Gligorov, Vladimir

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Southeast Europe: Regional Cooperation with Multiple Equilibria

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The wiiw Balkan Observatory

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Vladimir Gligorov

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The wiiw Balkan Observatory

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About

Shortly after the end of the Kosovo war, the last of the Yugoslav dissolution wars, the Balkan Reconstruction Observatory was set up jointly by the Hellenic Observatory, the Centre for the Study of Global Governance, both institutes at the London School of Economics (LSE), and the Vienna Institute for International Economic Studies (wiiw). A brainstorming meeting on Reconstruction and Regional Co-operation in the Balkans was held in Vouliagmeni on 8-10 July 1999, covering the issues of security, democratisation, economic reconstruction and the role of civil society. It was attended by academics and policy makers from all the countries in the region, from a number of EU countries, from the European Commission, the USA and Russia. Based on ideas and discussions generated at this meeting, a policy paper on Balkan Reconstruction and European Integration was the product of a collaborative effort by the two LSE institutes and the wiiw. The paper was presented at a follow-up meeting on Reconstruction and Integration in Southeast Europe in Vienna on 12-13 November 1999, which focused on the economic aspects of the process of reconstruction in the Balkans. It is this policy paper that became the very first Working Paper of the wiiw Balkan Observatory Working Papers series. The Working Papers are published online at www.balkan-observatory.net, the internet portal of the wiiw Balkan Observatory. It is a portal for research and communication in relation to economic developments in Southeast Europe maintained by the wiiw since 1999. Since 2000 it also serves as a forum for the Global Development Network Southeast Europe (GDN-SEE) project, which is based on an initiative by The World Bank with financial support from the Austrian Ministry of Finance and the Oesterreichische Nationalbank. The purpose of the GDN-SEE project is the creation of research networks throughout Southeast Europe in order to enhance the economic research capacity in Southeast Europe, to build new research capacities by mobilising young researchers, to promote knowledge transfer into the region, to facilitate networking between researchers within the region, and to assist in securing knowledge transfer from researchers to policy makers. The wiiw Balkan Observatory Working Papers series is one way to achieve these objectives.

The wiiw Balkan Observatory

IBEU

This study has been developed in the framework of the IBEU project - Integrating the Balkans in the European Union: Functional Borders and Sustainable Security.

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Southeast Europe: Regional Cooperation with Multiple Equilibria

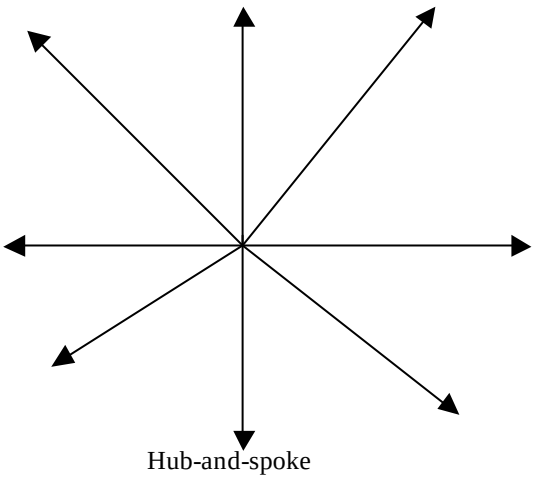
Abstract

It is argued in this paper that the lack of regional cooperation can be remedied by the speed up of the process of EU integration. That is reinforced by the considerations based on the theory of optimal currency areas. Though the current Stabilisation and Association process (SAP) may produce the same results though that process is riskier and requires more time.

1. Introduction

It is assumed in this paper that, in general, when it comes to trade, investments and pretty much everything else, Southeast Europe maintains a hub-and-spoke relationship with the European Union. 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 then the relations of the region as a whole with the EU (Gligorov, 1997). This could be simply represented in the following way:

Figure 1

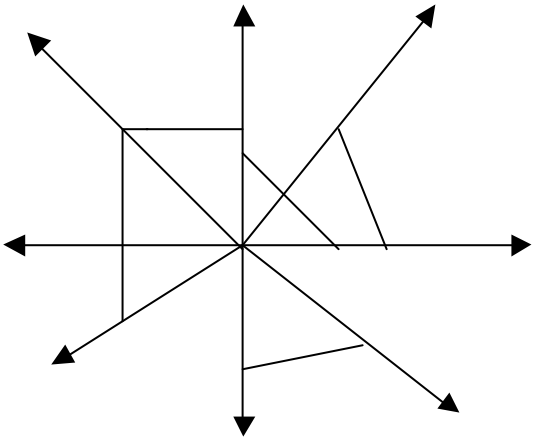


Hub-and-spoke

Another possibility of representation is that of a broken cobweb, where there are also complex and significant relations between some countries in the region. For instance, in the case of Southeast Europe, there are a number of sub-regions, the most

important one being that of the Western Balkans. But the region as a whole is internally disintegrated and partially integrated in a number of different ways.

Figure 2



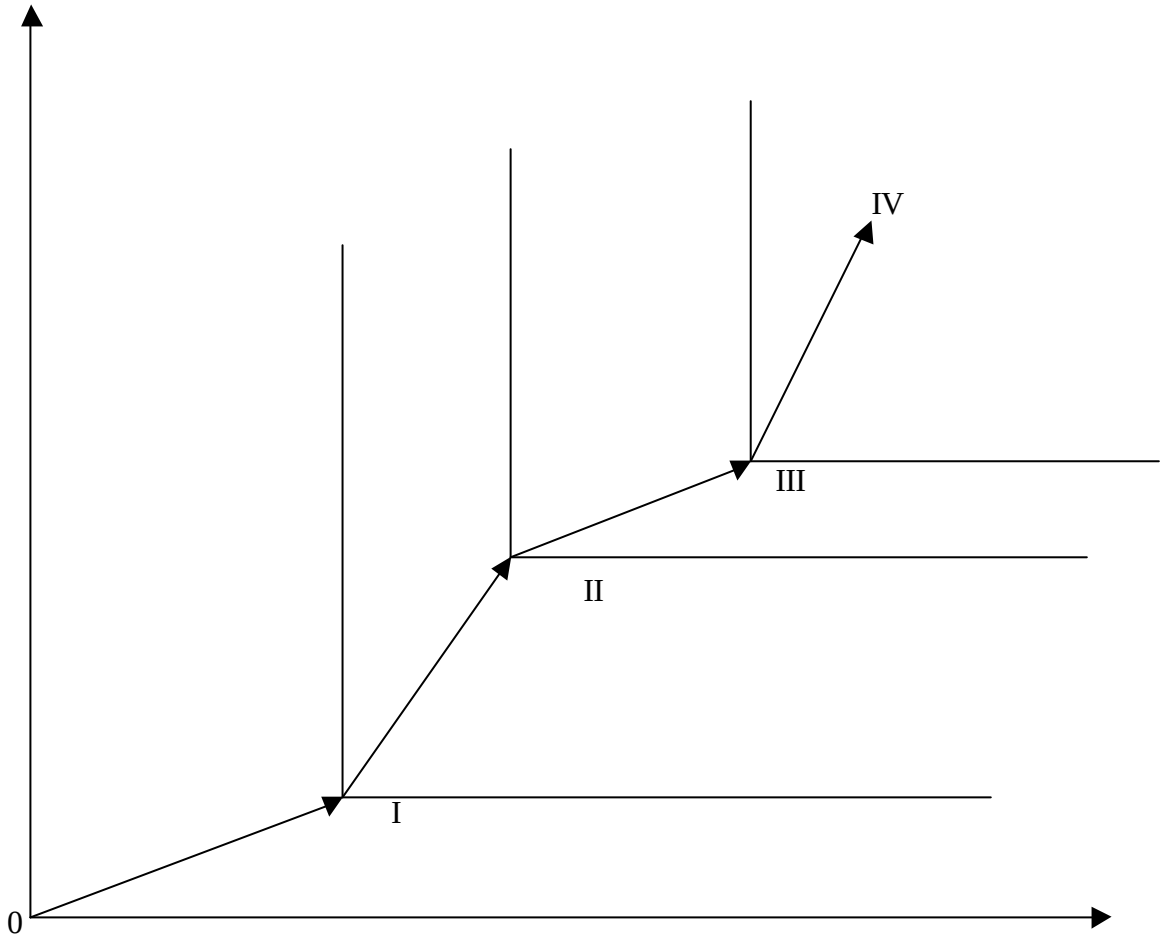
Broken cobweb

This representation suggests that the centre has the same type of relationship with all the countries, which is in fact not so in the case of the SEE.[1] The process of integration with the EU is pre-dominantly bilateral, though it also has a regional dimension, so that quite a complicated web of relations emerges. This is important in this context because different types of trade regimes and policies apply to different countries depending on how advanced they are in the process of EU accession.

Still, the hub-and-spoke model (modified at times to include some broken and preserved regional ties, i.e., the broken cobweb model), represents the key relationship better than others. This model of international relationship may emerge because regional cooperation is weak and fragile, while that with the EU is the more desirable one. In that case, regional co-operation will either fail to emerge or would tend to produce sub-optimal equilibria. One possibility that could be considered is illustrated in the figure 3.[2]

[1] More on that in Gligorov (2004).
[2] The figure can be interpreted as a multi-party centipede game.

Figure 3



Regional cooperation with multiple -equilibria

Let us assume that, with a given process of cooperation with the EU, no-regional cooperation (regional autarchy) is the worst alternative. In figure 3 that is the point O at the origin. Better than that is some sub-regional co-operation (bilateral or multilateral), point I. Even better than that is some restricted regional co-operation (functional regional integration), point II. Full regional cooperation is, let us assume, an even better solution (regional integration), point III. Finally, full EU integration could be the best solution, point IV. In other words, more cooperation is collectively better than less cooperation (levels of integration are Pareto-ranked). It is, still, possible to imagine that each one of these outcomes, though not Pareto-optimal, is an equilibrium. This is because of the distributional effects that each of these moves may involve. It may seem, for instance, that the direct move from point 0 to point IV is preferable for all because the intermediate steps may involve distributional effects that may be unacceptable to some.

To move from one equilibrium to another, certain institutional or political preconditions have to be met. For instance, to move from autarchy, one or the other country could take the lead to propose a bilateral agreement that could lead to a Pareto-improving contract. In the case of a sub-regional agreement, a two-step procedure could be followed. Two countries would agree to co-operate and than peer-pressure may induce the co-operation of the other countries in this sub-region. Similar mechanism may induce a restricted regional co-operation, that is a co-operation in one or the other area of policy. Finally, full regional co-operation may be impossible to reach through regional leadership, a series of bilateral agreements and peer pressure. It may require an outside actor to move the region towards the Pareto-optimal level of co-operation.[3] That will almost certainly be the case if the process of regional cooperation is only a step or a part of a process of wider integration, which is in this case that of the integration with the European Union. Given the importance of the European Union for each country in the region, it will have to be this outside actor.

This actor can rely on competition, co-ordination, leadership and integration. This is especially appropriate for the situation modelled as the hub-and-spoke structure. In that case, improving relations with one of the countries in the region may increase the interest of the other countries in the region to join. This strategy is sensitive to distributional effects that these piece-meal interventions in a region may have. It may lead to the process of a positive peer-pressure, but it may lead to a slowdown of the process in the rest of the region.

Co-ordination has been tried several times in the Balkans (e.g., with SECI, Stability Pact and quite a number of other international or regional initiatives) and has not produced results beyond some restricted regional or sub-regional co-operation. This is because co-ordination may work where there is an institutional failure, but not where there is a conflicting distribution of interests for co-operation.

Leadership is the next possible strategy that could be tried, where the EU would lead with specific incentives that should sweeten the process of regional co-operation. This has also been tried, the best example being the extension of preferential treatment to the countries in the Western Balkans. This has initiated a

[3] The choice or appointment of the outside agent is a separate issue. In the case of the Balkans, EU is practically the only candidate because of the economic and political role that it plays in the region. On some theoretical considerations important for the role of the policy leader or agenda-setter and for the dilemma between the bilateral and multilateral integrations see Aghion, Antras and Helpman (2004) and a short summary in the appendix.

series of bilateral free trade agreements, but not yet the creation of a regional free trade area.

Integration would be, in that sense, the preferred instrument to achieve full regional cooperation. For instance, a customs union with the SEE would be a possibility. Also, inclusion of SEE in EU programmes could be useful. In the end, the initiation of the pre-accession process would be the best way to push for full blown regional cooperation.

Similar, though perhaps inferior solutions, could be introduced in various sectors and in different policy areas. What precise form that would take may depend on the sector or on the issue. But the general point is that as long as regional relations are such as represented by the hub-and-spoke model, increased regional cooperation can be achieved only with the increased outside intervention.

2. Multi-speed hub-and-spoke

As the relationship of the EU with the SEE is basically bilateral, the hub-and-spoke model produces a multi-speed process of integration. In SEE, there are countries that are in the pre-accession process (negotiation for membership) and those that are taking part in the Stabilisation and Association Process (SAP), which is in the end based on an association agreement (called Stabilisation and Association Agreement, or SAA). Within the second group, the SAP proceeds with different speeds for different countries. The word countries should be used cautiously, as some of the political entities in SEE are not states in the usual sense of that word. In any case, different political units are at a different stage in the process of EU integration.[4]

The efficiency of this process is difficult to assess *a priori*. It is presumed on a specific structure of public preferences. SEE countries should prefer EU integration to SEE disintegration or, in other words, they should see the solution to their domestic and regional problems within the process of EU integration. This is the underlying assumption in most cases where there are still latent possibilities of further disintegration, e.g., in the case of Serbia and Montenegro, Bosnia and Herzegovina and Macedonia.

[4] Details can be found in the later part of this paper.

Somewhat more schematically, it could be argued that SAP has been based on a number of assumptions, which can perhaps be presented schematically and sequentially in the following way:

Assumption 1: Balkans produces problems, EU produces solutions (in other words, the Balkans left to itself tends to disintegrate into intractable conflicts, usually referred to as Balkanisation).

Assumption 2 : Solutions are preferred to problems. (This is not a trivial assumption in view of the previous assumption about the internal inclination to slide into Balkanisation).

Assumption 3: EU integration is the preferred goal for all the countries or political entities in SEE. (This may in fact not be true without qualification of the conditions under which integration is to take place.)

Assumption 4: EU integration is a solution to SEE problems. (This is the crucial assumption that relies on the belief that the problems of the Balkans are basically European problems and can be solved in the same way in which the security and other problems have been solved by Europeisation).

If this assumptions are granted, then it follows that EU integration could be a solution to SEE disintegration. Still, the process me y not be self-sustainable, i.e., it could brake down at any point because, as argued above, multiple equilibria may exist. Thus, a continuity assumption is needed:

Assumption 5: Process of EU integration is preferred, at every level, to SEE disintegration. (Clearly, this has not been the case so far in most Western Balkan countries and to an extent in Southeast Europe as a whole.)

Then, the process of EU integration is self-sustainable however slow it may happen to be and however it is implemented. In that sense, SAP offers enough incentives for each and every country in SEE to put EU integration above regional disintegration. Assuming that the problems are generated within the domestic political process, then SAP should provide enough incentives for the transformation of domestic political agenda in the SEE in the direction of the EU integration climbing up to the top of every domestic political agenda.

In order for the multi-speed process to work, this is still not enough. It is necessary to add either an assumption that these bilateral processes are independent of each other or that they are reinforcing.[5]

Assumption 6: Bilateral SAAs either do not interfere with each other (they are independent) or they complement each other (they produce positive peer pressure).

As is well-known, this may not be the case if there are externalities that separate bilateral agreements create. In that case, regional cooperation may be advisable. The SAP is aware of that, but it assumes that:

Assumption 7: Prospect of EU integration is enough to generate incentives for regional cooperation.

This, however, is a rather strong assumption and does not seem warranted just on the bases of the previous assumptions. An additional assumption is necessary:

Assumption 8: Regional cooperation is in the interest of each and every country in the region (even without the SAP).

This, as argued before, may not be enough for regional cooperation to emerge. And if the prospect of EU integration, structured as a process of bilateral convergence, is not enough to generate regional cooperation, more active role by the EU is necessary. Otherwise, with all the assumptions here made being true, they will still be too weak to produce regional cooperation.

2.1. EU as an anchor and an agent

As argued above, the process of integration could be represented as that of multiple-equilibria which can be Pareto-ranked. Assuming that there are more than two countries, e.g., there is more than one country on the coordinates of the figure 3, their ever increasing integration is beneficial to them all, but at each point, each country could do even better with a different type of integration or even with disintegration. Thus, to move the process from one knot to another, a push of some sort is necessary. This push or support can come in different forms, some of which were mentioned above. Let us assume that the push is coming from the EU. Than, the EU can play a number of various roles that are already known from the experience of former accessions as well as from the history of involvement in Southeast Europe and

[5] In Aghion, P. Antras. E. Helpman (2004) it is argued that the leader, in this case the EU, is indifferent between the bilateral and multilateral trade agreements if there are no externalities and the ensuing free trade area is super-additive, i.e., an improvement for everybody. This will be the case if the various bilateral free trade agreements are independent of each other or all externalities are positive.

in the Wider Europe also. Here, only some of the possible roles will be discussed; in particular those that have historically been relevant in this region and in the case of the EU Eastern enlargement and could still prove instructive

EU as a destination. In the case of former Yugoslavia, EU took the role of a desirable goal or a destination. At that tome, in late eighties, the process of integration of reforming socialist countries did not exist. Thus, the prospect of eventually joining the EU without additional incentives proved not to be enough for a country or a region to put this goal ahead of its internal problems.

EU as an intervener. In the Balkans, EU has also played a role of an intervener or mediator. Indeed, in some cases, its loose contractual relations with the countries and political entities in the region have been more than compensated with the direct involvement in the governing of these entities. This is certainly the case in Bosnia and Herzegovina and in Kosovo, but also in Macedonia and even in Serbia and Montenegro, where EU is deeply involved in the constitutional process.

This does not produce very good results, because EU's strength is in integration, not in liberal imperialism. This also does not necessarily lead to greater regional integration, as it often means post-crisis management and is not based on the strategy of integration. Still, the involvement of the EU makes it easier if not imperative to move from intervention to integration as a pullout is in most case not a good option.

EU as coordinator. Immediately after the Dayton Agreement (end 1995), EU started developing a regional policy for the Balkans. The basic idea was to presume the prospect of integration with the EU on regional cooperation. It was argued that regional integration has its advantages anyway, but those can be seen even more clearly if they are put in the context of EU integration.

It makes sense to analyse this role of the EU in some more detail. A coordinator can be useful in engineering collective action if there is an interest in cooperation, but there is no institution to support it. Then, a coordinator supplies the forum in which individual interest in collective cooperation can be articulated. If everybody knows that they have an interest in cooperating, the coordinator can help for that knowledge to become common.

In this case, EU thought that the emergence of the common knowledge that there was an interest in regional cooperation would be made clear if it was connected with the process of integration with the EU. This seems as a particularly appropriate method if an externality is to be internalised. For instance, it suggests itself as a good method to deal with security issues, which are such that they, by definition, involve an externality.

In the case of the Balkans, the initial regional approach to Western Balkans did not prove to be very influential. Clearly, coordination was not enough. Basically because it did not appear to all in the region that regional cooperation was in their individual interest. This approach was even strengthened with the setting up of the Stability Pact after the war in Kosovo.[6]

EU as an anchor. In the enlargement process that is approaching its completion in 2004, EU played the role of an anchor. This is appropriate for a hub-and-spoke model of relationship, assuming that there is not so much to be gained from regional cooperation and there is a contractual commitment on both sides to work for integration. These conditions were met in Central Europe and the process produced the desired result, possibly even in shorter period of time than initially anticipated.

However, in the case of the two SEE countries, Bulgaria and Romania, the process did not produce the same result in the same period of time. Eventually, it will prove to lead to the integration of these two countries in transition, but it will last longer. This is partly due to the fact that the regional aspect was more important in their case. It is at least conceivable that a different development in the Balkans would have speeded up the process of transformation and integration of these countries too.

EU as a regional anchor. Given the level of EU involvement, the expected integration of a number of countries in the region and the weak power of the other types of relationships, the best approach is that of increased commitment to integrate. That would achieve three things:

- introduce level plain field in a region where jalousie plays a huge role,
- introduce positive peer-pressure, and
- transform domestic political agenda.

[6] On the Stability Pact more in Gligorov (2004).

This approach could also increase the interest for regional cooperation, as it would be geared towards EU integration and coordinated by the need to converge to the EU institutions and policies. It can be hoped, then, that the process of regional cooperation, which is emerging anyway, will be speeded up and will increasingly rest on regionally generated political preferences rather than on the *ad hoc* institutions and outside facilitators. The only important outside actor, at least when it comes to the process of economic integration and cooperation, would be the EU.

3. Optimal Integration Areas in Transition

3.1. Trade and policy integration

One way to look at regional integration and cooperation is through the generalisation of the theory of optimal customs and currency areas. In the case of the SEE and the Balkans, trade integration was seen as the primary instrument of regional cooperation. However, trade integration leads to the issue of policy integration, as the theory of optimal currency areas implies. Thus, here, first some comments on this theory will be made and then a number of possible areas of policy cooperation in the SEE will be looked at.

3.2. Diversity of exchange rate arrangements

Why are there so many different exchange rate regimes in transition economies and also in the Balkans? Here is one illustrative classification of currently existing exchange rate regimes in Central and Southeast European countries:[7]

Table 1.

Euro: Kosovo, Montenegro
Currency board: Bulgaria, Bosnia and Herzegovina, the Baltics
Fixed pegs: Croatia, Macedonia, Serbia and Montenegro
Crawling pegs: Romania
Managed float: Slovenia, Slovakia, Albania
Float: Poland, the Czech Republic

[7] There is some confusion about the exchange rate regimes in Southeast Europe as in many other cases because there is often significant difference between the officially announced exchange rate regime and the actual policy followed by the monetary authorities. In table 1 it is the actual policies followed rather than the regimes announced that are being considered.

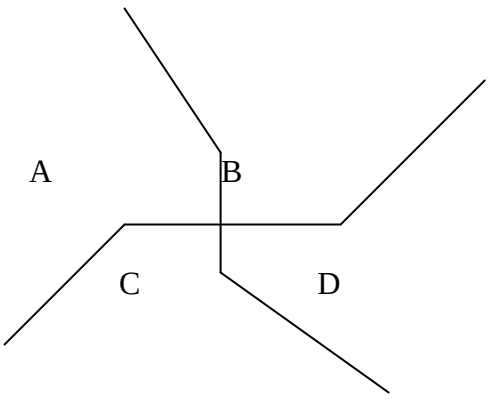
And why is there such a difference in the level of euroisation, i.e., currency substitution? In one study,[8] currency and asset substitutions vary from quite low levels in Hungary (6 per cent of total currency) to a very high level in Croatia (46 per cent). In general, currency substitution is much higher in the Balkans than in Central Europe.

Finally, why are many of these countries interested in the quick adoption of euro? Part of an answer to these questions can be found in the theory of optimal currency areas (OCA), though the empirics of this answer may not be straightforward. Here, a simple exposition of the concept of OCA will be followed by some tentative answers to the above question in view of the situation one finds in transition countries and in the Balkans.

3.3. States and Regions

The breakthrough idea of the OCA is that states are not necessarily optimal currency units. Regions or the world may be.[9] Central banks, however, are, as a rule, associated with states, indeed are, as a rule, state owned or regulated institutions with a monopoly of money-issuing powers. Thus, as a rule, monetary jurisdictions do not coincide with the optimal currency areas. The question then arises what are the exchange rate regimes that monetary authorities should introduce and whether the theory of OCA can still shed some light on these choices? A simple picture, figure 4, can be helpful in answering this question.

Figure 4



Two countries and two regions

8 Feige (2003).

9 A region or a state is an OCA if it can ensure (i) full employment, (ii) balanced current account, and (iii) price stability.

Let us assume, as in the original Mundell's treatment of the problem,[10] that there are two countries with two currencies, but there are also two regions that are optimal currency areas that cut through these two countries. Areas A and B in the above picture are together a country S1, while C and D are the country S2. Region R1, however, consists of A and C and the region R2 of B and D. The regions differ in terms of comparative advantage, i.e., they specialize in the production of different goods because of the difference in factor endowments. It may be noted and will become important later that regions are more homogenous and more specialized than the states, which have a more diversified structure of production. As stipulated, S1 and S2 have their separate currencies, but it is the regions R1 and R2 that are optimal currency areas. What currency and exchange rate arrangements are possible?

Apart from the assumed situation of two states with two currencies, there is the option of two regions with two currencies, that of four states with four currencies and that of two states, two regions and one currency. There are other possibilities, but those will be put aside for the most part here. It is interesting to note that two of these options unambiguously conform to the idea of optimal currency areas: that of two regions with two currencies and that of four states with four currencies. The latter case is easy to see, but it also provides for a slightly paradoxical characteristic of the OCAs. If the two regions, which are OCAs by definition and are homogenous, are split, the four regions that emerge are also OCAs because they are all homogenous. However, if the four OCAs are put together, they do not combine into an OCA. This is obvious because that is like integrating the two states, but they are not, here by definition, an OCA. This proves the following proposition:

Proposition 1: OCAs do not necessarily aggregate into OCAs.

The interesting question is whether they in fact disintegrate into OCAs? In the example above, it is assumed that this is the case. But it could be the case, in principle, that two states that are not OCAs by themselves could create an OCA if they got together. In particular, as argued by Mundell, the world could be an optimal currency area, while each state in the world may not be. This prompts the following proposition:

Proposition 2: Non-OCAs may aggregate into an OCA.

10 In Mundell (1961).

In the above picture, that would mean that, in principle, the two states, S1 and S2, though not optimal currency areas by themselves, could be, had we not assumed otherwise, an optimal currency area if they got together and formed a common state or a common monetary area. In that case, the alternative of one currency area for however many states and regions that could be conjured up from the above picture would also be an optimal one.[11]

This conceptual analysis is useful because it leads to some conclusions about the possible exchange rate regimes that the various territorial arrangements could adopt. In the case of the two or more OCAs, flexible exchange rates are the preferred exchange rate regime. That is because it could ensure the existence and persistence of both the external (balance of payments) and the internal (full employment) equilibrium together with price stability, which is in fact what is meant by a currency area being optimal. In the case of the S1 and S2, it is not clear what exchange rate regime should apply. Assuming that there is only the choice between two exchange rate regimes, fixed and flexible or floating, only the one in which these two states adopt a fixed exchange rate regime is theoretically interesting. If they were to adopt the float, the distinction between the states and regions would become irrelevant. However, if they are to adopt the fixed exchange rate regime, that could be for two reasons: either they are in fact an OCA when they integrate or the whole OCA argument is not very relevant for the choice of the exchange rate regimes in this case.

There are thus at least three cases to consider:

Case 1: An optimal currency area and the optimal or non-optimal currency areas or the world around it. In this case, the OCA should adopt a flexible exchange rate regime. In other words, however optimal the rest of the world, an OCA should float its currency.

Case 2: A non-optimal currency area facing an OCA. In that case, a fixed exchange rate regime, i.e., joining the OCA may be the superior choice.

Case 3: A non-optimal currency area facing another non-optimal currency area. The choice of an exchange rate regime would depend on the optimality of the aggregate. If it is non-optimal, OCA considerations are not relevant, but others may be. If the integrated whole is an OCA, then a fixed exchange rate regime is warranted.

[11] The proof could go like this. The world is a closed economy and an optimal currency area. Parts of it are not, if there are non-optimal currency areas at al. Thus, non-OCAs aggregate into and OCA.

3.4. Transitional Currency Areas

Mundell's case for the currency unions rests on two arguments. One is that they can come into being when political costs are low. If one looks at figure 4 and considers all the possible territorial arrangements that it lends itself to, there is no doubt that some of those are politically more costly than the others. For instance, the four state-four currency solution is probable if the political costs of the territorial rearrangement are close to zero.[12] The creation of a currency union is clearly easier when political costs are lower. In any case, political costs are important because central banks are state banks. They are also important if the coordination of monetary and fiscal policies is considered as those can substitute for each other up to a point.

The other argument is a type of an *argumentum ad absurdum* which is interesting in itself. Assume that optimal currency areas are those that can ensure full employment with external equilibrium. Then, there should be a currency union wherever there is an unemployment that is the consequence of a supply or demand shock. The price-adjustment via the exchange rate flexibility assumes some degree of money illusion. Now, the smaller the currency area the less realistic is the assumption of money illusion. It can be expected, in other words, that wages will be indexed on the exchange rate, at least when it comes to their downward adjustment. In that case, the argument for Balkanisation (i.e., proliferation) of the currency areas breaks down.

Another reason is trade integration. If countries trade a lot with each other, their business cycles will be harmonized and their currency union will be a Pareto improving policy choice. In terms of the theory of OCA, trade integration can transform previously existing OCAs into a non-OCA (if a state disintegrates into regions) and two non-OCAs into an OCA. If it is also assumed, though this is an ongoing debate, that monetary borders impede trade integration, then what is *ex ante* a non-optimal area can become an optimal area *ex post* through a surge in trade integration.

If these three reasons are taken together (others will be added as I go along), then the questions posed in the introduction of this section do not seem all that puzzling. The diversity of exchange rate arrangements in transition countries probably reflects the distribution between the optimal and non-optimal currency areas, though floats are rarer. This could be because transition economies can rarely be optimal

12 They can come about if the costs are very high too, as when a country or a set of countries disintegrate through a combination of an inter-state and civil wars.

currency areas as the direction of their trade and production structures are changing quite fast. Also, the political readiness to eventually join the euro can be explained in the same way. The political cost is low, because the countries are future members of the EU anyway. Small open economy argument applies too in a number of cases. Finally, trade integration, which has been quite significant in a number of cases, changes the locus of optimality.

More interesting is the issue of currency substitution. In some countries, especially in the Balkans, this is a pervasive and persistent fact. It is mostly higher than in the Central European countries though their trade integration with the euro zone is as a rule lower. Here, perhaps, Mundell's small country argument applies. This may be an indirect way of signalling the lack of money illusion in these countries. As a rule, they are quite integrated with the euro area, if the balance of payments as a whole is taken into account, which is another criterion that has been put forward in the literature on OCAs. Thus, rather than indexing wages on the euro directly, the preference for the euro saps the ability of the central bank to pursue active monetary policy and thus ensures that the erosion of the wages, at least through this channel, does not happen. For the same reason, wages can have an upward bias. As indeed they tend to have in Balkan countries with fixed exchange rate regimes as the wages are not indexed on the foreign currency. That does not mean that this is an optimal policy for these countries, as they also have high unemployment rates that are also quite persistent.

Finally, the criterion of diversity or specialization should be commented on. Clearly, the diversity of the currency union increases if transition countries are added to the euro area countries. The presumption in the theory is that there should be, *per absurdum*, a new currency wherever there is a specialization. This is clearly not feasible. Therefore, another criterion is used: that a currency union should not be prone to asymmetric shocks, i.e., it should not have regions that are highly specialized and quite different from the rest of the union. But this is too crude a criterion, because specialization is clearly efficient. Thus, non-OCAs can aggregate into OCAs if the states or regions are not large enough compared to the union as a whole. Thus, increase of diversity by the agglomeration of specialized regions support the establishment of a currency union that is an OCA as long as the regions are small compared to the union as a whole.

These comments are offered more as hypothesis to be tested in future empirical research. Here it is only argued that the theory of OCA is consistent with what is being observed in transition countries and economies.

3.5. Conclusions on OCA

The diversity of exchange rate arrangements in transition as well as the preference for the euro does not present a puzzle within the theory of optimal currency areas. The advantage of the theory is that it explains these facts endogenously rather than by an appeal to more usual arguments about the credibility of the central banks in emerging markets. Once the EU enlargement lowers the political risk to joining the currency union and increases the trade integration, fixed exchange rates of one kind or another look like a Pareto improving option. This is the case even in the transition countries which are yet to join the EU, on account of them being small and probably non-optimal currency areas. There seem to be rare cases of small transition countries that are optimal currency areas, which perhaps explains the success of the use of flexible exchange rates in those cases.

4. Areas of regional cooperation

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 counties 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[13] 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,

[13] For more on that see Bicanic, Gligorov and Krastev (2004).

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.

5. Conclusion

It is argued in this paper that the lack of regional cooperation can be remedied by the speed up of the process of EU integration. Though the current process will in the end produce the same results, the difference in time and in risks is potentially quite significant.

Appendix: Unilateral, bilateral and multilateral liberalisations

In the case of a small open economy, unilateral trade liberalisation is the best policy because the country is a price taker and protection distorts its allocation of resources. Unilateral trade liberalisation can also be a good strategy for a regional leader, by which a regional price-setter could be meant. It could be the initial move to be followed by an offer of a free trade agreement or a customs union.

The leader may have a choice between bilateral and multilateral free trade agreements to proceed on the path to full regional trade liberalisation. In that case, the preferable strategy will depend on the following (Aghion, Antras and Helpman, 2004):

Coalition Externalities (definition): There are positive coalition externalities in a country when a free trade agreement by other countries increases its welfare and a negative coalition externalities decreases it.

Grand-Coalition Superadditivity (definition): There is grand-coalition superadditivity if the aggregate welfare under multilateral agreement is higher than under any combination of unilateral trade policies and bilateral free trade agreements.

Proposition (benchmark): If there are no coalition externalities in the follower countries and there is grand-coalition superadditivity, then:

(i) the leader is indifferent between multilateral and sequential bargaining; and

(ii) the grand coalition forms and there is global free trade.

Proposition (free trade): If there is grand-coalition superadditivity, then:

(i) the leader is indifferent between multilateral and sequential bargaining if and only if there are no coalition externalities in the follower countries;

(ii) the leader strictly prefers sequential bargaining when there are negative coalition externalities in at least one of the follower countries;

(iii) the leader strictly prefers multilateral bargaining when there are positive coalition externalities in both follower countries; and

(iv) the grand coalition forms and there is worldwide free trade.

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