BRILL | Ferdinand Schöningh

SOUTHEASTERN EUROPE 46 (2022) 1–22

SOUTHEASTERN EUROPE

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Foreign Direct Investment and Backward Spillovers in the Western Balkans

The Context, Opportunities and Barriers to the Development of Regional Supply Chains

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Abstract

This article investigates how regional supply chains support the Western Balkans' economic growth. It first identifies the role of the CEFTA free trade agreement in expanding the size of the local market and opening up regional trading opportunities. It recounts how the larger market and specific industrial policies have attracted foreign direct investment (FDI) to the region in recent years. It analyses how these two factors have combined to generate export-led growth in the region and have brought about substantial structural changes within these economies. The article argues that to take continued advantage of the success in trade liberalisation and FDI attraction, policymakers should pay special attention to promoting backward spillovers by promoting linkages between local small and middle sized enterprise (SME) supplier firms and the newly arrived multi national corporations embedded into global value chains. Policies should be adopted which build the capacity of local SME suppliers within regional supply chains, both in terms of labour force skills and technological

 | DOI:10.30965/18763332-46010001

upgrades. The EU's recently launched Economic and Investment Plan for the Western Balkans and the activities of the Western Balkan Six Chamber Investment Forum may support such policies.

Keywords

foreign direct investment – backward spillovers – regional supply chains – CEFTA – Western Balkans

1 Introduction*

In recent years, the Western Balkan region has attracted a substantial flow of new foreign direct investment (FDI). For the first time in the transition process in the region, this FDI has flowed into the manufacturing sector. In the period since the global economic crisis of 2008, the region has grown relatively quickly based on this inflow of productive capital, interrupted only briefly by the COVID-19 pandemic. The new FDI inflow has supported a transition to an export-led economic growth model, which has given rise to a surprising renaissance of the region's economies (World Bank, 2019; Bartlett and Osbild, 2019). However, neither between nor within countries of the region have the benefits of this growth been evenly spread. As the regional chambers of commerce have noted: "Despite regional synergies … paired with geographical, language and cultural proximity, the level of intra-[regional] supply chain integration is not high" (WB6 CIF, 2017). This article investigates the context, opportunities, and barriers to developing regional supply chains that could spread the benefits of this foreign investment to the domestic business sector. Specifically, we are interested in how domestic small and medium sized enterprises (SMEs) can be supported to supply inputs to multinational companies (MNCs) established in the manufacturing sector in the region.

This inflow of foreign investment has been accompanied and supported by measures of regional cooperation based on efforts to create a single economic space designed to boost trade and attract FDI to a large open regional market. The Central European Free Trade Agreement (CEFTA) was launched in the

* The authors would like to thank the editor and two anonymous referees who reviewed the earlier version of this manuscript and provided valuable suggestions and comments. An earlier version of this article was presented at the 2nd LSEE-CEFTA Academic Network Workshop: "CEFTA after Poznan: Commercial and Institutional Issues" Skopje, 13–14 September 2019.

region in 2006 and has led to a subsequent expansion of intra-regional trade. Since 2017, under the "Berlin Process", the countries of the region, with the support of the EU, have begun to develop a Regional Economic Area (REA) designed to encourage the inflow of FDI throughout the region based on a common approach to investment promotion (Sanfey and Mijatović, 2019).

In 2020 the EU launched an Economic and Investment Plan for the Western Balkans to further this process (European Commission, 2020). This plan has ten flagship initiatives to further develop regional economic integration and integration with the EU through the creation of a Common Regional Market, building on the achievements made so far within the REA. This aims to attract global investors to the region and assist them in diversifying their suppliers, enabling deeper economic integration with the EU single market in the future. Some countries in the region have provided substantial incentives to attract such investment, although as yet not in the coordinated manner envisaged by the Berlin Process (RCC & CEFTA, 2018). Generous subsidies provided by North Macedonia and Serbia, and to a lesser extent in Bosnia and Herzegovina, have attracted an increased flow of FDI and led to an expansion of their manufacturing industry, especially into the machinery and transport equipment sectors. At the same time, Albania, Kosovo, and Montenegro have based their economic development mainly upon the expansion of services exports, some expansion of processed food exports (Albania), and exports of miscellaneous manufactured goods (Kosovo). Consequently, a process of divergence between the economies has taken place. We argue that one potential solution to this divergence is the creation of regional supply chains to create spillover effects from multinational companies in the region.

An additional flagship initiative of the Economic and Investment Plan is a set of measures to invest in the competitiveness of the private sector. The EU aims to provide a combination of grants and guarantees to support the development of innovative business ecosystems based on the triple helix approach of collaboration between the business sector, government, and the research and development institutions. In this way, the initiative aims to raise the quality standards of companies and the availability of export-oriented investments in order for the region's private sector to benefit from greater market integration and trade within the region and with the EU. It also aims to support the implementation of Smart Specialisation Strategies to support regional research, innovation, and technology transfer. All of these initiatives could support the development of regional supply chains and the ability of SMEs to supply inputs to the new factories that have been established by foreign investors in the region, as well as promote the backward linkages from those multinational corporations (MNCs) to the domestic economies.

The article is set out as follows. In section 2, we discuss the role of trade liberalisation in expanding trade flows within the Western Balkans and creating tendencies towards the divergence between economies. In section 3, we explore the role of industrial policy focusing on foreign investment attraction measures in further driving trends towards divergence in the region. In section 4, we provide empirical evidence on how export-led growth policies have led to divergent patterns of export growth, and on the nature of the structural change that has taken place. In section 5, we explore the extent and nature of the spillover effects from MNCs into the local economies and show that these have been minimal. We also provide qualitative evidence on best practice examples of knowledge and technology spillovers from MNCs to domestic SMEs in North Macedonia. In section 6, we set out our conclusions, emphasising the opportunities for developing regional supply chains and the vital role of state aid supported by announced EU plans and programmes in assisting the development of the domestic private sector and encouraging regional economic integration.

2 CEFTA and Regional Supply Chains

Regional free trade agreements (FTAs) such as CEFTA are likely to have a range of positive effects. Firstly, the mutual reduction of tariffs will likely lead to a fall in the price of traded goods and hence an increase in trade volume.[1] Secondly, greater competition from imports is likely to undermine the restrictive practices of monopolistic firms operating in small national markets and may increase the efficiency of previously protected producers (Collier et al., 2000). This is relevant to the Western Balkan economies, where incumbent firms benefit from substantial privileges due to their close links to their governments, and are often in a position to stifle domestic competition.

These expectations have been borne out by empirical research. Petreski (2018) finds that CEFTA increased trade flows within the region by 74%

1 However, just as trade is created between partners, so trade may be diverted from third countries (Viner, 1950; Schiff and Winters, 2003). However, trade diversion is less likely to be a problem in an economy with a low external tariff towards third countries, or similar tariff structures towards third countries. This is the case in relation to trade between the Western Balkan economies and the EU, since under the Stabilisation and Association Agreements (SAA) the Western Balkan economies have eliminated most tariffs on trade with their main trading partner, the EU. In addition, the government will lose tariff revenues. The recent reimposition of tariffs by Kosovo on imports from Bosnia and Herzegovina and Serbia shows that this loss of tariff revenues can be a serious problem for small economies within an FTA such as CEFTA.

between 2006 and 2015.[2] Albania appears to have been a major beneficiary, with exports to the region increasing from a low base by anything up to 144% between 2006 and 2016 (Choi and Minondo, 2019).[3] The trade growth with the EU proceeded at an even faster pace, so that the ratio of exports within the Western Balkan region to exports to the EU fell over the period from 2017 to 2018 (Nikolic, 2020).[4] A study by Grieveson et al. (2021) argues that while CEFTA played a significant role in promoting intra-regional trade, the effect was weakest (and perhaps even negative) for Serbia, which directed its export growth mainly towards the EU. Despite this, the liberalisation of trade within the Western Balkans has had a demonstrably beneficial overall effect on trade flows in the region.

In addition, neoclassical economic theory suggests that regional convergence is likely to be the outcome of such trade liberalisation arrangements. This is because differences in relative factor prices are likely to be reflected in capital flows and trade flows, and it can be expected that efficiency-seeking multinational companies will be attracted to countries with relatively low labour costs. The larger market size may also increase economies of scale for both domestic and foreign companies operating in the region, reducing the cost of production and attracting additional direct foreign investment (FDI) from multinational corporations (MNCs). All of this may further contribute to export-led economic growth and development.

2.1 *Backward Spillover and Regional Supply Chains*

Nevertheless, despite all the above-noted benefits of the CEFTA free trade agreement, some of the forces at work may offset the anticipated benefits, something which occurs through the process of geographical "agglomeration". Agglomeration occurs when industries are incentivised to cluster together in a particular location (Krugman, 1991). The factors that favour agglomeration include increasing returns to scale, knowledge spillovers, technical external effects between firms located close to each other, labour market pooling such that firms can benefit from a locally available supply of skilled labour, and backward (demand) and forward (supply) linkages which create interdependencies between the location decisions of firms.

2 An earlier study by Petreski (2013) estimated even larger trade gains from CEFTA implementation.

3 For a contrary view see Begović (2011). However, this study was conducted in the early stages of CEFTA implementation and so it could be expected that it would not pick up much of the eventual impact on trade flows.

4 A recent estimate of the gains from trade integration of Western Balkan countries with the EU is given by Reiter and Stehrer (2018).

A substantial body of research has investigated how foreign MNC activities have affected the performance and productivity of domestic firms. Vertical spillovers related to MNC effects on supplying firms are known as "backward" spillovers.[5] Several research studies have explored the extent of backward spillovers in the Central and South-East European (CESEE) transition economies. An early study by Schoors and Van der Tol (2002) found evidence of backward spillovers from foreign MNCs to domestic Hungarian companies, and Javorcik (2004) found similar evidence for Lithuania. In contrast, in the Czech motorcar industry, Ayyagari and Kosova (2010) found no evidence of backward spillovers and another study, principally related to the linkages with Volkswagen-Skoda, found an absence of domestic suppliers and that most inputs came from "follow-source" suppliers, i.e. foreign-owned affiliates of global MNCs (Rugraff 2013). These examples are relevant for the Western Balkan countries where the motorcar industry has been a principal sector for FDI in recent years. For example, in Kragujevac, where FIAT has a large factory producing motorcars in a special economic zone (SEZ), foreign component-producing follow-source suppliers based in the SEZ have become the major suppliers of components to FIAT, thus limiting the potential for domestic SMEs to become engaged in supplying components to the factory.

If agglomeration effects are sufficiently strong, they may bring about the concentration of manufacturing activities in one country and the de-industrialisation of another. Regional divergence rather than regional convergence may be the net outcome (Bartlett, 2007, 2009). Divergence of production and income levels may threaten economic and social cohesion and undermine the political will for regional cooperation.[6] Such regional divergence due to agglomeration effects could be offset if the benefits of FDI were to be spread throughout the region rather than concentrated in one country or locality. This could occur if regional supply chains were established, which would spill the benefits over to small firm suppliers operating throughout the region.

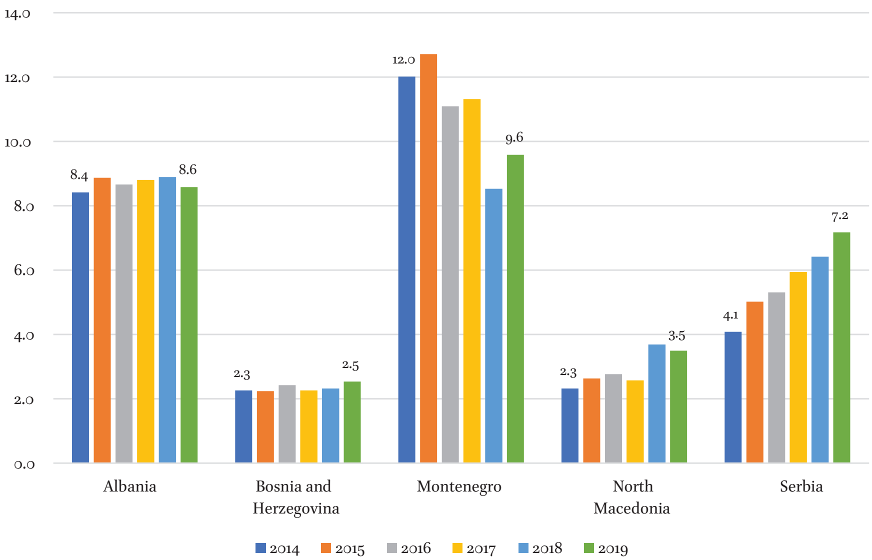
5 Vertical linkages with supplying firms are known as "backward" spillovers, vertical linkages with firms that purchase goods or services from MNCs are known as "forward" spillovers. Horizontal spillovers refer to MNC effects on domestic producers in the same industry. For detailed evidence of intra-industry (horizontal) spillovers in the WB region and how these vary by the origin of investors comparatively to other regions in the European periphery see Monastiriotis (2016).

6 This may be part of the explanation for the growth of tensions that have recently between observed between Kosovo and Serbia (Milosevic and Hrnjaz, 2018).

3 Attracting Manufacturing FDI as an Industrial Policy

Before the global economic crisis in 2008, there was little evidence of any foreign direct investment (FDI) into the manufacturing sector in the Western Balkans. FDI was mainly attracted to the service sectors, for example telecommunications and finance and privatisation projects, inevitably a self-limiting field (Botrić, 2010). One careful study showed that the region was at a particular disadvantage, having attracted less inward FDI than expected given its location, the size of its economies and other characteristics favourable to FDI inflows (Estrin and Uvalic, 2014). They put this negative performance down to a "Balkan effect" related to the legacy of the region's history of political turbulence and armed conflict in the 1990s.

In recent years, the industrial policies of North Macedonia and Serbia have involved renewed efforts to attract FDI in the manufacturing sector (Bartlett et al., 2017). These policies have involved a range of subsidies to multinational corporations, which have generated a remarkable increase in FDI in recent years, especially in Serbia, where FDI inflows have increased from 4.1% of GDP in 2012–2014 to 7.2% of GDP in 2017–2019 (see Figure 1). Inward FDI has also increased in North Macedonia, from 2.3% to 3.5% of GDP over the same period.



Note: Data for Kosovo is not available

FIGURE 1 Inward FDI to the Western Balkans % GDP (3-year moving average)
UNCTAD ONLINE DATA

In the other Western Balkan countries, the inflows of FDI have remained constant or even fallen (in the case of Montenegro).

In addition to general subsidies, the policies have, in particular, led to the establishment of special economic zones (SEZs) in these economies (Bartlett et al., 2017). In the SEZs, companies enjoy a wide range of benefits including 0% VAT, 0% customs duties, 0% profit taxes, and other subsidies. Industrial policies have generally been based on low corporate profit taxes rates and investment and employment subsidies. These policies have been used to aggressively attract multinational companies to the region.

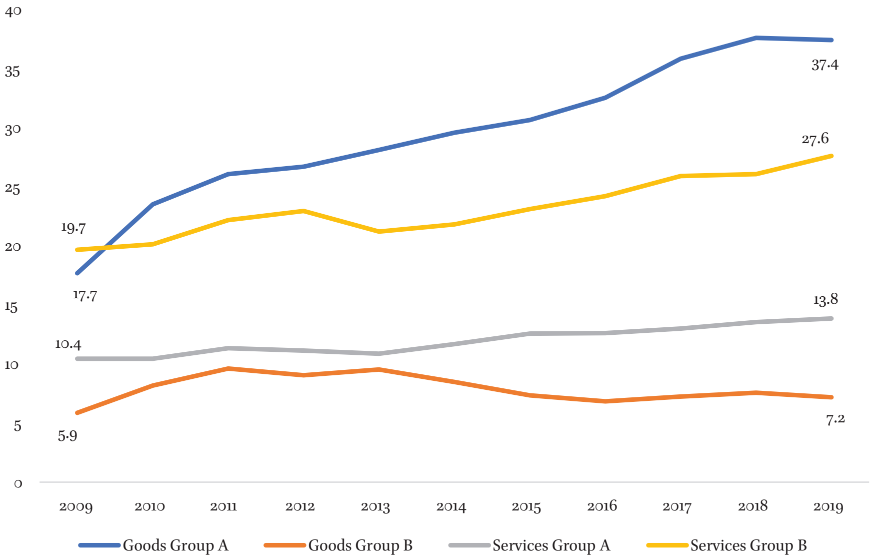
This type of industrial policy, specifically in Serbia and North Macedonia, and to some extent in Bosnia and Herzegovina, has led to an increase in manufacturing output by using subsidies to attract multinational companies in the manufacturing sector (Bartlett et al., 2019). This has led to the development of new manufacturing centres in these economies, attracting the bulk of manufacturing investment in the region and leaving other economies, that have not adopted such policies, behind. This agglomeration of activity has also been an effect of the CEFTA agreement, which has enabled investors to locate in the economies with larger investment subsidies, sell their products throughout the region and export to the EU.

4 Export-led Growth and the Restructuring of Export Patterns

During the period before the economic crisis of 2008, the export performance of the Western Balkan countries was weak, and the region was dependent on inflows of external resources (Uvalic and Cvijanovic, 2018). This led to a call for a reorientation to export-led growth and an industrial policy that would identify key growth sectors for government support. This has been one of the motivations of the policy focus on smart specialisation strategies adopted in some of the countries in the region with support from the EU. It has also led some countries to adopt strong industrial policies based upon attracting FDI through the use of subsidies and the creation of SEZs. In this section, we examine the combined effects of the free trade arrangements and the FDI attraction policies on the expansion and restructuring of exports in export-led growth in the region.

The continued integration of the Western Balkan economies into the EU led to the growth of exports of both goods and services after the economic crisis of 2009. This has been reinforced by the success of the CEFTA, which has led to a growth of intra-regional trade. Observation of the sectoral export patterns of the economies of the Western Balkans reveals that three of the economies, which we call the "Group A" countries, specialise in manufacturing activities (Bosnia and Herzegovina, North Macedonia, and Serbia). In contrast, the "Group B" countries have specialised in the export of services (Albania, Kosovo, and Montenegro) (see Figure 2). The export growth of manufacturing as a percentage of GDP in Group A has been remarkable, increasing from an average of 17.7% of GDP in 2009 to 37.4% of GDP in 2019, while services exports increased by a relatively trivial amount. Within this group of countries, the most significant gain was made by North Macedonia, whose exports of goods as a percentage of GDP increased by 17.6 percentage points (p.p.) from 2009–2019, to reach 47.5% of GDP in the latter year. Similarly, the exports of goods as a percentage of GDP increased by 15.1 p.p. in Serbia and by 13.6 p.p. in Bosnia and Herzegovina over the period.

In the Group B countries, the exports of services increased from an average of 19.7% of GDP in 2009 to 27.6% by 2019, while exports of manufactures correspondingly increased by only a trivial amount, and even fell in Montenegro by 5.1 p.p. as the country rapidly deindustrialised. The greatest gain was made in Kosovo, whose exports of services as a percentage of GDP increased by 13.5 p.p. from 2009–2019. The exports of services as a percentage of GDP increased by 9.3 p.p. in Montenegro to reach 34.3% of GDP in 2019 on the back of a rapidly



Note: Group A = Bosnia and Herzegovina, North Macedonia and Serbia; Group B = Albania, Kosovo and Montenegro.

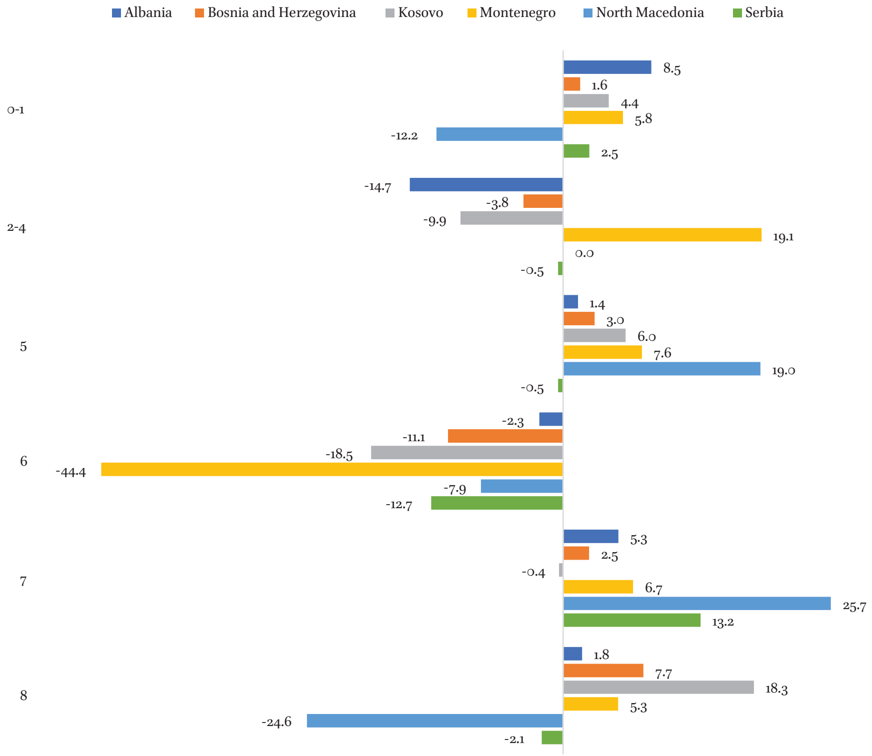
FIGURE 2 Exports of goods and services by country group (% GDP)
EUROSTAT ONLINE DATA [NAMA_10_GDP]

expanding tourism sector. The least change took place in Albania, where the exports of services increased by just 3.8 p.p. over the period (and exports of goods also increased by a relatively small 2.4 p.p.). The overall outcome has been a tendency towards divergence of the economies in the region.

Previous research has identified that the flow of FDI into the Western Balkans is below that which would be expected given the region's geographic position close to the EU and its middle-income level of development (Estrin and Uvalić, 2014). Recently, the inflow of foreign direct investment (FDI) into the manufacturing sectors in the Western Balkan region has begun to pick up. Much of it has been attracted into sectors related to the motorcar components industry linked to global value chains (GVCs) and international production networks (IPNs), mainly through inward processing of intermediate goods (Shimbov et al., 2016). As a result, the region is gradually becoming integrated into GVCs/IPNs in the manufacturing industry. Analysis of industrial production by industrial sectors shows a structure of production consisting mainly of parts and components for final products and raw materials (Shimbov et al., 2013). For example, in Bosnia and Herzegovina, some final export products are the main components and sub-components for producing machinery and electrical equipment. In Serbia, some final products are assembled and exported as vehicles, but most inputs and equipment are imported, and many export products are components and sub-components or raw materials. In the growing IT and business service sectors, many local companies from the region work for foreign partners as outsourcing suppliers. Such intermediate goods have been an essential driver of export growth (OECD, 2013) and upgrading their technology level (Shimbov et al., 2019). Consequently, a rapidly changing structure of exports can be observed.

The remarkable changes brought about by the entry of MNCs into the manufacturing sectors in the Western Balkans can be seen in Figure 3, which shows the pure restructuring of the composition of exports in the region, normalising for absolute growth.[7] This shows the considerable gains made by the ISTC sector 7 – machinery and transport equipment – which were driven by changes in export composition in North Macedonia and Serbia, the two countries where the foreign investment attraction policies have had the greatest impact in drawing MNCs into the motor manufacturing industry, and the supply of parts and components industry (though in the case of FIAT in Serbia also into the final products industry – motor cars). The proportion of North Macedonian exports in this sector increased by 25.7 p.p. between 2008 and 2020, followed by Serbia with a 13.2 p.p. increase. The remarkable turnaround in the fortunes

7 For each country, the sum of structural changes adds up to zero.



Note: Standard International Trade Classification (SITC) sectors. 0–1: food, drinks and tobacco; 2–4: raw materials; 5: chemicals and related products; 6: manufactured goods classified chiefly by the material; 7: machinery and transport equipment; 8: miscellaneous manufactured articles.

FIGURE 3 Change in goods export structures by ISTC sector, 2008–2020 (percentage points)
EUROSTAT ONLINE DATA: INTERNATIONAL TRADE OF EFTA AND ENLARGEMENT COUNTRIES [EXT_LT_INTERCC__CUSTOM_797985]

of North Macedonia led to a trade surplus in manufactured goods in that country by 2020. North Macedonia also benefitted from a considerable increase in the exports of chemicals and related products, which grew by 19.0 p.p. over the period. Other notable gains in export shares took place in the exports of raw materials in Montenegro, which compensated for the collapse in the export of aluminium finished products by exporting raw materials. Kosovo also recorded a notable increase in miscellaneous manufactured goods.

Overall, most countries increased their exports of food, drinks, and tobacco, a large part of which can be attributed to the positive effects of CEFTA, which boosted this trade, especially from Albania to other countries of the region. The exports of chemicals and related products also saw a general increase in their shares. However, the exports of raw materials and the manufacture of goods classified chiefly by materials (processed raw materials) recorded an overall diminution in their share of exports. The implication is that the Western Balkan countries have mainly experienced a substantial restructuring of their economies, leading to a surge in exports of goods and /or services over the last decade. This is a promising development that is in line with the recommendations of observers for a new growth policy. However, the question remains open whether this achievement, based at least to some extent on the inflow of new forms of foreign direct investment (even in the services sectors such as tourism), has led to an associated growth of backward spillovers to the domestic economies and thence to an embedding of the new economic production structures that could ensure sustainable growth in the future. In the next section, we explore the importance of backward spillovers and the development of regional supply chains for ensuring regional convergence among the Western Balkan economies.

5 Backward Spillovers in the Western Balkans

Backward spillovers are the key factors enabling the FDI inflow to impact local economic development positively. However, a lack of absorptive capacity of domestic firms may limit the contribution of MNCs to local economic development (Nicolini and Resmini, 2010). Often domestic firms lack the quality standards, the scale of production and the connective networks that would enable them to take advantage of the opportunities available to integrate into global value chains in which foreign MNCs, especially those located in SEZs, are embedded. This phenomenon appears to be widespread. In a study of Polish firms, Marcin (2008) found that the absorptive capacity of local firms places a limit on the size of spillovers. Gorodnichenko et al. (2014) also found that the limited absorptive capacity of domestic firms can be a barrier to backward spillovers.[8]

In the Western Balkans, Estrin and Uvalic (2016) were unable to identify any backward linkages from FDI in the Western Balkan region from 2002–2012, whether in value-added, manufacturing employment, or manufacturing exports. A more recent study found that little changed in the following decade. Investments by multinational companies in the Western Balkan region have provided few linkages to the local economy and have done little to develop

8 Here, absorptive capacity is designed as the distance of the technology used by the firm in question from the "efficiency frontier" defined by the best-performing firms.

intra-regional trade (Bartlett et al., 2019). This suggests the need for a more proactive role of central and local governments in building the supply capacity of local SMEs to engage in supply-chain relationships with the MNC manufacturers, inside or outside SEZs. The recently created Western Balkans Six Chamber Investment Forum (WB6 CIF) has identified the need to facilitate business contacts and promote the region as a single investment destination (WB6 CIF, 2017).

Data on the sales by domestic firms to MNCs based in their country are available from the Balkan Business Barometer survey implemented over several years by the Regional Cooperation Council. These surveys show that only a small proportion of the sales of domestic companies are made to foreign MNCs based in their country. Over the five years of the survey, the highest proportion of sales made by domestic firms to foreign MNCs was in Bosnia and Herzegovina and Serbia, while the average for all economies over all five years was just 4.8% of sales (see Table 1). This suggests that the backward spillovers in business generated in the domestic economy by foreign MNCs are extremely limited. Given this, it is likely that all other forms of backward linkages are also small.

Due to local suppliers' relative lack of capacity and technical quality, most MNCs look beyond the Western Balkan region to meet their supply needs. According to one interviewee, "we usually use regional suppliers, because it is

TABLE 1 Percentage of your domestic sales made to multinationals located in seller's economy (% of total sales in each country)

	Albania	**Bosnia and Herzegovina**	**Kosovo**	**Montenegro**	**North Macedonia**	**Serbia**	**Western Balkans**
2015	2.0	7.0	3.0	6.0	0.0	4.0	3.7
2016	1.5	6.4	4.1	6.9	3.4	5.1	4.6
2017	2.0	3.0	4.0	5.0	3.0	7.0	5.7
2018	2.0	4.0	4.0	3.0	2.0	5.0	3.3
2019	4.0	7.0	9.0	3.0	4.0	9.0	6.0
2020	1.1	6.3	3.1	6.5	5 .9	6.7	5.5
All years	2.1	5.6	4.5	5.1	3.1	6.1	4.8

Note: the survey is conducted annually among 200 businesses in each country. Data for Kosovo in 2017 has been adjusted for probable outliers.

SOURCE: RCC BALKAN BAROMETER ONLINE DATA "EXPORT AND IMPORT OF SEE BUSINESSES: DOMESTIC SALES PERCENTAGE", HTTPS://WWW.RCC.INT/BALKANBAROMETER/RESULTS/1/BUSINESS.

quite difficult to find local companies to meet requirements for our company".[9] MNCs are interested in finding suppliers from the Western Balkan region but face numerous obstacles to developing these backward linkages, including the small size of local companies and the lack of clusters and networking between companies on a local or regional basis. Other factors are also important. Chief among these are higher regulatory quality and greater internet penetration. While the latter is improving in the CEFTA parties, the former remains an issue for the development of regional value chains and economic development more generally. Improved regulatory quality and institutional linkages should foster vertical coordination between buyers and sellers, which is of particular importance for supplying MNCs, whether based in SEZs or outside such zones. Data from the World Bank Doing Business reports show considerable variation among the CEFTA parties, with especially long waiting times at their borders recorded for Albania, Kosovo, and Montenegro (see Sanfey and Mijatović, 2019). These three countries have benefited the least from the growth of manufacturing exports linked to the increased presence of MNCs, so this could be an important policy area for future attention.

5.1 *Findings from Field Research*

Further evidence on the weak nature of backward linkages in the Western Balkans is provided by the results of field research carried out by the authors in North Macedonia and Serbia in 2017. The qualitative interviews suggest that local suppliers have little engagement with SEZ value chains. As the manager of one SEZ-based MNC reported to us, "the involvement of the local suppliers is very restricted as they only get involved in construction and provision of services. The integration of local suppliers into supply chains is limited".[10] In Serbia, multinational companies located in SEZs mainly import intermediate products. Some local sourcing takes place, but mostly in services (transport, packaging, catering, etc.). At the same time, companies in the Western Balkan region are suppliers of intermediate products to EU and global companies and importers of intermediate products from EU and global markets. These internationalised local companies show that there is some capacity to meet the requirements of MNCs, for example, in delivering small customised series of components in the metal industry. Local suppliers are mostly engaged in the provision of indirect services unrelated to production inputs. Several MNCs based in SEZs are interested in cooperating with local SMEs and actively look for local suppliers, but local suppliers often fail to meet the quality, technology,

9 Interview North Macedonia, February 2017.
10 Interview Tetovo, North Macedonia, February 2017.

standards, and price requirements. Moreover, local suppliers are not organised and do not cooperate with each other.

SEZ-based MNCs mainly use local suppliers for construction work in building factories, for maintenance services, and for transportation. According to one interviewee, SEZ-based companies are mainly interested in using local suppliers due to their lower prices and close location, reducing transport costs and easing access to maintenance services. However, even for these service inputs, the supply is still insufficient in amount and quality.[11]

5.2 *Employment and Training*

The most remarkable linkage with the local economy is in labour employment. Some SEZ-based companies find a need for more qualified labour and include training in their human resource strategies. Other SEZ-based companies provide work-based training in their companies. For example, in the SEZ in Kragujevac, FIAT has established a training centre. In North Macedonia, Van Hool, based in the "Skopje 2" SEZ, has contracted a training company to deliver training courses to its welding professionals. Other SEZ-based companies send their employees abroad for training. A company, "Kemet" in North Macedonia, regularly sends its workers abroad for six-month training courses in Germany, Italy, and the UK. In Smederevo in Serbia, the "Rosa Catena" company, which produces chains from steel plates, sends its operators to Italy for training.

5.3 *Long-Term Relationships*

The extent of backward spillover may also depend on the MNCs' characteristics. Determining factors have been found to include whether the ownership structure involves a joint venture with a domestic company (in the case of Romania) (Javorcik and Spataraneu, 2008) and the degree of export orientation (Sgard, 2001). The nature of the relationship between MNCs and domestic component suppliers is also of essential significance. Long-term contractual relationships between the two are more likely to generate positive spillover effects than short-term contracts. Suppliers based in locations where there is an agglomeration of MNCs, such as close to SEZs or large cities, may also reap the benefit of repeated relationships over a long time. Such relationships can build trust between MNCs and their suppliers and foster positive backward spillovers (Dyer and Singh, 1998).

11 Interview with Plant Manager, ADIENT, North Macedonia, February 2017.

Another driver of increased productivity among supplier companies is the imposition of quality standards by foreign MNCs in SEZs. In our field research interviews, SEZ managers pointed out that reliability, price stability, and quality standards remain the biggest concern for increasing the local supply base for SEZ companies in the Western Balkans (see Box 1). Suppliers have to follow standards. For example, Tigar Tyres dictates conditions, standards, and innovations (Tigar is the third biggest exporter in Serbia).[12] Products and services that are supplied to Tigar Tyres pass through quality control every six months.[13] The service company supplier Energomont must follow the standards and requirements set by Siemens.[14] The SEZ-based company Dunkermotoren wanted to find local suppliers, but has stated that the local SME s do not have the required quality level, technologies, or standards to become suppliers.[15]

5.4 *Technological Upgrading*

An additional channel for backward spillover occurs when MNCs provide advanced technology to their domestic suppliers to improve their productivity and the quality of the goods and services they supply. There is some evidence that backward spillovers in the form of knowledge transfers are limited to better-performing suppliers in high-technology industries (Gersl et al., 2007; Javorcik and Spataraneu, 2008). Furthermore, Domanski and Gwosdz (2009), Jürgens and Krzywdzinski (2009), and Gentile-Lüdecke and Giroud (2011) all identify that the presence of foreign MNCs in Central Europe has led to an upgrading of the domestic component supply industry. Gorodnichenko et al. (2014) analysed an enterprise survey covering 17 transition countries and found strong evidence of positive backward spillovers to domestically owned firms. MNCs often transfer technology to domestic component suppliers to increase the quality of the inputs they receive (Pack and Saggi, 2001). In Lithuania, for example, Javorcik (2004) found that MNCs have a strong interest in upgrading their supplier base to improve the quality of locally purchased inputs. Such technology transfer has also been observed in Hungary (Schoors and Van der Tol, 2002) and the Czech Republic (Stancik, 2007). Quality standards also have a role to play in upgrading the supply chain. For example, Gorodnichenko et al. (2014) found that when foreign firms demand higher standards, they incentivise domestic suppliers to improve the quality of their products and services. However, there has been little effort to develop backward linkages in

12 Interview Municipality of Pirot, March 2017.
13 Interview Pirot Free Zone Management Company, Pirot, March 2017.
14 Interview Free Zone Subotica, March 2017.
15 Interview Regional Development Agency Panonreg, Subotica, March 2017.

the Western Balkans through technology transfer. SEZ managers indicated that SEZ-based companies had made little effort to increase the capacities of their suppliers.

However, there are a few isolated examples of successful cooperation and technology transfer between SEZ-based MNCs and domestic suppliers. For example, Van Hool, a bus manufacturer, obtains almost all its inputs from suppliers in Spain, Germany, Romania, and Turkey. The local supply is mainly limited to providing transport services, food, and gas supplies. This is because of the limited capacity of local suppliers to produce the quantity required according to the standards set by Van Hool. Therefore, the company has chosen a gradual strategy to help develop the local supply chain to meet the quality standards requirements. The company has several suppliers of inputs for production purposes. Four are based in North Macedonia, one in Serbia, and one in Turkey. It is estimated that 10% of the total value of supplies is bought from local and regional suppliers, mainly in the form of products such as steel, pallets, small boxes, and plastic elements. The strategy for developing the production capacities of the local suppliers consists of support in guiding them through the requirements for US markets. They support local companies in accessing loans and finance for their investments in production capacities, helping them approach local banks by showing the contracts they have with those local companies and the cash flow they could expect to earn to repay the loans.

One local supplier of Van Hool, based in Stip, constructed a new plant for bus chassis welded elements and acquired welding certificates compliant with European standards. Van Hool supported the supplier with training material, books, and equipment. The intensity of this support led to additional capacity, more jobs, new machines, and even robotic equipment to meet Van Hool's requirements for their factories in Skopje and Belgium. As a result, the supplier advanced its technology and innovation system and, due to that, it has won contracts with other companies, showing that the company benefited from being part of a more extensive network and obtaining contracts with other large companies around the world. In the opinion of one insider, Van Hool brought this company to a higher technological level.[16]

16 Interview, North Macedonia, February 2017.

6 Conclusions

The Western Balkan region has made significant progress in expanding regional trade through CEFTA and attracting FDI consequent to its large open market and low labour costs. However, this success has come at the price of regional divergence of production capacity and export performance. If it is to survive the strains created by such divergences, the gains need to be shared more widely among all countries in the region. This can only be done by ensuring that the new production capacities are embedded in each economy through the emergence of regional supply chains that will enable backward spillovers throughout the region. These spillovers could facilitate the development of new labour force skills and the entry of new SMEs in the form of supplier companies to foreign MNCs throughout the region. These would, in turn, lead to technology and knowledge transfers and the creation of new jobs, especially for youth, for whom unemployment rates remain high.

Government intervention can play an essential role in stimulating such backward spillovers between foreign-owned MNCs and domestic components supply firms (UNCTAD, 2001). Local suppliers (SMEs) need support in upgrading their skills, quality, standards, and technology. Cooperation (networking) between them also needs to be supported, as does their cooperation with local technical and vocational schools. Although some state aid is available to local SMEs to supply MNCs in the region (e.g., the RAS programmes in Serbia[17]), more could be done to assist local suppliers in connecting with MNCs and enhancing the quality of their production to meet the technical requirements of the global value chains in which these MNCs are embedded. The EU's recently launched Economic and Investment Plan for the Western Balkans promises to support this type of activity. Linkages with small IT companies could provide services to MNCs, offering IT solutions for their operations, 3D printing, and product design solutions. IT services outsourcing is a growing sector in the Western Balkans, but linkages with MNCs are not yet well established.

In order to embed sustainable growth and rebuild the region's economies as they emerge from the COVID-19 recession, FDI attraction policies need to move to the next phase – to support linkages with domestic SMEs on a regional

17 According to the Development Agency of Serbia (RAS), efforts are being made "to enhance the business capacities of the local suppliers by implementing Supplier Development Program, which is in the line with the strategic priorities of the Government of the Republic of Serbia". See: https://ras.gov.rs/en/invest-in-serbia/why-serbia/local-suppliers.

basis. For example, in its Economic Reform Programme 2019–2021, North Macedonia has prepared measures and planned funds to encourage FDI companies to develop backward linkages with local enterprises (MoF, 2019). This policy should be scaled up to a regional level to generate beneficial backward spillovers from the MNCs that have recently located in the manufacturing sectors of some of the Western Balkan countries.

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