, namely the EU member states and CEFTA countries. It is clear that trade with the EU constitutes the big part of overall trade volume in the region.
- Trade with Russia remains significant for the countries of the region mainly due to oil and natural gas imports.
- Trade with other states of the region is limited in scope and volume. Increased volumes of trade are identified among countries of the following characteristics: neighboring, historical ties, social and ethnic relativity. These are the cases of trade relations between Kosovo and Albania, Kosovo and FYROM, Serbia and Montenegro, Serbia and B&H, Serbia and FYROM.
- The dominance of raw materials and labor intensive products is not favorable for sustainable development and competitiveness.
- Western Balkan economies compete in the same external markets.

The following conclusions can be therefore extracted by the assessment of the data presented in this paper:

- Growth rates for individual states are considerable, at least until the 2008 financial crisis;

– Although noticeable improvements have been realized in terms of institutional reforms and structural changes, still a lot has to be done for the countries in question to become mature market oriented economies;
– The examined economies compete among themselves with low RCA;
– Institutional and economic environment in all countries of the region is not business friendly;
– Production depends on raw materials and low-cost labor;
– Economic integration of the individual states within the EU increases;
– Intra-regional trade is very limited without prospects for development in the near future.

The above conclusions bring us in front of a paradox: although the economic environment improves on state-to-state basis, regional entrepreneurship and business cooperation is very limited, even non-existent.

## 5. Regional Business Clusters: growth leverage in the Western Balkans

Empirical research shows that until today endogenous entrepreneurship in the Western Balkans is underdeveloped: trade within the region is less than could be expected; a key characteristic of the intra-regional trade flows is the relatively low ratio of goods exports to GDP (Michalopoulos, 2003). All countries have significant deficits of goods trade and of combined goods and services trade; while local companies can hardly meet the competitive challenges from imported goods. Business clustering is assumed to raise national/regional economic growth; when localized positive spillovers exist, the spatial concentration of economic activities has a beneficial effect on productivity, innovation, and hence the growth of real output in the agglomeration (Gardiner et al., 2011).

Thus, a positive relationship is assumed to exist between regional concentration of production and the rate of economic growth. Competitiveness is in the core of regional economic agglomeration, thus the focus should be on how to leverage the region's strong industrial agglomerations (Porter, 2003; Cortright, 2006; Ketels and Memedovic, 2008). Research further suggests that regional economic performance depends on the industrial composition across neighboring countries rather, than within narrow political boundaries (Delgado et al, 2010). On this ground, a strong cluster environment for business of neighboring countries would enhance growth at the region-industry level by facilitating operational efficiency, capital investment and innovation, thereby increasing job creation and productivity (Porter, 1990, 1998).

Regional business clusters in Western Balkans are scarce and institutional support for national clusters is also very limited (Machacova and Elke, 2008). Any existing clusters in the region are the outcome of external donors' policies rather than genuine local initiatives; they have very limited government support although they are national in character and nature; awareness of clustering advantages is very low, even for their members. In other words, they are underdeveloped, while good practices are missing due to the fact that they are rather new initiatives without precedents. In conclusion, regional business clusters is a tool not yet applied in the Western Balkans; thus, it can be considered as an innovative mechanism to promote entrepreneurship, business cooperation and competitiveness in all neighboring countries of the region.

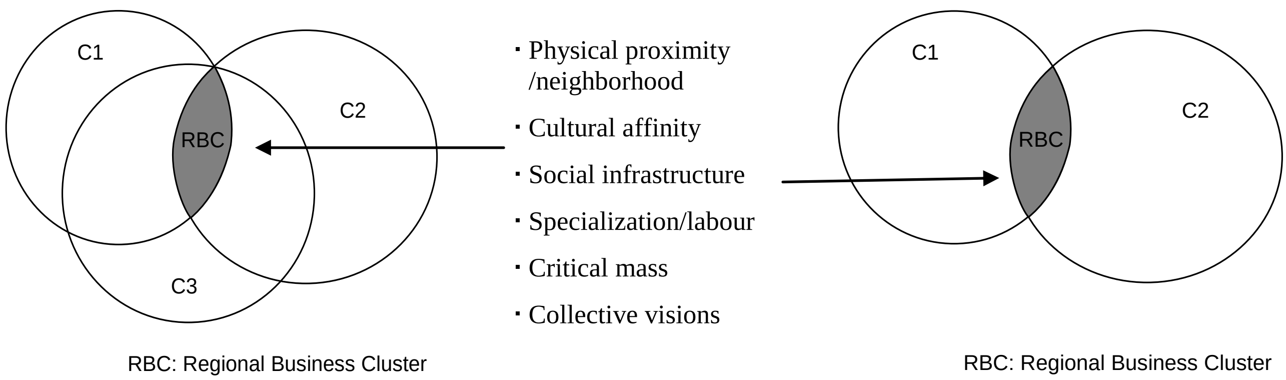
Clusters require tight interaction among entrepreneurs and institutions and cooperation at both local and regional levels. Thus, clustering needs promotion by many inter-related policy areas, concerning small and medium sized enterprises (SMEs) support, FDI promotion, education and training, infrastructure and logistics provision, research and development (R&D) and competition. Special measures are also needed to strengthen social capital (OECD, 2005). The potential of clusters to mobilize local economies should be viewed by Western Balkan policy makers as a tool to boost growth in this disadvantaged region. Cluster policies and initiatives have emerged in recent years in the CE countries, with positive results in Slovenia, Slovakia, Poland, Hungary and Czech Republic. In all such cases, various policy tools and initiatives have been used to foster cluster development directly or indirectly.

In Western Balkans, poor know-how and marketing inadequacies prevailing in the region's national economies could be surpassed through cooperation of mutual benefits. Business cooperation should exceed market overlapping and boost intra-regional trade, on the basis of product improved quality and international competitiveness (Salavrakos and Georgieva, 2010). In order to counteract the region's marginalization and deficiencies, we propose the establishment of cross-country - preferably triangular or biangular - business clusters which fulfill the following preconditions:

a) Geographical proximity, meaning neighboring areas of different Balkan states;
b) Common cultural and religious background, including the language element;
c) EU membership of one cluster partner-state: i.e. Greece, Romania or Bulgaria.

The proposed cluster in the case of a three or two nation-states partnership, whereas C1 = Country 1, C2= Country 2, C3 = Country 3, can be mapped as follows:

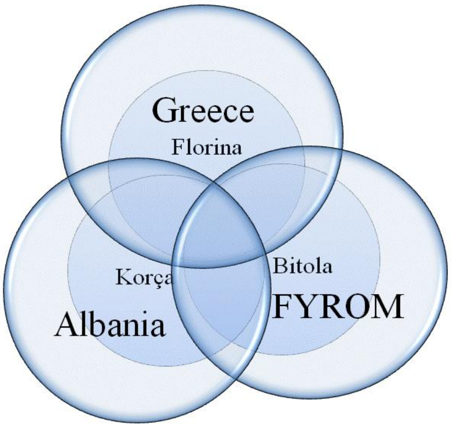
**Figure 3**: Regional Business Clusters between three, or two neighboring Countries




The designated RBC area in the figure is the specific location which satisfies the above mentioned preconditions, forming the necessary cultural, political and economic background for business development in the region. As an example in reference to the Greek business sector, which already holds important places in all the Western Balkan countries, such RBC areas can potentially be the following:

- Ipirus (Greece), Korca (Albania), and Ohrid (FYROM);
- Florina (Greece), Bitola (FYROM), and Korca (Albania);
- Thessaloniki (Greece), Blagoevgrad (Bulgaria), and Veles (FYROM)

**Figure 4:** Potential business cluster in border regions




| Country | Region | Business field for potential Cluster |
|---|---|---|
| Greece | Florina | agro-food (beans)<br>rural tourism |
| FYROM | Bitola | agro-food (apples)<br>rural tourism |
| Albania | Korça | agro-food (manufacturing) |

The aforementioned border regions are defined by non-economic aspects such as the dominant socio-cultural conditions - related to the national, linguistic and geographic parameters that influence border interaction. Under this perspective, border regions are examined as social construction, where the role of norms, collective identities and shared memories is important in interaction (Keating, Loughlin, and Deschouwer 2003).

Our policy recommendation does not imply any kind of free trade zone or common market institutional arrangements, since the involvement of an EU member-state automatically implies the EU *acquis communautaire*, which does not allow for legally binding arrangements. It rather implies the necessary political willingness and financial support to overcome existing impediments and boost competitive advantages in regional business. In this framework, a series of policy initiatives and measures can be proposed for the specific RBCs, targeting at:

– joint business projects, joint efforts for product development, shared supplies, production and marketing;
– joint action for an extrovert business orientation, e.g. international fairs and expositions, for a common marketing and sales platform, e.g. promoting the comparative advantages of the cluster;
– know-how exchange and sharing of expertise and skills, e.g. language skills and competences, cultural acquaintance, human resources exchange, training courses, learning from good practices and diffusing innovation;
– building institutional and administrative capacity, sustaining entrepreneurship across the regions involved;
– developing infrastructure and technology projects, enhancing accessibility and mobility of production actors across the regions involved.

RBCs defined by the framework depicted in Figure 4, meaning the cultural particularities, the political interests and the economic objectives of private and public stakeholders in the countries involved, can counteract stagnation and form the leverage for local and regional development in the Western Balkans.

## 6. Conclusion

This paper addressed the issue of the inadequate analyses provided by neo-classical theory, for regional integration and development. Especially in the case of the complex situation of worn-torn regions such as the Western Balkans, more enriched approaches should be adopted, in order to capture the reality of socio-cultural tensions and institutional and economic transition. Such approaches are necessary to explore in depth the regional particularities and assess the national strategies applied, so to make appropriate recommendations for growth and competitiveness. Entrepreneurship and business cooperation are central issues for intra-regional development; their achievement requires specific policies based not only on macro- and micro-economic factors, but on socio-cultural and institutional factors as well.

By adopting such a framework of analysis, we attempted to integrate the political, cultural and socio-economic situation of the Western Balkans nation-states in the assessment of the region’s pattern of integration and development. Our aim was to avoid simplified explanations and demonstrate a paradox: despite evidence for economic progress of the individual states, endogenous growth is weak as intra-regional integration is still of limited scope and regional business co-operation is scarce. This means that regional business development has not yet managed to overcome the political and cultural obstacles between the individual states in the region.

On this ground, we have proposed as an alternative to stagnation and seclusion, the establishment of regional business clusters in border-areas of the region’s states. Up to date, business clusters in the region have merely been formed at the national level, with questionable results in terms of efficiency. We suggest the political, institutional and financial support of business clusters of a cross-national character, based on geographic proximity and neighborhood, as well as shared historical background and culture (referring to religion, or even language). Such regional business clusters have the potential to provide the necessary conditions for regional competitiveness and development.

The effort should focus on diminishing the impact of the borders, which comprise much more than physical barriers. This effort requires a thorough analysis of the particular ways to bring closer all the stakeholders involved, at every level: institutional, entrepreneurial, cultural, lingual, academic, etc. Political willingness is however in the core of this process; and this still remains the big question for regional co-operation and integration in the Western Balkans. Mere market forces have not been capable to overpass national borders in the region. Unless there is a genuine political will, or even an external force that will motivate this potential, international competitiveness and sustainable development in the Western Balkans will be not achieved in the near future.

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