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Challenges for Western Balkan Countries Regional Integration: the Case of North Macedonia

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Abstract

This paper aims to elaborate on the possibilities that increased regional integration initiatives can have in boosting mutual trade among the countries in the Western Balkans region, such as: creating a Regional Economic Area by 2023; the creation of a Common Regional Market based on EU rules in the period 2021-2024 and the initiative "Open Balkan" created between North Macedonia, Serbia, and Albania for enabling free movement of goods and free movement of workers. For our research, the gravity model of trade for North Macedonia covering the period 2005-2020 is applied. The influence of bilateral and regional trade agreements on the country's trade is analyzed. The results have shown that for North Macedonia, CEFTA-2006 membership has higher significance for increasing trade when compared to the agreement signed with the EU and to the other bilateral free trade agreements signed with EFTA, Turkey, and Ukraine. This paper point out that deepening trade integration through different regional initiatives could have a positive influence on increasing mutual trade.

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Keywords: Regional integration, trade agreements, CEFTA-2006, EU, North Macedonia

Introduction

The process of regional integration in the case of Western Balkan countries may be analyzed by following two different integration paths – the first one considering the integration process within CEFTA-2006, and the second one by measuring the individual progress of each of CEFTA member-states towards the EU. Members of CEFTA-2006 are seven signatories (parties). Except for Moldova, all of them geographically belong to the Western Balkan region: Albania, Bosnia and Herzegovina, Kosovo, Montenegro, North Macedonia, and Serbia.

Despite the geographic compactness of the Western Balkan region, the EU happens to be the leading trade partner of all CEFTA-2006 members accounting for almost 70% of the whole region's export and around 60% of all imports. All CEFTA-2006 parties got a preferential bilateral free trade agreement (a Stabilization and Association Agreements for Western Balkan countries or Association Agreement for Moldova) with the EU and for almost a decade enjoy preferential treatment for almost all the export to the EU free of all qualitative and quantitative barriers. The trade regime for sugar, wine, baby beef, and certain fisheries is an exception from the offered EU preferential treatment and these goods are traded under the regime of tariff quotas.

CEFTA-2006 is the second-largest destination for export within the Western Balkan region. The creation of the free trade area for agricultural and non-agricultural goods resulted in a trade creation effect within the member-states' economies in the first couple of years of the Agreement's coming into force. This effect was also confirmed by a World Bank estimation which pointed out that bringing up CEFTA-2006 to the level reached by EFTA member-states might lead to a 2.3% of annual GDP growth. If CEFTA-2006 parties could reach the level of the EU integration, the GDP growth was estimated up to 6.7% annually (World Bank, 2019). The European financial and economic crises in 2008, however, interrupted the boost of trade within CEFTA-2006, and additionally diverted trade flows from within the region towards the EU market. Currently, Western Balkan economies record a high level of economic integration with the EU which accounts for almost 2/3 of their total trade exchange of goods, while the trade exchange within CEFTA - 2006 fell between 10-15% of the total trade exchange of goods of its member-states.

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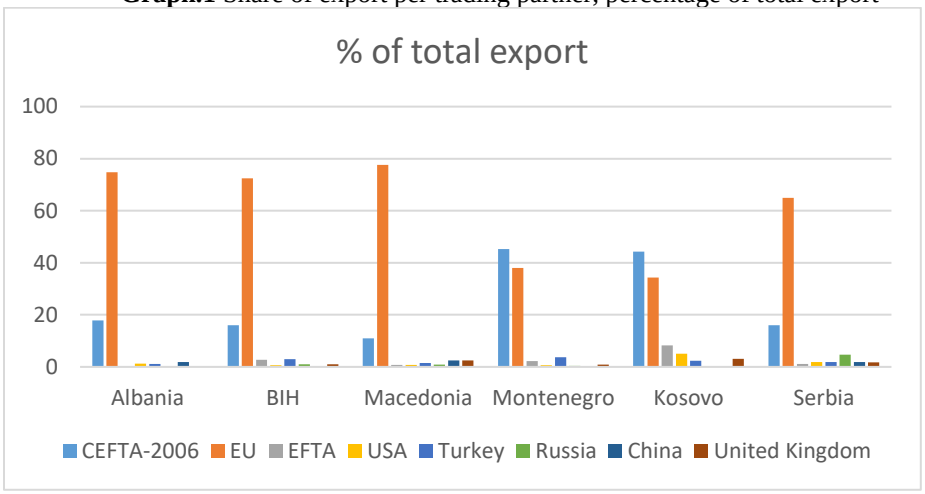
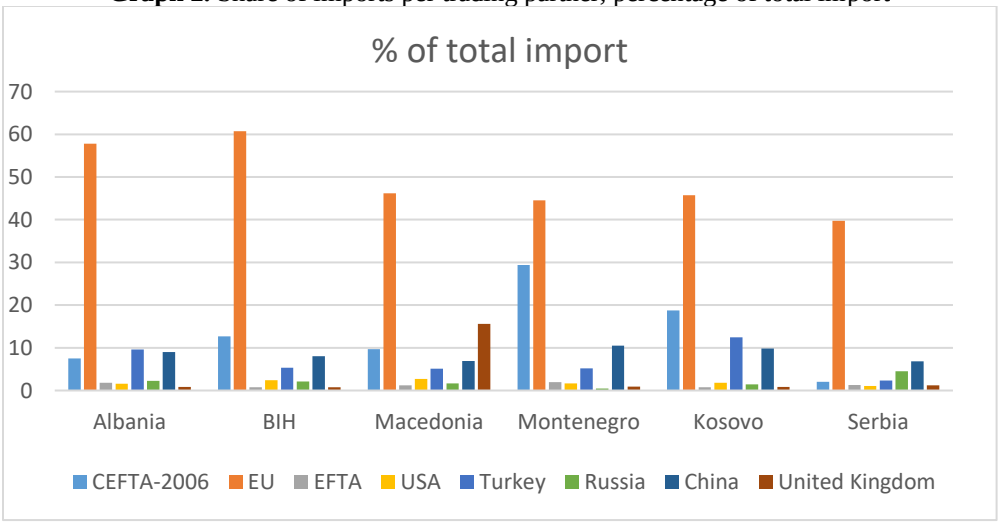
Graph.1 Share of export per trading partner, percentage of total export



Source: International Monetary Fund, Direction of Trade Statistics, https://data.imf.org.

The analysis of the trade flows of Western Balkan countries per trading partner is given in graphs 1 and 2. Data indicates that for Montenegro and Kosovo exporting to CEFTA-2006 members is more important than exporting to the EU market. However, for Albania, Bosnia, North Macedonia, and Serbia, the European Union's market is the most important for their exports. For the import, data indicate that for all Western Balkan countries import coming from the European Union has a dominant share. Import from CEFTA-2006 members is in the second place.

Graph 2. Share of imports per trading partner, percentage of total import



Source: International Monetary Fund, Direction of Trade Statistics, https://data.imf.org.

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Considering the negative impact that the financial and economic crisis from 2008 had upon the CEFTA-2006 integrative process, in 2014 an initiative under the so-called Berlin Process was pushed forward to support and enhance further economic integration of the region. However, the initiative ended up with negative results and the resurrection of protectionism. In 2017, the Berlin Process launched a new idea of converting CEFTA-2006 into a Regional Economic Area to be fully established in 6 years (by 2023). By 2019 it was evident that this new idea did not decrease trade protectionism, thus integrative processes within CEFTA-2006 were at a stand-still. In 2020 a new Action Plan envisaged for creation of a Common Regional Market based on EU rules in the period from 2021-2024. The reluctance of all member-states to proceed according to the new Action Plan reached its pick with the outburst of the COVID-19 crises and the new macroeconomic challenges that the region had to solve as a new priority. Many authorities tried to estimate and measure the impact that the creation of a Common Regional Market within CEFTA-2006 would have upon the economic welfare of each of the member-states, but it was and still is unclear how the region is supposed to become a common market without previously becoming a customs union. Thus all estimations provided vague, ambiguous, and unclear results and recommendations which did not help to overcome the already present reluctant attitude. The latest 2021 Open Balkan Initiative in which only Albania, North Macedonia, and Serbia participate, brought even more confusion and resentment to the other four CEFTA-2006 member-states.

In this paper, the importance of the regional component for enhancing trade integration is highlighted, which appears to be very important, in the period of the new COVID-19 crisis. For this purpose, the gravity model to North Macedonias' trade is applied, to indicate the importance of the regional component of free trade agreements for increasing mutual trade and enhancing trade integration. In the first section, a literature review on the importance of the process of regional integration is provided. In the second section, the model and the data used for the gravity model for North Macedonia's trade are explained. In the next, third section, the results from the analysis are presented and in the fourth section, a conclusion is provided.

1. Literature Review

Regional cooperation is considered to be one of the greatest accomplishments of the Western Balkans (Levitin et al., 2018). It is associated with numerous advantages for the region, encompassing improved regional stability, as well as promotion of the intra-regional trade of goods and services, economic competitiveness, and foreign investment inflows. As pointed out by many researchers, the regional integrations, in general, have a potentially important contribution to make to economic growth, development, and a rise

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in the living standard (Fetahu, 2014, Agbonkhese et al., 2014, Aliu-Zhuja et al., 2014). Since the beginning of the century, the strategy for strengthening the economic regional cooperation in the Western Balkans included two broad approaches: intraregional trade integration and trade integration in the much bigger EU market. What distinguishes Western Balkan countries' EU accession process from that of the latest EU member-states is that, in addition to their bilateral accession process with the EU, the Western Balkan countries have also had to achieve benchmarks in terms of their intraregional relations (Bertelsmann Stiftung, 2020). As a result, the regional cooperation initiatives for the Western Balkan countries over the past two decades include bilateral investment treaties (BITs), free trade agreements (FTAs), and the Central European Free Trade Agreement (CEFTA-2006) and EU Stabilization and Association Agreements (SAAs). This segment proceeds with a brief overview of the empirical literature on the impact of the existing trade liberalization measures on trade in goods in the Western Balkans and a discussion of the newest initiatives toward deeper regional integration.

The first stream of research implementing gravity models emphasizes the role of non-economic factors, as the most important determinants of trade in Western Balkan countries. The role of regional integration, commonly depicted in the following studies by dummy variables for the different bilateral and multilateral FTAs, appears to be marginal or even negative. One of the earlier relevant studies authored by Begović (2011), shows a significant but negative effect of trade liberalization on bilateral trade flows in CEFTA-2006 member-states, suggesting that integration in CEFTA-2006 did not improve trade in the region for the observed period (1999-2007). The author interprets the lack of positive trade effects from CEFTA-2006 as an indication that at the time, potential political and institutional benefits from CEFTA-2006 may have prevailed. Klimczak et al. (2015) show that the trade liberalization process (encompassing both bilateral FTAs and CEFTA-2006) had a positive but insignificant influence on bilateral trade in the Western Balkan countries, whereas non-economic factors, such as language, culture, and common history, were the most important determinants on the bilateral trade in the region. Pere et al. (2017) estimate separate gravity models for the exports and imports of the Western Balkan countries and show that exports are positively affected by the common language and common borders with third countries, as well as with the EU, and with large and highly industrialized countries. Regarding the dummy variable for the CEFTA-2006 agreement, calculations in the export model record a statistically significant and negative impact, except for Serbia.

The recent research employing longer datasets and more advanced methodology, on the other hand, provides clear and robust evidence of the favorable impact of bilateral and multilateral FTAs on trade in the Western

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Balkans. Petreski (2018) measures the effect of CEFTA-2006 membership by using a Conditional Mixed Process estimator whereby CEFTA-2006 is instrumented by a set of variables measuring democracy and governments' negotiation and is treated as endogenous creation. The results from the gravity model show that CEFTA-2006 increased intra-regional trade by 60% to 74%. According to the author, besides CEFTA-2006's importance in building members' competitiveness and generally increasing their cooperation capacities, it may have played an important role in mitigating the even stronger dependence of Western Balkan countries on trade exchange with the EU by rebuilding the regional market. Grieveson et al. (2020) apply a structural gravity model to test whether the export performance of the Western Balkan countries has been improved by trade liberalization in general, and by intra-regional trade liberalization in particular. Their results show that FTAs by the Western Balkan countries had a weaker relationship with their export performance than FTAs in general. However, the influence of CEFTA-2006 membership on promoting intra-regional trade was more favorable than the rest of the FTAs implemented by the Western Balkan and other countries, with an estimated rise in exports of 37.7%. In addition, the authors point to heterogeneity in the relationships between different FTAs and trade for different countries in Western Balkan, showing only a marginal impact of CEFTA-2006 on trade exchange between Serbia and the rest of the region. Also, their results show that both EU membership and the SAA are related to trade in a statistically significant way, finding that for the Western Balkan countries the magnitude of an increase in exports to the EU from a country with a SAA is more limited, i.e. down to 24.6%.

Lastly, the next step toward the strengthening of the regional economic integration is the initiative for the creation of a Common Regional Market (CRM) for the Western Balkan Six (WB6). The intention is to extract the benefits of increased market size and improved product and service quality, making the region more attractive to foreign investors. The aim is to remove barriers to enable the free flow of goods, services, capital, and 'highly skilled' labor, achieve digital integration, and introduce standardized rules for businesses. The qualitative analysis by Srbinoski et al. (2022) shows that the CRM plan is complementary to the EU integration objectives of North Macedonia and has the potential to accelerate the process of its accession to the EU. Nevertheless, there are several potential economic constraints on the CRM project. In particular, the authors argue that it is uncertain that the CRM would increase the intraregional trade, given the structural characteristics and limited size of the region and the rising importance of trade with the EU. Moreover, the manufacturing in the WB6 is less specialized and less localized, further constraining the potential for trade.

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Table 1: Main finding of the studies investigating regional integration in the CEE and SEE

Study	Geographical coverage	Main findings
Levitin et al. (2018)	Western Balkan countries	The EU remains the main external anchor for the region's stability whereas strengthening regional cooperation is an explicit requirement for the Western Balkans aspirant countries in their EU membership bids.
Fetahu (2014)	Albania and the EU member-states	The economic patterns installed in Albania are strongly influenced by foreign request coming from abroad, especially from the EU community.
Aliu-Zhuja et al. (2014)	Kosovo	Membership in the EU is more than necessary and integration agreements are more than reasonable and offer the possibility of approximation of the intent of Kosovo.
Bertelsmann Stiftung (2020)	Western Balkan countries	In addition to their bilateral accession process with the EU, the Western Balkan countries have to achieve intraregional integration.
Begović (2011)	CEFTA-2006 member-countries	Trade liberalization has a significant but negative effect on bilateral trade flows in CEFTA-2006 member-states.
Klimczak et al. (2015)	Western Balkan countries	Non-economic factors, such as language, culture and common history, are the most important determinants of the bilateral trade in the Western Balkans.
Pere et al. (2017)	Western Balkan countries	Exports are positively affected by the common language and common borders with third countries, as well as with the EU, and with large and industrialized countries, whereas the CEFTA-2006 agreement dummy has a negative impact on exports.
Petreski (2018)	CEFTA-2006 member-countries	CEFTA-2006 increased intra-regional trade by 60% to 74%.
Grieveson et al. (2020)	Western Balkan countries	CEFTA-2006 membership promotes intra-regional trade in the Western Balkan and other countries, with an estimated rise in exports of 37.7%.
Srbinoski et al. (2022)	Western Balkan countries	Common Regional Market for the Western Balkan countries can potentially accelerate the process of the EU accession.

Source: compilation done by the authors

2. Explanation of the econometric model and data

For this paper, a gravity panel model for North Macedonia's trade covering sixteen years period from 2005 to 2020 (including 2005 and 2020) is constructed, where the influence of bilateral and regional trade agreements on the country's trade is analyzed. The trade flows of North Macedonia with 40

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trading partners are measured. Gravity models in international trade have long been used as a workhorse for analyzing bilateral trade flows. This model is widely used to examine country-specific trade characteristics (Anderson et al., 2003). The gravity model is OLS without effects. Although there are different modifications of the classical gravity model (Helpman et al., 2008; Almog, et al., 2019) for this paper the basic model is used by constructing the following equation:

$$LnTRADEijt = \alpha_1 lnGDPcapitaijt + \alpha_2 lnREMOTNESSijt + \alpha_3 lnPOPijt + \alpha_4 EUjt + \alpha_5 CEFTAjt + \alpha_6 FTAjt + \beta_1 PROjt + \beta_2 LANGUAGEjt\ \gamma_j + \lambda t + u_{it} \quad (1)$$

The influence of certain independent variables on North Macedonia's trade is investigated. The dependent variable trade (TRADE*ijt*) is constructed as a sum of North Macedonia's export and import to its trading partners in absolute values. Three regressions are constructed for testing the influence of trade agreements on North Macedonia's trade. For all three regressions, commonly used variables in gravity models are tested: GDP per capita, remoteness, and population. Additionally, from these standard independent variables, three dummy variables are applied: the membership of the trading partner in CEFTA-2006, being a member of the European Union; or having signed a free trade agreement with North Macedonia and being one of the EFTA countries, Turkey or Ukraine, for example.

In the second regression, the variable productivity measuring country's labor productivity is added, and in the third regression, the variable common language is added.

The variable GDP per capita is the most common indicator for measuring the level of economic development. In this model, the variable is calculated as the difference between the maximum and the minimum value of GDP per capita of North Macedonia and the trading partner at constant prices (*GDPcapitaijt)*. The expectation is that the coefficient should be statistically significant and positive, thus meaning that an increase in the gap in the GDP per capita between North Macedonia and its trading partners should increase the intensity of mutual trade.

The variable remoteness is also a standard variable applied in gravity models measuring the weighted geographical distance (*REMOTNESSijt)*. Because the geographical distance is constant through time a dynamic component is added - geographical distance weighted by the GDP of the economies. The idea of using remoteness is to make an approximation for each country's set of alternatives considering the distance and economic size of the other countries. The formula for remoteness is based on Head (2000):

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$$Rem_{it} = \frac{1}{\frac{DIS_{i,j_1}}{GDP_{jt_1}} + \frac{DIS_{i,j_2}}{GDP_{j_{t2}}} + \cdots + \frac{DIS_{i,j_r}}{GDP_{jt_r}}}$$

The coefficient measuring remoteness should be significant and negative since the expectation is that when the distance between two countries is higher it should likely have a negative impact on their bilateral trade.

The variable population (*POPijt)* represents the sum of the population in North Macedonia and the trading partner. The expectation is that a bigger population means biga ger market and therefore bigger potential for trade. So, it is expected that the sign of this variable should be positive.

For the purposes of the research and investigating the influence of regional and bilateral trade agreements on trade, three dummy variables are added. The first dummy variable is the EU and measures whether North Macedonia's trading partner is a European Union member with whom the bilateral trade is under preferential treatment. The second dummy variable is CEFTA-2006 which measures the trade flows with the other partners which are part of the regional integration CEFTA-2006. The third dummy variable, FTA, measures the trade of North Macedonia with the partners with whom North Macedonia has bilateral free trade agreements, like Turkey, EFTA countries, and Ukraine. The impact of these signed preferential trade agreements, no matter whether bilateral or regional, should be positive and statistically significant over trade.

In the second regression, the variable productivity *(PROjt)* is added to measure the influence of the differences between labor productivity in North Macedonia and its trading partners. If the sign of the coefficient for labor productivity is negative it means that an increase in the difference between labor productivity between North Macedonia and its trading partners will lead to decreasing bilateral trade. If the sign of the coefficient is positive it means that increasing the difference in labor productivity will lead to increased trade among North Macedonia and its trading partners.

In the third regression, a dummy variable for language *(LANGjt)* is added for testing the influence of sharing a common language between the trading partners on trade.

The general fit of the model is high, explaining around 60% of the variation in trade. Since the results are stable in all three equations, the results are considered to be robust. The data for the trade flows from and to North Macedonia are derived from the National Bank of the Republic of North Macedonia and the other data are from the World Bank data development indicators. The explanation of the data is given in Table 2 in the Appendix.

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3. Explanation of the results

In Table 1 the results from the gravity model are provided. It can be seen that all analyzed variables are statistically significant in all three regressions and bear the same sign. This gives the impression that the results are stable and robust. R2 and adjusted R2 are around 60% which points out that the independent variables explain on a satisfactory level the dependent variable trade.

Table 2. Results from the gravity data model

No of observations	599	587	587
Dependent variable	Ln (TRADE) in all three specifications		
LOG (CAPITADIF)	0.314276*** (0.06771)	0.535938*** (0.079209)	0.477921*** (0.074294)
LOG (REMOT2020)	-0.328188*** (0.070433)	-0.31902*** (0.077643)	-0.27848*** (0.072692)
LOG (POP)	1.483945*** (0.104069)	1.46883*** (0.109757)	1.525757*** (0.102756)
EU	2.757062*** (0.177778)	2.731643*** (0.18309)	2.660339*** (0.171272)
CEFTA-2006	4.202928*** (0.281989)	3.995254*** (0.274988)	3.300122*** (0.268165)
FTA	2.095796*** (0.246074)	2.374491*** (0.247807)	2.457498*** (0.231747)
LOG (PRO)		-0.43976*** (0.083117)	-0.21927*** (0.08139)
LANG			1.799177*** (0.198492)
R-squared	0.567987	0.591039	0.643526
Adjusted R-squared	0.563455	0.585918	0.638416

Note: Numbers given in parenthesis are corresponding standard deviations. *** : p< 0.01; **:p< 0.05; * : p < 0.1

Source: Authors` calculations

The results for the variable GDP per capita difference are positive and statistically significant. These results confirm the reality that with the increment of the gap in GDP per capita between North Macedonia and its trading partners the possibility for trade increases. This is completely true as Macedonia's greatest trading partners are countries with significantly higher GDP per capita and is in line with the results that Kikerkova and al. (2021) have found in the analysis of the bilateral trade flows of North Macedonia.

The results for the variable Remoteness are statistically significant with a negative sign which is also in line with the expectations. The main feature of gravity models is that the increase of the distance between the trading partners has a negative influence on their mutual trade. With the increase in the distance between the trading partners, their trade should also decrease.

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The influence of the variable Population is statistically significant and positive. The coefficients of the regressions are also stable and with a similar value in all three regressions.

The main findings of our paper are included in the results from the influence of the dummy variables: European Union member, CEFTA-2006 member or EFTA member-country, Turkey and Ukraine on North Macedonia's trade. All results are statistically significant, with positive signs and stable coefficients. What is more prominent and worth mentioning is the highest coefficient obtained from the trade with CEFTA-2006 partners. These coefficients in the three regressions are higher than the results from the influence of the trade with European Union members and with the free trade agreements signed with EFTA countries, Turkey and Ukraine. This shows that a 1% increase in the trade with the CEFTA-2006 partner could lead to an increase in North Macedonia's trade of 4.2% (3.99% or 3.3% respectively). Although these results might look opposite to the reality that North Macedonia and most of the Western Balkan countries trade more with the European Union than among themselves, they indicate that there is still potential in the increasing trade by deepening trade integration processes through different regional initiatives. In this line what this research proposes is a deepening of trade facilitation measures and increased application of mutual digital tools to facilitate trade. Similar results were also obtained by Petreski (2013) when the author estimated that CEFTA-2006 should have a larger effect on trade than the Stabilization and association agreements signed between these countries and the EU.

In the second and the third regression the variable labor productivity is added, which results are significant with a negative sign. These results show that the increase in the difference in labor productivity between North Macedonia and its trading partners should have a negative influence on North Macedonia's trade. The results are in line with the economic structure of the country (Kikerkova et al., 2021).

In the last regression, the dummy variable Language is added, more as a control variable, which indicates that sharing a common language among the trading partners should have a positive influence on trade.

Conclusion

The existence of many regional initiatives and the negative influence of the COVID-19 pandemic on trade inspired this paper that aims to elaborate on the possibilities that derive from the latest regional integration initiatives which might further support trade liberalization and boost CEFTA-2006 trade exchange. For this purpose, this research is focused on data on the trade exchange of goods of North Macedonia for 15 years from 2005-2020, and the influence of bilateral and regional trade agreements on the country's trade is

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estimated by a gravity model. According to the results of the model, in the case of North Macedonia, CEFTA-2006 membership has a higher significance of increasing trade when compared to the preferential agreement with the EU members, as well as to bilateral free trade agreements signed with EFTA countries, Turkey and Ukraine. Although this model does not provide any insight or information on other member-states within CEFTA-2006, having in mind some of the authors' previous research on the trade exchange of goods within the free trade area, the authors strongly believe that similar even identical results could be obtained in their cases (with exception of Moldova which traditionally has negligible economic and trade links with the region). The greatest limitation of the research so far is that the analysis has been done on the trade of North Macedonia and in the future, there should be a focus and elaboration on the situation of the other Western Balkan countries.

As for the possible solutions for further trade liberalization and deeper economic integration authors recommend deepening regional cooperation which could be possible by implementing trade facilitation measures, such as: expanding the concept of green corridors and green lanes in all border crossing points; increasing the number of joint customs control points, expanding the Mutual Recognition Programmes in different areas (which to some extent has been already happening); enabling a fast implementation of the Mutual Recognition Agreements of Authorized Economic Operator programs; enabling the implementation of compatible digital platforms for smooth cross-border paperless trade exchange throughout the region, etc. Yet, it should be emphasized that all the efforts are going to be condemned to fail if there is not a strong political will that will back them up at the regional level.

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Appendix

Table 3

Variable	Explanation	Source	Expected sign
Trade	export + import from Macedonia to the trading partner in absolute values	World Bank national accounts data and National Bank of the Republic of North Macedonia	
GDPcapita	max-min value of GDP per capita constant prices 2020 US dollars of Macedonia and the trading partner	World Bank national accounts data	+
Remoteness	distance in km * GDP constant2010 US dollars trade partner/world GDP constant 2010 US dollars	Google maps and World Bank national accounts data	_-
Population	The sum of the population of Macedonia and the trade partner	United Nations Population Division. World Population Prospects: 2019 Revision.	+/-
Labor productivity	Max-min value of GDP per person employed (constant 2017 PPP $)	World Bank national accounts data, and OECD National Accounts data files.	+
EU	Membership in EU	Dummy variable	+
CEFTA-2006	Membership in CEFTA-2006	Dummy variable	+
FTA	Free Trade Agreement with Turkey, Ukraine, and EFTA	Dummy variable	+
Language	Countries that have a common language	Dummy variable	+