The Impact of Economic Disintegration in Eastern Europe on Firms, Trade Patterns and Intensity:

An Exploration of the Effects and Policy Implications

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INTRODUCTION

Political devolution, in the form of state disintegration and newly emergent borders, was a powerful force in the 1990s. Beginning with the abrupt collapse of centralized political control in the Soviet Union, Czechoslovakia and Yugoslavia, the trend continues in such distant locations as Quebec, Kashmir and East Timor. The era also saw the normalization of trade relations between Western and Eastern Europe with the end of the Cold War, as well as the deepening integration of Western Europe. The increasing liberalization of trade and rising popularity of economic integration seem to be diminishing the importance of political boundaries for many free-market democracies. The nations of Eastern Europe were in a highly transitional period during this time, which led to significant restructuring of trade relationships—including the diminishing intensity and importance of their economic ties with former economic union members.

Neoclassical economic theory states that market integration is rational because firms are able enjoy economies of scale and achieve greater levels of efficiency. Economic integration also rationalizes the production of goods and services and ultimately provides for a higher average standard of living and greater welfare in the long run due to increased levels of trade. Despite this economic rationale, many economic unions are splintering, although some try to maintain some of the benefits of integration. This paper will explore the costs of economic disintegration and its impact on trade patterns and intensity throughout Eastern Europe, looking at both the macroeconomic and firm level. This is the logical way to measure the effects of disintegration as trade is one of the main channels for the realization of the gains from economic integration. This paper aims to determine how businesses are coping with the erection of new borders, and the possible policy alternatives that could mitigate any resulting negative impacts.

While the level of trade flows has been measured for the former constituent members of the Soviet Union and Czechoslovakia by other researchers, this has been very difficult to carry out in Yugoslavia due to the lack of reliable data (except between Croatia and Slovenia). Further, the military conflict involvement and simultaneous transition to a free-market economy also complicate the picture. The case of Croatia is therefore given special attention in order to determine how the forces of disintegration have influenced individual firms. The difficulty of determining the specific effects of disintegration by evaluating economic data (which is largely unavailable) makes a qualitative study the optimal approach to this question. Managers of large firms were key informants in order to best discern the impact of the economic fragmentation on their organizations. The study will help determine if businesses have had to find new sources of
inputs or different markets for their goods since independence and also how their workers were affected. Considering the limited amount of research on this subject, particularly at the microeconomic level, it is important to note that this is an exploratory project.

This research model is subject to bias in many ways since this topic addresses sensitive issues of the war, as well as income, which many people may feel uncomfortable discussing openly. People are also reluctant to speak negatively about Croatia’s status as an independent nation, even if they believe their living standards or business conditions were better before disintegration, for fear of sounding unpatriotic. There may be additional cultural issues that I am unaware of that have affected this analysis. The strategy of snowball sampling could have easily resulted in informants with similar backgrounds, experiences and thoughts on certain topics. However, this approach seems the most effective and feasible given time, language, and budget constraints. The firms interviewed did represent different sectors, giving a broader significance to the results. It is also important to note that the firms interviewed were only the successful ones. Many other firms have closed in the wake of Yugoslav disintegration, so the sample is not entirely representative.

This paper is divided into three parts. Part One reviews the literature on economic integration theory and on empirical studies of the effects of economic integration in the European Union. Part Two acknowledges what limited research has been done on economic disintegration and reviews the literature on the cases of the Council for Mutual Economic Aid, the Soviet Union, Czechoslovakia, and Yugoslavia. Special attention was given to this final case, in which firm managers were interviewed to determine the specific effects of disintegration on businesses in Croatia. The paper culminates in Part Three with some general lessons about disintegration and possible policy recommendations that could ease the economic shocks of disintegration.

PART ONE: ECONOMIC INTEGRATION
THOUGHT ON ECONOMIC INTEGRATION

At the core of the idea of economic integration lies trade—the movement of goods, services, as well as people and capital across borders. The notion that trade is beneficial has been around at least since Adam Smith argued in *The Wealth of Nations* (1776) that a nation will trade when it has an absolute, or competitive, advantage in the production of a good. (That is, when the nation can produce the commodity cheaper than its trading partner.) International trade allows a firm to expand its market size so that it can reap the benefits of internal economies of scale. In 1817 David Ricardo reasoned that even if a nation has an absolute cost advantage in the production of all goods, it might still trade with others based on differences in relative internal economic capabilities. “A country has a comparative advantage for the purposes of trade in those commodities which its industry produces most cost effectively relative to other commodities” (Malizia and Feser, 1999, p. 153). In sum, international trade is not necessarily about competition, but rather about mutually beneficial exchange (Jovanović, 1998, p. 3).

Economic integration rationalizes the production of goods and services and ultimately provides a higher average standard of living and greater welfare in the future. However, the benefits of integration come in the long run, after a brief adjustment period, but are greater than the possible short-run costs (ibid).

Many economists argue that international economic integration is a particularly desirable strategy for small and medium-sized countries. In theory, large and developed countries such as the United States have a diversified economy, which allows them to follow autarchic economic policies. However, small countries, such as Croatia, are more dependent on external relations, so an autarchic policy is not economically rational for them in the long-term. Integration can serve as a reliable ‘insurance policy’ against sudden changes in the trading behavior of partner countries that they are highly dependent on. Such a policy would also provide an increase in business predictability, which has a potentially positive impact on domestic and foreign investment (ibid, p.1). Further, “the efficient operation of many modern technologies requires secure access to the widest market which does not exist in small, and sometimes medium-sized countries” (ibid, p. 3). Access to a larger market also

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The benefits of integration include:

- Enhanced efficiency in production made possible by increased specialization in accordance with the law of comparative advantage;
- Increased production levels due to better exploitation of economies of scale made possible by the increased size of the market;
- An improved international bargaining position, made possible by the larger size, leading to better terms of trade;
- Enforced changes in efficiency brought about by enhanced competition;
- Changes affecting both amount and quality of the factors of production due to technological advances, i.e. changes in the rate of growth. (El-Agraa, 1989, p. 344)
allows firms to gain economies of scale benefits, as well as a stronger international bargaining position on the terms of trade.

Economic integration itself, and not just trade, was not mentioned in the literature on the economic interrelationship between states until the 1940s. Viner was the first to lay the foundation for the theory of customs unions (1950), which represented the core of the traditional theory of international economic integration (Jovanović, p. 5). The concept evolved over the ensuing decades after much debate over the definition and what exactly was to be integrated. Tinbergen (1954) offered one of the first definitions of integration, maintaining that there are two parts to integration. **Negative** integration is the removal of discriminatory and restrictive institutions and the introduction of freedom for economic transactions, such as the removal of tariffs and quotas. **Positive** integration is the adjustment of existing policies and the establishment of new policies and institutions endowed with coercive powers, such as the introduction of common economic policies (ibid, p. 5). History has shown that negative integration is the easier of the two and is therefore generally the first step in increasing ties between nations, since positive integration infringes upon sensitive issues of national sovereignty. Most economic theorists agree that economic integration is a process by which a group of countries strives to increase its level of welfare through a weak or strong partnership between themselves and that this involves at least some division of labor and freedom of movement for goods and services within the group (ibid, p. 9).

There are five key theoretical types of economic integration, which are summarized in Table A. These types vary according to the degree or depth of integration they attain. These distinctions are an attempt to answer the question about what exactly is to be integrated—citizens, markets, production, consumption, commodities, services, regions, factors, money, resources, etc. Jovanović describes the main attributes of each type:

- **Free Trade Area:** An agreement among countries about the elimination of all tariff and quantitative restrictions on mutual trade. Every country in this area retains its own tariff and other regulation of trade with third countries. Usually has rules preventing trade deflection (the import of goods from a third country to country A which has a relatively lower tariff, and then re-exporting to partner country B). Free trade areas must address the problem of production deflection, which occurs if the production of goods that contain imported inputs is shifted to countries that have lower tariffs if the difference in tariffs offsets the difference in production costs.

- **Customs Union:** Participating countries not only remove tariff and quantitative restrictions on their internal trade, but also introduce a common external tariff on trade with third countries. The participating countries take part in international negotiations about trade and tariffs as a
single entity.

- **Common Market:** In addition to the requirements for a customs union, there is free mobility for the factors of production. Common regulations (restrictions) on the movement of factors with third countries are introduced.

- **Economic Union:** Assumes a common market and harmonization of monetary, fiscal (taxation and budgetary issues), industrial, transportation and regional policies.

- **Total Economic Union:** Consists of a union with a single economic policy and a supranational government with great economic authority. There are no administrative barriers to the movements of goods, services and factors, hence prices are equalized net of transport costs.

### Table A. Types of International Economic Integration

<table>
<thead>
<tr>
<th>Policy Action</th>
<th>Free Trade Area</th>
<th>Customs Union</th>
<th>Common Market</th>
<th>Economic Union</th>
<th>Total Economic Union</th>
</tr>
</thead>
<tbody>
<tr>
<td>Removal of tariffs and quotas</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Common external tariff</td>
<td>No</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Factor Mobility</td>
<td>No</td>
<td>No</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Harmonization of economic policies</td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Total unification of economic policies</td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>Yes</td>
</tr>
</tbody>
</table>

Source: Jovanović

### EMPIRICAL STUDIES OF ECONOMIC INTEGRATION

#### The European Union

The European Union (EU) is the largest and most recent example of economic integration. It consists of fifteen independent states in Western Europe and was founded to enhance political, economic and social co-operation. (See Table B for a list of EU members and their population.)

The EU was founded on November 1, 1993, and three new members (Austria, Finland, and Sweden) have joined since January 1, 1995. The EU’s predecessor, the European Economic Community (EEC), was established in 1957 upon the signing of the Treaty of Rome. The founding members included France, the Federal Republic of Germany, Italy, Belgium, the Netherlands and Luxembourg. In 1973 the United Kingdom, Ireland and Denmark joined.

### Table B. EU Countries and Population

<table>
<thead>
<tr>
<th></th>
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</tr>
</thead>
<tbody>
<tr>
<td>Austria</td>
<td>8.1 million</td>
</tr>
<tr>
<td>Belgium</td>
<td>10.2 million</td>
</tr>
<tr>
<td>Denmark</td>
<td>5.3 million</td>
</tr>
<tr>
<td>Finland</td>
<td>5.2 million</td>
</tr>
<tr>
<td>France</td>
<td>59.3 million</td>
</tr>
<tr>
<td>Germany</td>
<td>82.8 million</td>
</tr>
<tr>
<td>Greece</td>
<td>10.6 million</td>
</tr>
<tr>
<td>Ireland</td>
<td>3.8 million</td>
</tr>
<tr>
<td>Italy</td>
<td>57.6 million</td>
</tr>
<tr>
<td>Luxembourg</td>
<td>4.4 million</td>
</tr>
<tr>
<td>Netherlands</td>
<td>15.9 million</td>
</tr>
<tr>
<td>Portugal</td>
<td>10.0 million</td>
</tr>
<tr>
<td>Spain</td>
<td>40.0 million</td>
</tr>
<tr>
<td>Sweden</td>
<td>8.9 million</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>59.5 million</td>
</tr>
</tbody>
</table>

Source: CIA World Factbook
Economic integration was used after World War II to realize political goals, chiefly to anchor West Germany within the Western European alliance. Indeed, from the outset, the agenda of the EC included the idea of fostering political community through socio-economic integration, clearly demarcating it from other economic unions such as the North American Free Trade Agreement (Werner, 1996). Since World War II, the concept of cooperation has rapidly gained ground in Europe, calling for the reduction of economic disparities between regions and greater social unification. Consequently, cohesion and convergence have been the overarching objectives of Community policy.

**Impact**

Before this arrangement, European currencies were not convertible and domestic trade was highly protected. Intra-European trade was based on bilateral clearing arrangements institutionalized by the European Payments Union (McCauley, Sawyer, and Arestis, 1996). Since that time, the economies of member states have slowly integrated. By the end of the 1968, the customs union was completed—all import tariffs were removed, accomplishing Tinbergen’s negative integration. Table C shows that reciprocal trade between EC countries has constantly increased during this period. From 1960 to 1973 the trade between the six founding countries increased from 35 to 50%, in terms of the share of overall trade. Trade then stagnated until the mid 1980s, prompting steps toward further integration (Werner, 1996).

<table>
<thead>
<tr>
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<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>World EC</td>
<td>World EC</td>
<td>World EC</td>
<td>World EC</td>
<td>World EC</td>
</tr>
<tr>
<td>Belgium and Luxembourg</td>
<td>37.5</td>
<td>64.8</td>
<td>42.8</td>
<td>71.2</td>
<td>48.9</td>
</tr>
<tr>
<td>Denmark</td>
<td>27.0</td>
<td>52.3</td>
<td>23.4</td>
<td>46.7</td>
<td>25.3</td>
</tr>
<tr>
<td>Germany</td>
<td>15.9</td>
<td>44.8</td>
<td>17.6</td>
<td>50.9</td>
<td>20.4</td>
</tr>
<tr>
<td>Greece</td>
<td>12.7</td>
<td>50.6</td>
<td>12.7</td>
<td>53.4</td>
<td>17.6</td>
</tr>
<tr>
<td>Spain</td>
<td>8.1</td>
<td>47.8</td>
<td>9.2</td>
<td>44.4</td>
<td>11.2</td>
</tr>
<tr>
<td>France</td>
<td>11.0</td>
<td>45.8</td>
<td>12.5</td>
<td>57.2</td>
<td>16.6</td>
</tr>
<tr>
<td>Ireland</td>
<td>33.6</td>
<td>72.2</td>
<td>35.3</td>
<td>71.6</td>
<td>45.8</td>
</tr>
<tr>
<td>Italy</td>
<td>11.7</td>
<td>42.9</td>
<td>13.1</td>
<td>49.5</td>
<td>18.4</td>
</tr>
<tr>
<td>Netherlands</td>
<td>37.7</td>
<td>62.7</td>
<td>36.4</td>
<td>67.8</td>
<td>40.6</td>
</tr>
<tr>
<td>Portugal</td>
<td>19.8</td>
<td>48.3</td>
<td>20.3</td>
<td>49.6</td>
<td>22.2</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>16.0</td>
<td>26.7</td>
<td>16.7</td>
<td>31.2</td>
<td>22.3</td>
</tr>
<tr>
<td><strong>EC-12</strong></td>
<td>8.8</td>
<td>45.0</td>
<td>8.3</td>
<td>51.9</td>
<td>10.2</td>
</tr>
</tbody>
</table>

By the 1980s the expected benefits of the EEC had not fully materialized and new steps were decided on towards positive integration (Cecchini, 1988). Thus, the Internal Market Program (IMP) was launched by the Single European Act in 1986 to establish an area without internal frontiers, creating an area in which the circulation of goods, services, capital and labor is unimpeded. The significant non-tariff barriers to trade that remained, including varying technical standards for goods and different currency regulations for movements of capital, had inhibited integration from producing the desired levels of trade and economic growth (Werner, 1996). The EC Commission aimed to overcome these barriers with the aim of establishing the Single European Market in 1993. It required the harmonization of Community-wide policies, such as uniform trade and competition policies, standards and technical rules, as well as the facilitation of intra-Community mobility by promoting the mutual recognition of qualifications (ibid). The result was the formation of Jovanović’s economic union.

Currently, EU currencies are fully convertible. Capital controls, intra-EU tariffs and quotas have been eliminated (McCauley, Sawyer, and Arestis, 1996). The path of monetary union has gone through a number of stages that ultimately culminated in the Maastricht Treaty that laid out a precise path and timetable for economic and monetary union. The common currency was adopted on January 1, 1999 and will be used by 12 of the member countries on January 1, 2002, further facilitating cross-border transactions and reducing costs. However, the United Kingdom, Sweden and Denmark are slow to surrender their national currency because of the lack of control over monetary policy this would entail and also because it remains a powerful national symbol to some.

There were significant expectations of the benefits of the deepening integration. Many recent studies have attempted to determine if these results have materialized. A 1996 report on price competition and price convergence conducted an analysis of the overall trends in price dispersion in the EU. It found that, as expected, prices had tended to converge across the EU. There has been a general trend towards price convergence in the EU-12 (the original 12 members, before Sweden, Denmark and Austria joined) over the period 1980 to 1993 and this process prices has actually accelerated following the launch of the IMP (NTUA, CES and Middlesex University, 1996). The tendency for prices to converge has been comparatively greater in the three member states (Greece, Portugal and Spain) which joined the EC later than those in the EU-9, reflecting a “catch-up” effect of integration (ibid).
Table C shows that reciprocal trade between EC countries rose to 60% of the total amount by 1992, likely because of the increased integration efforts to facilitate trade. However, other researchers have determined, using the gravity model\(^1\), that the formation of free trade areas in Western Europe has had only a “moderate positive effect on trade flows” (Fidrmuc and Fidrmuc, 2000, p. 15). Nevertheless, they assert that this should not be interpreted as evidence of failure of EU integration, but is more likely a reflection of the ongoing process of global liberalization, which reduces the relative advantage of regional integration (ibid).

Additional studies have also noted that the nations of the EU saw improved economic conditions as the integration was deepened and trade increased, although perhaps not much above the normal level\(^2\) as found by Fidrmuc and Fidrmuc. In a European Commission white paper, the authors attempted to quantify the effects of all the measures designed to bring about a single market, noting that on average, econometric calculations show that the contribution of integration to economic growth has accounted for around 0.4 % of GDP per year in the period 1986 to 1992 (European Commission, 1993). Most European economies experienced an enhanced performance relative to the U.S. and Japan in the post-1987 period compared with the 1975 to 1987 experience (Fingleton, Lewney and Pinelli, 1996).

The poorest countries to join the EU to date have been Italy (1957), Ireland (1973), Greece (1981), Spain (1986) and Portugal (1986). Initially each of these additions caused fears of mass migrations in the wealthier countries, but these proved to be unfounded,\(^1\)

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\(^1\) The gravity model of trade relates bilateral trade between two countries to the distance between them and their economic sizes proxied usually by their gross outputs. It is also able to control for other factors affecting trade, such as business cycle effects, price level changes and global trade development.
as the economic situations improved in them. Of these countries, Ireland stands out as a remarkable success story. In the early 1970s, just before joining the then EEC, Ireland’s GDP per capita, adjusted for purchasing power parity, was only 61% of the EU-15 average; by 1990 it had reached 73%, and it is currently at 115% of the average, ranking third in the EU (see Table D) (The Economist, May 19-25 2001). In just 30 years the country overtook the majority of EU countries. However, Ireland’s economic boom is not due just to EU membership, as comparison with the other countries indicates. Greece joined the EEC with an income level of 69% of the community average, but this level has actually dropped to 67% (although in absolute terms the country is much better off) (ibid). Table D shows the dramatic differences in their growth rates after EU accession. Spain and Portugal have narrowed the gap with the EU average, but are still far below. Part of the Irish success story can be explained by the country’s good use of EU aid, ensuring that it was well-administered and went into infrastructure projects of lasting value (ibid). They also attracted many foreign investors who wanted to take advantage of the single market by cutting bureaucracy and corporate taxes. This indicates that integration alone will not lead to total convergence. Transfer payments and their effective use are also necessary to narrow the gap. The Economist also observed that Greece apart, the history of the EU since 1957 suggests that member states’ income levels do gradually converge, although some will always be higher than others.

There is additional evidence of a trend of convergence. The largest improvements in performance relative to the U.S. and Japan in the post-1987 period compared with the 1975 to 1987 period were in the worst-off countries (referred to as Objective 1), with the exception of Greece and southern Italy (Fingleton, Lewney and Pinelli, 1996). This again demonstrates the “catch-up” effect for most lagging regions. In the post-1987 period gross value added (GVA) per capita in Objective 1 and peripheral regions grew faster than over the period 1975 to 1987 (ibid). This contrasts with the growth in the better-off countries and non-peripheral regions, which was slower after 1987 than before. GVA per capita in Objective 2 (the next-to-worst) regions grew more slowly than in other regions, before and after the IMP (ibid). Border regions, which tended to grow slightly faster than interior regions prior to the IMP, increased their growth advantage after 1987, compared with interior regions, where growth slowed noticeably (ibid). Analysis of employment growth also shows that the worst-off, peripheral and border regions appear to have improved their position relative to the other regions in the post-1987 period with respect to the pre-1987 period. Regions specialized in manufacturing appear to have outperformed the other regions in the post-1987 period with respect to both GVA per capita and employment growth (ibid). This all indicates

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2 The normal level is the level predicted by the gravity model.
the significant advantages of integration and the “catch-up” effect that prompts growth in the poorer regions.

However, measures of inequality and clustering give an overall impression of a significant and enduring contrast between the richer core and poorer peripheral regions. Nonetheless, there is some indication of a trend towards lower inequality and lower clustering, but beginning long before the IMP (ibid). This indicates that some of the benefits of free trade, as well as development programs, were felt before the launch of the IMP. Others have argued that the theory of cumulative causation has prevailed and that the market dynamics emphasized in the EU tend to accentuate inequality. (Cumulative causation says that growth centers will continue to prosper because of their existent infrastructure and concentration of industries whose high-tech nature, capital intensity and cost structures ensure scale economies. This concentration diverts investment from poorer regions and attracts skilled labor, leaving the lagging regions in the underdevelopment trap.) Foreign direct investment has agglomerated in the increasingly wealthy regions, generally the capital cities, in the EU’s southern, poorer members (Greece, Spain and Portugal), thus having limited impact on the overall economies (Jaggi, 1996). Instead of workers moving to other EU members where there is demand, thereby alleviating unemployment in their native countries as neoclassical theory predicts, significant labor mobility has occurred mostly within these countries, as both skilled and unskilled workers have migrated to the prosperous industrial and commercial centers (ibid). Werner also found that persisting or even increasing gaps between low-income and high-income regions within member states tend to contain potential migration flows within individual member states, rather than inducing workers to migrate across national borders (Werner, 1996). This phenomenon has accentuated already wide disparities in income and living standards between the urban and peripheral areas. Skills, higher incomes and jobs become concentrated in industrial regions of the three nations, thereby depriving the struggling regions of human resources, demand and a tax-base (Jaggi). While integration has led to the increase of exports to northern EU countries from the south, the level of imports has outpaced this growth (ibid).

In order to alleviate these persistent problems, the EU has launched programs, such as the structural funds, to ease the effects of these losses on the struggling regions and provide infrastructure aid. In fact, due to the increased spending, industries related to infrastructure works in the worst-off countries greatly outperformed both their historical trends and the growth rates in other industries, over the post-1987 period (Fingleton, Lewney and Pinelli, 1996). However, these programs should not be seen as simply a transfer payment to ‘compensate the losers’, but as a long-
term strategy to foster technology transfer, encourage banking and commercial services, correct for infrastructure imbalances, and ensure human capital formation (Jaggi). They are essential to meet the EU’s social objectives of cohesion and convergence. As the case of Ireland demonstrated, it is the effective use of aid that fosters growth and ensures the realization of the benefits of integration.

This evidence points to the conclusion that there has been an overall increase in economic welfare in the EU due to its integration’s resultant increased levels of trade as well as convergence, as the theory on this subject indicated. However, not all regions or firms in all sectors have benefited. Due to the increased competition, many less-efficient firms will or have closed, and some poor regions will likely continue to suffer from out-migration and underinvestment, even with the assistance of the structural funds. Further, this is a long-term process and full benefits should not be expected immediately. The achievement of the gains of integration are also realized through transfer payments and effective economic development strategies, as the contrast between Greece and Ireland illustrates. Yet, as the research in this field indicates, there is a significant overall benefit, and the advantages will increase as the effects are further felt and as the short-term adjustment period ends. There are particular advantages for border regions, which profit from their new non-peripheral positions. Although the internal market has not reached its full potential, its credibility and irrevocability have exerted profound effects on business behavior (European Commission).
PART TWO: ECONOMIC DISINTEGRATION

THOUGHT ON ECONOMIC DISINTEGRATION

While there has been a fair amount written on economic integration theory, very little has been said about the converse situation—disintegration. With the end of the Cold War and revived nationalism throughout Eastern Europe, disintegration has been a powerful trend, deserving of more consideration. Neoclassical theory has had a difficult time addressing why countries disintegrate since theory presupposes rational behavior in individuals and organizations. History has shown that disintegration usually occurs due to an increasing dissatisfaction with social, political and economic conditions, often inciting resentment of transfer payments to worse-off regions or rekindling feelings of domination by another group. Further, the end of the age of empires has reduced the advantage of large unions as a form of protection. “Globalization,” or the increasing liberalization of trade worldwide, has also reduced the relative advantages of economic unions.

Fidrmuc and Fidrmuc (2000) are the only ones to have explored the cost of disintegration in Eastern Europe. They note that this lack of interest is likely due to the predominant orientation of economists on integration since it is more forward-looking. However, the cost of borders in general has been documented. Ricardo Hausmann, studying the effects of geography on development, noted that national borders make nations artificially more distant and accentuate transportation costs. Even within North America, simply crossing the U.S.-Canadian border is equivalent to adding from 4,000 to 16,000 kilometers worth of transportation costs (Hausmann, 2001). Indeed, “Canadian provinces trade 20 times more intensively with each other than with U.S. states, after controlling for distance and economic size, despite large extent of economic integration and the absence of linguistic and cultural barriers between these two countries” (Fidrmuc and Fidrmuc, 2000, p. 8). Borders clearly do matter for bilateral trade flows, even when they do not imply the imposition of explicit barriers to trade directly (ibid, p. 21). With this in mind, the “commercial logistics of trading between countries with weak political institutions and a history of cross-border animosity will prove to be infinitely more expensive problems for importers and exporters” (Hausmann). Further, borders also create serious challenges for coordinating infrastructure development, particularly when relations between two nations are strained, as is the case with many disintegrated unions, such as Yugoslavia. The costs of disintegration would therefore be expected to be quite profound.
The impact of economic break-ups depends on many factors indicating the level of integration, which Fidrmuc and Horváth outlined. The degree of inter-regional labor mobility partly reveals the level of social integration, as workers are more likely to move when there are fewer cultural and language barriers. Sufficiently high labor mobility within the union serves to mitigate the effects of uneven regional unemployment, since workers can then move to the jobs in other regions of the union. The diversification of industrial structure also predicts the impact of disintegration. The more diverse a region’s economy, the more able it is to act in an autarchic manner, and therefore the less likely it is to be dependent on trade with other regions. It is also less likely to be devastated by shocks to a single industry. Inter-regional fiscal transfers are also a common policy of federal governments that is abandoned when countries split, creating an incentive for disintegration for more developed countries, but a loss to the underdeveloped ones. The intensity of intratrade reveals the level of the potential disruption of firm linkages. An amiable split that results in fewer barriers to trade (i.e. maintaining free trade agreements) can reduce the impact of the loss. Finally, the degree of openness of the economy is also a predictor of the impact disintegration will have on trade patterns (Fidrmuc and Horváth, 1998). While this list is not exhaustive, it does describe the main issues that determine the impact of economic disintegration on the new nations’ trading patterns and intensity.

Very little has been written about the impacts of economic disintegration at the firm level. Depending on the level of disintegration and the policies implemented to ease the effects, such as maintaining free trade arrangements, the forward and backward linkages of firms can be expected to be disrupted. Firms may have to find new suppliers for their products. New barriers to trade may cause firms to no longer be able to compete in certain markets, and they may have to search for new ones. Further, the movement of capital and labor will be impeded by the new borders, making it increasingly difficult for the firms and workers to make the most efficient arrangements. Firms may also suffer from a lack of investment, while investors may settle for suboptimal situations.

**ECONOMIC DISINTEGRATION EMPIRICAL STUDIES**

**The Council for Mutual Economic Aid**
The Council for Mutual Economic Aid (CMEA or COMECON) was set up in 1949 consisting of six East European countries: Bulgaria, Czechoslovakia, Hungary, Poland, Romania, and the USSR, followed later by the German Democratic Republic (1950), Mongolia (1962), Cuba (1972), and
Vietnam (1978). A number of developing countries have attended as observers. Its aim was to
develop the member countries’ economies on a complementary basis for the purpose of achieving
self-sufficiency, by means of central planning. There was multilateral cooperation between
member states based on five-year plans and inconvertible rubles.\(^3\) In its first years CMEA did little
more than foster bilateral trade, but after the mid-1950s it promoted economic specialization among
its members. However, proposals for large-scale economic integration, favored by the Soviet
Union, met stiff opposition from some countries, especially Hungary and Romania, which feared
domination by more industrialized members.\(^4\) Firms in these centrally planned states could not
export or import without authorization of the State Foreign Trade Organizations organized by
industry (Maurel and Cheikbossian, 1998). (However, the situation was different for the more
market influenced economies of Yugoslavia, which became a partial CMEA member in 1964, and
later in Hungary.) Firms sold their outputs valued at domestic prices to the Export State Agencies,
which traded with foreign partners at world prices. A symmetric system applied for imports.
These State Foreign Trade Organizations were not profit maximizers, but they had to reach targets,
for exports and imports, established by central planning. Moreover, since the internal price system
had not relationship to domestic costs, and since the ruble was inconvertible, the existence of these
organizations was justified (ibid).

In 1990 agreement was reached for a fundamental change in the economic policy pursued
by the CMEA and a free market, bilateral trade and convertible currencies were embraced. A
transitional period was expected to be required by members to accommodate this change in policy.
Rapid political and economic changes in the Communist world in 1991 led to the dissolution of
CMEA, which the new non-communist governments of Eastern Europe saw as an outmoded
instrument of Soviet domination. CMEA was then replaced by the Organization for International
Economic Cooperation, which would continue to encourage international trade between the
member countries on a bilateral basis and offer advice and information on regional economic
problems.\(^5\) However, the new East European leaders rejected continued cooperation with the
Soviet Union in large part because they believed it would slow the transition to a market economy
and integration with Europe.\(^6\) The Organization for International Economic Cooperation has
therefore been largely ineffective and there is no comparable successor to the CMEA.

\(^3\) http://ps.ucdavis.edu/classes/ire001/econ/comecon.htm
\(^4\) http://encarta.msn.com
\(^5\) http://ps.ucdavis.edu/classes/ire001/econ/comecon.htm
**Impact**

The deep social and economic structural differences between Eastern and Western Europe depressed the level of trade between them during the communist era, biasing upward intra-CMEA trade. However, the break-up of the CMEA brought about the collapse of trade within the area and was accompanied by a full-scale geographical reorientation of international trade from East to West. The liberalization of foreign trade in most former CMEA countries has been radical in both scope and in speed (Maurel and Cheikbossian, 1998). As the State Foreign Trade Agencies broke up, quotas were eliminated or reduced in the countries, giving them new trade policy tools. Trade was redirected toward wealthier, nearby Western European markets. The EU eliminated all tariffs for most of these nations, except in ‘sensitive sectors’, such as agriculture, industry or textiles (ibid). These restrictions have resulted in little change in the structure of trade, despite the increase in flows, thus the changes have not improved the comparative advantages of former-CMEA countries (ibid). However, the other preferential arrangements for East-West trade have diverted regional trade flows. The Central European Free Trade Agreement7 (CEFTA) was formed in December 1992 in response to this trend. Its goal was to eliminate trade barriers among the countries involved in the agreement, and to eliminate discrimination against intra-former CMEA trade compared with the EU.

Maurel and Cheikbossian observed that until 1990 trade between Eastern and Western Europe was below the normal level that the gravity model would predict. They also found that there has been a decrease in the level of intra-CMEA trade that is more than proportional to the drop in GNP contraction, indicating the CMEA trade collapse that is widely-held to be true. Despite the regional collapse and the reorientation of trade, the intra-CMEA trade remains above the normal level, and the normal levels of East-West trade have not yet been reached. *The Economist* also noted that East-West trade is at only half the normal level (May 19-25 2001). Maurel and Cheikbossian argue that the restrictive policy regarding ‘sensitive sectors’ does not allow former CMEA countries to export sufficiently in the sectors of their expected comparative advantages. However, former CMEA countries have higher than average transportation costs and that by taking this into account, the normal level of trade has already been reached with Germany, the main partner of Central and Eastern Europe (ibid). While trade potential remains with other EU countries, reducing the high regional transportation costs is necessary to increase the ultimate potential and realize significant economic gains.

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6 http://encarta.msn.com
The higher than average transportation costs among former CMEA countries can be explained by the fact that under the centrally-planned system shipment costs were not taken into account. The statistics indicate that this absence of geography in CMEA trade implies (paradoxically) higher transportation costs (Maurel and Cheikbossian). This paradox can be explained by noting that trade within the CMEA occurred largely on a bilateral basis with the USSR, while now the EU turns out to be a very attractive center for the Eastern European periphery (ibid). Thus, the structure of ‘hub and spoke bilateralism’ has remained, but the center has changed from the Soviet Union to the European Union. (*Hub and spoke bilateralism* explains that the creation of a trade network which originates from the center diverts trade flows in the periphery, and is responsible for the paradox that geographically close countries do not trade as much as expected.) The preference for EU markets is due to the view of trade with Western markets as a powerful tool of market restructuring, through the importation of a rational system of relative prices. Further, the wealthier EU countries have more money available to invest in the capital-starved countries of Eastern Europe.

### Table E. GDP (% change) for certain Former CMEA Members

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</tr>
</thead>
<tbody>
<tr>
<td>Bulgaria</td>
<td>-9.1</td>
<td>-11.7</td>
<td>-7.3</td>
<td>-1.5</td>
<td>1.8</td>
<td>2.9</td>
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<td>-7.0</td>
<td>3.5</td>
<td>2.4</td>
<td>na</td>
</tr>
<tr>
<td>Czech Rep</td>
<td>-1.2</td>
<td>-11.5</td>
<td>-3.3</td>
<td>0.1</td>
<td>2.2</td>
<td>5.9</td>
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<td>-1.0</td>
<td>-2.2</td>
<td>-0.2</td>
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</tr>
<tr>
<td>Hungary</td>
<td>-3.5</td>
<td>-11.9</td>
<td>-3.1</td>
<td>-0.6</td>
<td>2.9</td>
<td>1.5</td>
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<td>4.6</td>
<td>4.9</td>
<td>4.5</td>
<td>5.3</td>
</tr>
<tr>
<td>Poland</td>
<td>-11.6</td>
<td>-7.0</td>
<td>2.6</td>
<td>3.8</td>
<td>5.2</td>
<td>7.0</td>
<td>6.0</td>
<td>6.8</td>
<td>4.8</td>
<td>4.1</td>
<td>4.1</td>
</tr>
<tr>
<td>Romania</td>
<td>-5.6</td>
<td>-12.9</td>
<td>-8.8</td>
<td>1.5</td>
<td>3.9</td>
<td>7.1</td>
<td>3.0</td>
<td>-6.9</td>
<td>-5.4</td>
<td>-3.2</td>
<td>1.6</td>
</tr>
<tr>
<td>Slovak Rep</td>
<td>-2.5</td>
<td>-14.6</td>
<td>-6.5</td>
<td>-3.7</td>
<td>4.9</td>
<td>6.7</td>
<td>6.2</td>
<td>6.2</td>
<td>4.4</td>
<td>1.9</td>
<td>2.2</td>
</tr>
</tbody>
</table>

Source: Business Central Europe

Ultimately, the disintegration of CMEA has proved to be welfare improving for most of the nations of the former trading bloc. Table E shows that GDP in the countries has stabilized after the readjustment crisis in the early 1990s and begun steady growth, although this was also affected by the transition to a free market system. Intra-CMEA trade did not compensate for the destruction of trade with Western Europe under the centrally planned system. During the transition period of 1990 to 1992 there was a net loss of trade for CMEA countries, since the regional trade collapse was not compensated by a large enough reorientation with the rest of the world (Maurel and Cheikbossian). However, by 1993 the situation had improved and trade creation seems to increase yearly, with respect to both trade diversion and external trade diversion. Further, Table F demonstrates that the amount of foreign direct investment has been rapidly increasing in the more

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7 The members include Slovenia, Czech Republic, Slovak Republic, Poland, Romania, Bulgaria, and Hungary.
stable nations of Central Europe, fomenting additional economic growth. The EU as a key partner in trade and investment has proved to be more beneficial than the USSR, despite the barriers to trading in the ‘sensitive sectors’ that has not enabled the former CMEA countries to maximize the benefits of their comparative advantages.

The Union of Soviet Socialist Republics

The defeat of the Russian Empire in World War I led to the seizure of power by the communists and the formation of the Union of Soviet Socialist Republics (USSR, or Soviet Union) in 1922, creating the first nation based on Marxist socialism. The brutal rule of Josef Stalin, which lasted from 1924 to 1953, strengthened Russian dominance of the Soviet Union at a cost of tens of millions of lives (CIA world factbook). Politically the USSR was divided from 1940 to 1991 into 15 constituent or union republics, which were formally joined in a federal union, but until the final year or so of the USSR’s existence the republics had little real power. (See Table G for a list of the republics and basic descriptive statistics, and Figure 1 for a map of the region.) Until 1989 the Communist party indirectly controlled all levels of government and the party’s politburo effectively ruled the country (ibid). Soviet industry was owned and managed by the state, and agricultural land was divided into state farms, collective farms, and small, privately held plots. General Secretary Mikhail Gorbachev, who held power from 1985 to 1991, introduced fundamental changes to the Soviet system, including glasnost (openness) and perestroika (restructuring) in an attempt to modernize communism. However, his initiatives inadvertently released forces that by December 1991 broke up the USSR into 15

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**Table F. Foreign direct investment stock ($bn) for certain Former CMEA Members**

<table>
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<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Bulgaria</td>
<td>0.0</td>
<td>0.1</td>
<td>0.1</td>
<td>0.2</td>
<td>0.3</td>
<td>0.4</td>
<td>1.0</td>
<td>1.5</td>
<td>2.3</td>
<td>3.9</td>
<td></td>
</tr>
<tr>
<td>Czech Rep</td>
<td>0.0</td>
<td>0.6</td>
<td>2.9</td>
<td>3.6</td>
<td>4.5</td>
<td>7.1</td>
<td>8.5</td>
<td>9.8</td>
<td>12.5</td>
<td>17.5</td>
<td>na</td>
</tr>
<tr>
<td>Hungary</td>
<td>0.6</td>
<td>2.1</td>
<td>3.6</td>
<td>5.6</td>
<td>7.1</td>
<td>11.9</td>
<td>15.0</td>
<td>16.1</td>
<td>17.5</td>
<td>19.3</td>
<td>20.2</td>
</tr>
<tr>
<td>Poland</td>
<td>0.1</td>
<td>0.4</td>
<td>1.4</td>
<td>2.3</td>
<td>3.8</td>
<td>7.8</td>
<td>11.5</td>
<td>14.6</td>
<td>22.5</td>
<td>28.0</td>
<td>na</td>
</tr>
<tr>
<td>Romania</td>
<td>0.0</td>
<td>0.0</td>
<td>0.1</td>
<td>0.2</td>
<td>0.6</td>
<td>1.0</td>
<td>1.2</td>
<td>2.4</td>
<td>4.5</td>
<td>5.4</td>
<td>na</td>
</tr>
<tr>
<td>Slovak Rep</td>
<td>na</td>
<td>na</td>
<td>0.1</td>
<td>0.2</td>
<td>0.6</td>
<td>1.0</td>
<td>1.2</td>
<td>2.4</td>
<td>4.5</td>
<td>5.4</td>
<td>na</td>
</tr>
</tbody>
</table>

Source: Business Central Europe

**Table G. Descriptive Statistics on Former Soviet Republics**

<table>
<thead>
<tr>
<th>Country</th>
<th>Population (2000 est.)</th>
<th>GDP per capita (PPP) (1999 est.)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Armenia</td>
<td>3.4 million</td>
<td>$2,900</td>
</tr>
<tr>
<td>Azerbaijan</td>
<td>7.7 million</td>
<td>$1,770</td>
</tr>
<tr>
<td>Belarus</td>
<td>10.4 million</td>
<td>$5,300</td>
</tr>
<tr>
<td>Estonia</td>
<td>1.4 million</td>
<td>$5,600</td>
</tr>
<tr>
<td>Georgia</td>
<td>5 million</td>
<td>$2,300</td>
</tr>
<tr>
<td>Kazakhstan</td>
<td>16.7 million</td>
<td>$3,200</td>
</tr>
<tr>
<td>Kyrgyzstan</td>
<td>4.7 million</td>
<td>$2,300</td>
</tr>
<tr>
<td>Latvia</td>
<td>2.4 million</td>
<td>$4,200</td>
</tr>
<tr>
<td>Lithuania</td>
<td>3.6 million</td>
<td>$4,800</td>
</tr>
<tr>
<td>Moldova</td>
<td>4.4 million</td>
<td>$2,200</td>
</tr>
<tr>
<td>Russia</td>
<td>146 million</td>
<td>$4,200</td>
</tr>
<tr>
<td>Tajikistan</td>
<td>6.4 million</td>
<td>$1,020</td>
</tr>
<tr>
<td>Turkmenistan</td>
<td>4.5 million</td>
<td>$1,800</td>
</tr>
<tr>
<td>Ukraine</td>
<td>49 million</td>
<td>$2,200</td>
</tr>
<tr>
<td>Uzbekistan</td>
<td>24.7 million</td>
<td>$2,500</td>
</tr>
</tbody>
</table>

Source: CIA World Factbook
independent republics (ibid). Since then, Russia and the other fledgling republics have struggled in their efforts to build a democratic political system and market economy to replace the centralized controls of the communist period, as well as to embark on nation-building activities.

**Impact**

The former Soviet republics have faced great difficulty in establishing modern market economies and achieving strong economic growth. Russian GDP has contracted an estimated 45% since 1991, despite the country’s wealth of natural resources, its well-educated population, and its diverse, but increasingly dilapidated, industrial base (ibid). Drastic inflation has caused ordinary people find their wages falling by roughly 30% and their pensions by 45% (ibid). The situation is even bleaker for the other former Soviet republics that had very limited political infrastructure in place and far less diversified economies because of their smaller sizes and the legacy of Soviet central planning. Table H shows that Ukraine in particular has suffered since Soviet disintegration, and the Baltics\(^8\) and Russia initially faltered, but have recovered in terms of GDP. While these losses in the standard of living, and indeed loss of growth that Western European countries enjoyed during this

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\(^8\) Estonia, Latvia and Lithuania
period, are not entirely due to the disintegration of the USSR, this has clearly played a significant role, in addition to the transition to a market economy.

Table H. GDP per capita (PPP) ($) for certain Soviet republics

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</thead>
<tbody>
<tr>
<td>Estonia</td>
<td>4778</td>
<td>4433</td>
<td>3992</td>
<td>3803</td>
<td>3834</td>
<td>4171</td>
<td>4449</td>
<td>5082</td>
<td>5456</td>
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<td>na</td>
</tr>
<tr>
<td>Latvia</td>
<td>5472</td>
<td>5118</td>
<td>3463</td>
<td>3070</td>
<td>3213</td>
<td>3312</td>
<td>3515</td>
<td>3920</td>
<td>4136</td>
<td>na</td>
<td>na</td>
</tr>
<tr>
<td>Lithuania</td>
<td>na</td>
<td>na</td>
<td>3681</td>
<td>3409</td>
<td>3612</td>
<td>3853</td>
<td>4164</td>
<td>4425</td>
<td>na</td>
<td>na</td>
<td>na</td>
</tr>
<tr>
<td>Russia</td>
<td>5995</td>
<td>5845</td>
<td>5313</td>
<td>5009</td>
<td>4479</td>
<td>6630</td>
<td>6590</td>
<td>6760</td>
<td>6580</td>
<td>6900</td>
<td>7620</td>
</tr>
<tr>
<td>Ukraine</td>
<td>4490</td>
<td>4069</td>
<td>3720</td>
<td>3299</td>
<td>3900</td>
<td>3576</td>
<td>3339</td>
<td>3333</td>
<td>3310</td>
<td>3350</td>
<td>na</td>
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</tbody>
</table>

Source: Business Central Europe

Many of the smaller republics enjoyed inter-regional fiscal transfers from Russia and the other well-developed republics, such as the Baltics, in the Communist era. The four Central Asian republics, the poorest in the union, received substantial transfers of income through the fiscal system, which limited the dispersion on consumption standards among the 15 republics (Williamson, 1993, pg. 623). However, this aid was lost with disintegration, creating a significant drawback for the lesser-developed republics, but a benefit for the wealthier ones who were no longer subject to such broad redistributive convergence programs.

The impact of disintegration has also been affected by the intensity of mutual trade. The new market-determined trade relationships between independent states has not continued with the same intensity or in the same direction as that inherited from the Soviet centrally planned system. In 1993 Williamson noted that in the long run, the total volume of trade is likely to decline, and that there would be a dramatic shift in the composition of trade, with much less intratrade among the former Soviet republics than before and much more trade between each of them and the West (Williamson, p. 600). This reorientation of trade patterns is not surprising since the prior centrally planned trade arrangements were not necessarily optimal. For example, while the four Central Asian republics received fiscal transfers, they were damaged by the internal price structure of the Soviet Union, and were therefore expected to benefit from improved terms of trade as a result of the shift to world prices (ibid, p. 623). Indeed, these suboptimal links were significantly eroded with increasing trade openness and introduction of market forces. Fidrmuc and Fidrmuc found that the intensity of trade relations among the Baltic States in 1992 was 40 times the normal level and that this dropped to around 12 time the normal level in 1994. However, trade intensity increased again to more than 20 times the normal level between 1995 and 1997 (Fidrmuc and Fidrmuc, p. 19). It has since leveled out at around 13 times the normal level, likely due to Estonia’s inclusion

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9 Kyrgyzstan, Tajikistan, Uzbekistan and Turkmenistan
in the first wave of EU accession negotiations and the negative opinion of the European Commission regarding non-standard trade relations of potential new members with states not in the EU (ibid). Table I indicates that the Baltics have increased their exports over this period, likely benefiting from their cross-border ties with Western Europe (through Finland), as well their relatively advanced level of development.

### Table I. Exports ($bn) for certain Soviet republics

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</thead>
<tbody>
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<td>Estonia</td>
<td>na</td>
<td>na</td>
<td>0.5</td>
<td>0.8</td>
<td>1.3</td>
<td>1.9</td>
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<td>2.8</td>
<td>3.2</td>
<td>2.4</td>
<td>3.2</td>
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<td>Latvia</td>
<td>na</td>
<td>na</td>
<td>0.8</td>
<td>1.1</td>
<td>1.0</td>
<td>1.4</td>
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<td>1.8</td>
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<td>2.0</td>
<td>2.7</td>
<td>3.4</td>
<td>3.9</td>
<td>3.7</td>
<td>3.0</td>
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</tr>
<tr>
<td>Russia</td>
<td>48.8</td>
<td>50.9</td>
<td>53.6</td>
<td>58.3</td>
<td>69.6</td>
<td>81.1</td>
<td>88.6</td>
<td>88.3</td>
<td>74.2</td>
<td>74.4</td>
<td>105.2</td>
</tr>
<tr>
<td>Ukraine</td>
<td>na</td>
<td>50.0</td>
<td>11.3</td>
<td>12.8</td>
<td>10.3</td>
<td>13.1</td>
<td>14.4</td>
<td>14.2</td>
<td>12.6</td>
<td>11.6</td>
<td>na</td>
</tr>
</tbody>
</table>

Source: Business Central Europe

Similarly, Fidrmuc and Fidrmuc found that trade relations among Belarus, Russia and Ukraine followed a U-shaped pattern, as shown in Figure 2. Their trade intensity was also approximately 40 times the normal level in 1992. Disintegration decreased this amount to about eight times the normal level in 1997, but then rose again to more than 30 times the normal level in 1998 (ibid). This is likely due to the Russian financial crisis, which caused a breakdown of trade between the former Soviet Republics and Western countries and consequently the rise of relative importance of trade within the former Soviet Union (ibid). In addition, Russian-Belorussian efforts to re-integrate may have also affected the intensity of trade levels. Table I shows that while exports from Russia have grown (likely due to high oil prices in 2000), Ukraine has not recovered from the shocks of disintegration.

This decline in intratrade and shift to other countries also likely represents an attempt by the smaller republics to attain more favorable terms of trade, as well as to diversify their economies once the central planning structure that enforced their specializations was removed. Trofimov argues that the initially more developed country in a trade arrangement possesses a greater variety of intermediate factors, and its manufacturing sector is more efficient. Trade therefore results in the more advanced country producing more manufactured goods than its trade partner, unless
sufficient technology transfers occur (Trofimov, 1997). The poorer region ends up importing manufactured goods from and exporting basic resources to the more advanced country. In the long run the underdeveloped country may not lose in terms of welfare but may fall into the ‘underdevelopment trap’ (ibid). This may well be the case of many of the smaller former Soviet republics, especially those in Central Asia. Once exposed to the free market, these nations sought to further diversify their economic structure, not least because the trade links they had depended on were disrupted by the economic shocks following the break-up.

Throughout the USSR’s history, the degree of inter-regional labor mobility was influenced by many forces. While Russian language dominated throughout the USSR, most of the other Soviet republics had their own distinct languages, cultures and differing religions. However, these were suppressed throughout the communist period, which enabled the greater mobility of labor. Since 1985 there have been many structural shifts in the economy, creating uneven unemployment levels, which has increased the rate of occupational reallocation (Sabirianova, 2000, p. 29). Structural shifts, such as those caused by disintegration and the restructuring process, could even induce people to change their career despite a good occupational match or a well-established career. Further, downward occupational mobility is also a common labor response to negative demand shocks and poor firm performance—workers often react by choosing occupations with lower skill requirements since they have lower investment costs. In addition, local labor market conditions, which reflect an uneven speed of structural changes and unequal outside opportunities across regions, are critical determinants of occupational shifts (ibid). The push factor of high regional unemployment seems to be the most powerful cause of increased mobility.

**Policy**

In order to lessen the impact of the USSR’s disintegration, the Commonwealth of Independent States (CIS) was founded. The CIS is a community of independent nations established by a treaty signed on December 8, 1991, by the heads of state of Russia, Belarus, and Ukraine. By 1993 all of the former republics of the USSR except the Baltic states had become members. The organization was conceived as the successor to the USSR in its role of coordinating the foreign and economic policies of its member nations. The treaty recognized current borders and each republic’s independence, sovereignty, and equality, and established a free-market area embracing the republics’ interdependent economies and a joint defense force for participating republics.¹⁰

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However, the republics’ level of receptivity to integration with Russia has varied. All CIS nations now have their own currency, despite initial attempts to share a currency, and most members have criticized Russia for slow implementation of CIS agreements (ibid). Belarus has strengthened ties with Russia, signing a treaty to coordinate their defense and foreign policy apparatus and to eliminate trade restrictions and eventually unite their currencies in 1996. The two nations have since signed several follow-up agreements, but actual progress toward integration has been slow. In addition to Russia and Belarus, Kazakhstan (which has a large Russian community), and Kyrgyzstan also agreed to pursue economic integration without customs restrictions; an eventual customs union including additional CIS nations is planned, but again, little has been accomplished to date (ibid).

Nearly a decade after its creation, observers have noted that the CIS has failed to integrate the Soviet successor states in any meaningful sense. “Although, on paper, it has been the forum for several ambitious projects of cooperation, in reality the CIS has been gradually emptied of responsibility and has been witness to a diminishing base of collaborative activities” (Webber, 1999). The CIS has not met any of the expectations: it has not become the successor state to the USSR, and there is no Commonwealth citizenship, no standing joint armed forces and no common currency (ibid). Instead, there are divergent processes of state formation, nation building, economic diversification and foreign policies in constant uncomfortable interaction with one another (ibid). However, the organization has been successful in one key area—avoiding conflict and the total breakdown of links between the successor states. While the CIS’s founders had endeavored to facilitate the realization of more equitable and mutually beneficial economic cooperation, the political stability it contributed to is still a significant accomplishment. The post-Soviet space has been characterized by an increasing diversity of ties below the ambitious infrastructure of the 12-member CIS, forged through sub-regional and bilateral channels (ibid). The polarization of opinion among the member states of the CIS has clearly debilitated the organization.

Further, lack of CIS membership has not stopped trade relations between the Baltics and the other former Soviet republics. Alexseev and Vagin found that cross-border relations between the Baltics and the Russian city of Pskov remain of primary importance to the Russian city, despite their lack of CIS membership (1999). Agency policies at different levels of government in Estonia and Latvia (especially those with financing or prospects of financing from European institutions) have offered their Pskov counterparts tangible benefits that could not be matched by the Russian
federal center. A network of relations has been emerging between these officials in Pskov and in the Baltic states to deal with specific economic and trade issues in cross-border areas, marginalizing geopolitical tensions. The growth and internationalization of private business in Russia and the Baltic states, particularly in the oil and transit sectors, created a whole new layer of actors that did not exist in Soviet times and that now play a role in shaping regional development strategies in Russia (ibid). “The geoeconomics of oil and gas shipments through Russia’s northwest to the Baltic Sea and the converging interests of companies suggest that Pskov would be better off participating in a new Hanseatic League than withdrawing into Fortress Russia” (ibid).

**Czechoslovakia**

In the early 9th century the Czech and Slovak tribes formed the Greater Moravian Empire which covered Central Europe. In 906 the Empire was conquered and the Slovaks were ruled by the Hungarians for the next 1000 years. The rise of Bohemia continued for the ensuing 400 years as a kingdom under Czech rule and grew to include parts of Austria, Poland and Germany. Bohemia reached its cultural and political peak under Charles IV, who ruled from 1346 to 1378 and was crowned the Holy Roman Emperor, making Prague the empire’s leading city. This period was followed by 40 years of religious wars. In 1526 the weakened kingdom elected the Habsburgs to the Czech throne and for the next 300 years Bohemia was part of the Austrian empire. In 1618 the Czech Protestants revolted against the Habsburg rule, which touched off the Thirty Years’ War, a series of wars that spread throughout Europe. During this time the Habsburg armies defeated Bohemia and the country lost self-governing power. Both Slovakia and the Czech regions regained their independence in 1918 and formed Czechoslovakia. The two were separated from 1938 to 1945, but after World War II they were once again united and became a communist nation under the Soviet sphere. With the collapse of Soviet authority in 1989, Czechoslovakia regained its freedom through the peaceful “Velvet Revolution.” In 1993, the country underwent a “velvet divorce” into its two national components, the Czech and Slovak Republics. (Please see Table J for basic descriptive statistics and Figure 3 for a map of the region.) This break-up was two-fold: on January 1, the country disintegrated as a political union, while preserving an economic and monetary union to lessen the negative impact of disintegration. However, the Czech-Slovak monetary union collapsed just a few weeks later on February 8.
The velvet divorce was largely a result of the economic structural differences between the two parts, and the subsequent desired course of action, despite remarkable economic, social and demographic convergence during the communist period (Fidrmuc and Horváth, 1998). These differences were revealed by the unequal distribution of costs and benefits of the post-communist economic reform. Slovaks viewed the communist rule positively since they had benefited from the period’s industrialization, urbanization and economic growth, which resulted in greater convergence with the more advanced Czech Republic and a greatly improved standard of living (Hilde, 1999). In contrast, Czechs viewed the communist period as a time of great political repression and economic stagnation and were consequently enjoying the post-communist changes. Bohemia alone received 80 to 90% of foreign direct investment in 1991, causing many Slovaks to think the federal government was failing to advance their interests (ibid).

It is therefore not surprising that the two republics would choose different economic policies, which is what ultimately led to the disintegration of Czechoslovakia.

**Impact**

The extent of mutual trade between the Czech and Slovak Republics was and has remained relatively high, although the Slovak Republic is more dependent due to its smaller size. In 1991 the Czech Republic accounted for half of Slovak exports and imports, while the Slovak Republic accounted for about a third of Czech trade (Fidrmuc and Horváth, 1998). After the break-up, the
share of Slovak trade with the Czech Republic fell to 31% of exports and 25% of imports. Czech trade with the Slovak Republic declined to 14% of exports and 10% of imports (ibid). Mutual trade fell substantially in 1992 and 1993, but then leveled by the customs union. The gravity model that the trade level within Czechoslovakia exceeded the normal level by nearly 40 times (Fidrmuc and Fidrmuc, p. 18). However, this level dropped considerably during the first two years after the split and was at seven times the normal level in 1998 (see figure 4). Nevertheless, this level of trade intensity far exceeds that measured within the EU, even though the customs union between the Czech and Slovak Republics is largely comparable to trade liberalization within the EU (ibid, p. 19). Since the split, both countries have increased their trade with the larger, wealthier markets of Western Europe, which they border since these levels were below normal due to the previous influences of intratrade and trade with CMEA countries. A further decline in bilateral trade intensity between the two former constituent members is to be expected if the custom union is dissolved after Czech accession to the EU.

As noted, the two republics had varying levels of industrial structure diversification, which caused different impacts of the break-up. The Slovak Republic was more concentrated on exports biased toward manufactured products with relatively low value-added, as well as heavy engineering, metallurgy, and chemical industry, which made it more dependent on trade with CMEA countries. This made the Slovak Republic more susceptible to the shocks of restructuring that the whole region underwent, ultimately leading to the fundamental disagreement on economic policy, and the split (Fidrmuc and Fidrmuc, p. 10). Table K shows how the Slovak Republic’s level of exports has not grown in at the same rate as the Czech Republic’s since the end of the Cold War.

| Table K. Exports (Sbn) for Czech and Slovak Republics |
|---------------------------------------------|-------|-------|-------|-------|-------|-------|-------|-------|-------|-------|
| Czech Rep.               | 5.9   | 8.3   | 8.4   | 13.0  | 14.0  | 21.6  | 21.9  | 22.8  | 26.3  | 26.9  | 28.9  |
| Slovak Rep.             | 5.8   | 3.3   | 3.7   | 5.5   | 6.7   | 8.6   | 8.8   | 8.3   | 10.7  | 10.2  | 13.1  |

Source: Business Central Europe
Throughout its post-war history, there was a significant net transfer of funds from the Czech Republic to the Slovak Republic, largely in the form of federal tax revenue redistribution. Estimates of the size of the transfer in 1992 vary from 4.4 to 8% of Slovak GDP. Fiscal transfers had a large influence on the convergence of per capita income within the former federation—the gap fell from 40% in 1948 to 13% in 1988 (Fidrmuc and Fidrmuc, p. 12). The size of the net transfer increased throughout the transition period due to the asymmetric impact of reform-induced recession. However, this aid dried up with the split, creating an additional blow to the Slovak economy, but benefiting the Czechs. The Slovak Republic was at a further disadvantage for lacking the political infrastructure that the Czechs had in Prague. The initial shock of disintegration resulted in a budget deficit of 7% of GDP for the Slovak Republic (Business Central Europe).

**Policy**

By initially preserving the economic union, including a common currency, customs union and common labor market, despite the political separation, the two republics were trying mitigate the economic effects of the break-up. However, the brief life span of the monetary union reveals that monetary union was marred by low credibility, lack of political commitment, low exit costs, and the absence of fiscal transfers (Fidrmuc and Horváth). The benefits of a single currency rise with the volume of trade, which remains significant between the two countries. While Czechoslovakia could be considered an optimum currency area, it was in fact less integrated than some other existing unions, which facilitated the split. Further, the additional pressure on the Slovak economy due to the end of fiscal transfers ultimately created the need to resort to monetary policy to counter the effects. (Slovak inflation reached 23% in 1993, according to Business Central Europe). “In the absence of fiscal transfers, and given continuing economic decline and persisting unemployment differences between the two republics, monetary union would have been costly for the Slovak Republic even in the short run” (Fidrmuc and Horváth). “In fact, the costs of the break-up of Czechoslovakia and dissolution of the monetary union were relatively low, even in the short-run. It seems that in the world of free-trade, small countries and regions benefit since the importance of political boundaries declines” (ibid, p. 17).

Despite the free labor area that two republics retained, there was not an increase in labor mobility, and therefore this policy did not alleviate the situation in the Slovak Republic after the break-up. Sufficiently high labor mobility within the union serves to mitigate the effects of
asymmetric shocks, since workers can then move to the jobs in other regions of the union. While there were no formal barriers to mobility in the Czech and Slovak Republics, and language, cultural and religious ones were minimal, labor mobility was not high as revealed by regions suffering from persistently higher unemployment in the Slovak Republic. Research has indicated that while labor mobility did serve to reduce the impacts of asymmetric shocks in 1992, the amount was very modest, and therefore not very efficient (Fidrmuc and Fidrmuc, p. 11). Table L shows that unemployment remains markedly higher in the Slovak Republic, despite the opportunities to move to more prosperous regions. In fact, people are far more rooted in their communities than economic theory allows for. *The Economist* observed that “Poor Central Europeans may also be more reluctant to uproot themselves than is often assumed. Even within countries, populations can be strikingly immobile. In the Czech Republic and Hungary, the capitals... are booming, whereas other parts of the country have high unemployment. But there has been no mass migration to the cities” (*The Economist*, April 21-27 2001, p. 25).

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<th></th>
</tr>
</thead>
<tbody>
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<td>Czech Rep.</td>
<td>0.8</td>
<td>4.1</td>
<td>2.6</td>
<td>3.5</td>
<td>3.2</td>
<td>2.9</td>
<td>3.5</td>
<td>5.2</td>
<td>7.5</td>
<td>9.4</td>
<td>8.8</td>
</tr>
<tr>
<td>Slovak Rep.</td>
<td>0.8</td>
<td>0.0</td>
<td>4.8</td>
<td>12.2</td>
<td>14.8</td>
<td>13.1</td>
<td>12.8</td>
<td>12.5</td>
<td>15.6</td>
<td>19.2</td>
<td>17.9</td>
</tr>
</tbody>
</table>

Source: *Business Central Europe*

Yugoslavia

Yugoslavia consisted of six republics: Slovenia, Croatia, Bosnia-Herzegovina, Montenegro, Macedonia and Serbia (including the two autonomous provinces of Vojvodina and Kosovo). The history of the region is complicated, involving numerous population movements and mingling, as well as waves of foreign domination that affected the republics in different ways. Many Croats point to the long history of their nation, distinct from the other republics of Yugoslavia, as an explanation of the republic’s independence movement. When the Roman Empire was divided in 395, Slovenia, Croatia and part of Bosnia-Herzegovina remained with the Western Roman Empire, while present-day Serbia, Montenegro and Macedonia went to the Eastern Roman Empire, later known as the Byzantine Empire. In 925 Dalmatia (the coastal region) was united with Slavonia by Tomislav, forming a single kingdom that prospered for nearly 200 years. The throne fell vacant in the 11th century, resulting in power struggles that weakened central authority. Much of the Dalmatian coast fell under control of Venice from the 12th century until Napoleon conquered the Venetian Republic in 1797. The rest of the country fell under the control of Hungary when a group of Croatian nobles concluded the Pacta Conventa in 1102, conceding Hungary the Croatian crown.
in exchange for Croatian autonomy and for protection against the Orthodox Byzantine Empire. In 1389 Ottoman Turks took Serbia at the Battle of Kosovo. By the late 15th century, they controlled Bosnia and Herzegovina as well. During 400 years of rule under the Turkish Ottoman Empire, Islam took root among some Serbs and Croats, eventually creating a split between Muslims and Orthodox Christians. After the Turks defeated the Hungarians in 1526, northern Croatia and Slovenia turned to the Catholic empire of Austria-Hungary for protection. Dalmatia also remained under Austria after Napoleon was defeated. Many Croats and Slovenes converted to Catholicism, creating another distinction among Slavs. They remained under Habsburg influence until 1918. However, the Serbs gained their independence in 1878 after Russia defeated the Turks. Bosnia and Herzegovina fell under the Austro-Hungarians at this time. Kosovo and Macedonia, regions the Serbs considered theirs, remained with the Turks.

A revival of Croatian cultural and political life began in 1835. In 1848 a liberal democratic revolution led by Josip Jelačić was suppressed, but serfdom was abolished as a result. In 1868 northern Croatia was transferred from Austria to Hungary, united with Slavonia, and granted more autonomy. During the crucial period of nation-formation in the 19th century, Western European nations developed in a way that tied national identity with certain constitutional institutions and

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**Figure 5. Map of the former Yugoslavia (Macedonia not highlighted)**

Throughout the Croatia section I used the Croatian spelling for people and places to maintain accuracy. See
procedures and thus moderated political ideologies both among political elites and ordinary citizens. The value of democratic national integration is based on the fact that it guarantees a rational, procedural decision making in the political community (and thus excludes or at least reduces the influence of radical and emotional mobilization strategies) (Zakošek, 1993, p. 162). “The communicative character or democratic political institutions guarantee an open definition of the political community and disconnects membership requirements from quasi-naturalistic qualities (such as allegedly distinct ethnic origin or even race)” (ibid). In Central and Eastern Europe, the process of national integration was hindered economically by the peripheral position of the societies and their dependence on the core economies of the emerging world economy, and politically by the Habsburg, Ottoman and Russian Empires. Under these unfavorable conditions national integration in Croatia, and other nations in the region, was promoted mainly by national movements and intellectual elites, and based on ideologies of national integration (ibid, p. 163). While this trend was common to many nations throughout the region, it deftly describes the case of Croatian nationalism, which ultimately significantly contributed to Yugoslav disintegration.

With the defeat of the Austro-Hungarian empire in World War I, the Kingdom of Serbs, Croats and Slovenes was formed (called Yugoslavia after 1929, which means “southern Slavs”) that had its capital and power concentration in Belgrade. Many Croats supported the unity of the Slavic people with a nearly identical language, and believed that they would be less susceptible to the influences of the larger, surrounding powers when united (Economist Intelligence Unit). However, this was strongly resisted by Croatian nationalists who had been struggling for independence for decades, and arranged the assassination of King Aleksander I (of the Serbian line)

Appendix C for a pronunciation guide.
in 1934. After the German invasion of Yugoslavia in March 1941, a puppet government dominated by the fascist Ustaša movement was set up in Croatia and Bosnia-Herzegovina, which attempted to expel or murder all Serbs, Jews and Roma (gypsies). However, not all Croats supported these policies. Maršal Tito, the post-war leader of Yugoslavia, was a Croat-Slovene who fought with tens of thousands of Croats against this, and who ardently believed in Slav unity. Massacres of Croats conducted by Serbian Četniks in southern Croatia and Bosnia forced almost all antifascist Croats into the communist ranks, where they joined the Serbs defending themselves from the Ustaša. In all, approximately one million people died during the war, which was fought mainly in Croatia and Bosnia-Herzegovina.

At the end of World War II, Yugoslavia became communist in the Soviet image—the state owned the means of production, resources were allocated by detailed central plans, and the communist party stood without political opposition (Gapinski, 1993). Tito consolidated his power at the end of World War II by purging his government of non-communists and by holding fraudulent elections that legitimated the abandonment of the monarchy. The Federal People’s Republic of Yugoslavia was proclaimed under a new constitution in November 1945. The constitution divided the country into six republics, and two autonomous provinces within Serbia.

In 1948, Stalin expelled the country from the Cominform largely because Tito refused to submit to domination by the Soviet Union. By 1950 Yugoslavia was cut off from the Soviet Union and its eastern European satellites and steadily drew closer to the West. However, Tito ultimately came to conceive of his internal and foreign policy as being equidistant from both blocks. He sought closer cooperation among states that were “nonengaged” in the East-West confrontation. This split ultimately resulted in the Yugoslav rejection of statism and the creation of the “third way” (Gapinski, 1993). This new philosophy was self-management wherein capital was owned by society as a whole rather than by the state. Workers managed the socially owned firms consonant with legislated dictates. In a sense, workers acted as partners in the firms, and as such, they participated in the decision process. This doctrine took shape slowly from about 1950 (ibid).

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12Communist Information Bureau, which was an agency that was organized in 1947 and dissolved in 1956. Its members were the Communist parties of Bulgaria, Czechoslovakia, France, Hungary, Italy, Poland, Romania, the Soviet Union, and Yugoslavia. The Cominform attempted to reestablish information exchanges among the European Communist parties that had lapsed since the dissolution (1943) of the Comintern. Its decisions were not binding, nor was membership obligatory for Communist parties. It was not a reconstitution of the Comintern, only a setting up of information contacts. Its chief function was the publication of materials designed to demonstrate the unity of its members. In 1948 the Cominform expelled the Yugoslav Communist party because of the defiance by Tito of Soviet supremacy. In 1956, as a gesture of reconciliation with Tito, the Cominform was dissolved. (http://www.encyclopedia.com)
The 1960s and 1970s saw many tensions between federalists and nationalists within the nation. Tito’s response to the crises was the constitution of 1974, which included various internal rules and rituals (including a rotating presidency to lead Yugoslavia after Tito’s death) were supposed to formalize equality among the six republics and Serbia’s two autonomous provinces. This system promoted the weaker and smaller federal units at the expense of the big two, Serbia and Croatia. Serbia’s displeasure at the independent role assigned to its autonomous provinces and the promotion of minority identity (especially that of the ethnic Albanians in Kosovo) was felt already in Tito’s last years, but it became radicalized after his death in 1980. Serb resentment provided the opening for Slobodan Milošević and other promoters of recentralization, who contributed greatly to the undoing of Tito’s federal system during the following decade. The dissolution has brought into the open long suppressed conflicts between the developed republics, Slovenia and Croatia, and the less developed ones, above all Serbia, which center around the role and scope of the common state. (Table M shows the size and current economic power of the republics.) Slovenia and Croatia demanded greater degree of autonomy, proposing confederation as an alliance of sovereign states, while Serbia demanded a “democratic federation” that practically meant greater role of the central administration and elimination of the confederal elements introduced by the Constitution of 1974 (Pešić, 1993, p. 153). However, there were additional social factors that contributed to conflict, including the role of the personality of national leaders, and the mental atmosphere created by the intellectuals, the Church and the mass media (ibid).

In 1990 all of Yugoslavia’s republics, catching the tide away from Communist dictatorship sweeping Eastern Europe, held competitive multiparty parliamentary elections that were won by nationalist parties. In June 1991 Slovenia and Croatia declared independence, followed by Macedonia and Bosnia-Herzegovina, splintering the nation after 73 years of union. On April 27, 1992, Serbia and Montenegro acknowledged the breakaway of the four republics by proclaiming themselves the successor state to the Socialist Federal Republic of Yugoslavia, taking the name Federal Republic of Yugoslavia. However, Croatia, Bosnia-Herzegovina and Yugoslavia were embroiled in territorial battles for the following few years, resulting in mass migrations of different

<table>
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<th>Table M. Descriptive Statistics for the Former Yugoslavia</th>
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<tr>
<td>Country</td>
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<tr>
<td>Bosnia-Herzegovina</td>
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<td>Croatia</td>
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<td>Macedonia</td>
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<tr>
<td>Slovenia</td>
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<tr>
<td>Yugoslavia*</td>
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*Serbia’s population is 10,529,507 and Montenegro’s is 680,736 according to Encarta. Source: CIA World Factbook, 1999, 2000
ethnic groups. The Dayton peace agreement, signed in December 1995, brought an end to the conflict and restored the region of Eastern Slavonia (which makes up nearly a quarter of Croatia’s territory) to Croatia from Yugoslavia.

**Impact**

Slovenia, the most developed republic of the former Yugoslavia, was relatively unscathed in the conflicts of the 1990s. However, the disintegration and resulting wars that took place in the region during the early and mid-1990s affected Slovenia’s economy and trade relations, although in the short-term. GDP per capita was $6,052 in 1992, a sharp decline from the pre-independence figure of $8,658 in 1990 (Ramet, 2001). Tourism was limited by the war, and the large population of war refugees was a further drain on the economy. However, sound economic policies and the republic’s solid infrastructure and skilled workforce, helped reverse the downward trend. Table N shows that by 1993 GDP began to grow again and that exports rebounded by 1992. Inflation slowed by 1993, and investor confidence grew as demonstrated by the rise in foreign direct investment. By 2000, GDP per capita had grown to $16,790, adjusted for purchasing power parity, and the nation is currently slated for the next round of EU accession, symbolizing its stabilization and acceptance by Western countries. Slovenia is a clear case where disintegration has not harmed the country in the medium-term. Trade intensity with richer markets in the EU will likely increase with EU accession contributing to growth, and it has also been freed from the transfer payments to the worse-off former constituent members of Yugoslavia.

<table>
<thead>
<tr>
<th>Table N. Descriptive Indicators for Slovenia</th>
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<tbody>
<tr>
<td>Nominal GDP ($bn)</td>
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<td>GDP per capita PPP ($)</td>
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<td>GDP (% change)</td>
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<tr>
<td>Industrial production (% change)</td>
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<td>Unemployment (end-year %)</td>
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<td>Inflation (%)</td>
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<tr>
<td>Exports ($bn)</td>
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<tr>
<td>Imports ($bn)</td>
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<td>Foreign direct investment stock ($bn)</td>
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Source: Business Central Europe
Macedonia\(^\text{13}\), one of the least economically developed republics, saw its GDP fall by more than 30% in the wake of Yugoslavia’s disintegration, from 1991 to 1995 (Rusinow, Hayden, Dyker, 2001). International economic sanctions placed on the Federal Republic of Yugoslavia by the United Nations beginning in 1992 took away an important market, especially for the republic’s agricultural products. In 1994 and 1995 Greece imposed a blockade on Macedonia, deepening the country’s economic slump. (Greece asserted that “Macedonia” was historically and exclusively a Greek name and that its use by Greece’s northern neighbor implied a territorial claim to the Greek region of Macedonia.) An underground gray economy, which comprises businesses that operate outside the tax and social security systems and that disregard government regulations, grew in the FYROM during that period (ibid). It was estimated that in 1998 the gray economy accounted for fully one-half of the republic’s GDP. In March 1999 the North Atlantic Treaty Organization (NATO) began a campaign of air strikes against Yugoslavia over Kosovo, further isolating the nation and damaging its trade partner.

Bosnia-Herzegovina was one of the poorest republics of the former Yugoslavia and has suffered the most from the disintegration since it resulted in a territorial/ethnic conflict that was fought largely on its soil. The war shattered the newly independent country’s economy, and recovery has been tentative. At the end of the war, in 1995, the country was effectively divided three ways—among the Muslims, Croats, and Serbs—despite international attempts to unite it. In 1990 Bosnia’s imports totaled about $1.9 billion, consisting primarily of fuel, machinery, transportation equipment, miscellaneous manufactured products, and chemicals (Dyker, 2001). In the same year, exports totaled about $2.1 billion, consisting mainly of miscellaneous manufactured products, machinery, and raw materials (ibid). However, the war severely disrupted Bosnia’s trade, with both the rump Yugoslavia and Croatia imposing economic blockades on the republic and supply routes being obstructed by the fighting. In 1996 imports totaled $1.9 billion and exports $171 million. The huge trade deficit reflects the degree of Bosnia’s dependence on foreign aid (ibid).

The case of Serbia and Montenegro, which constitute the current Yugoslavia, is bleak as well. As a recent article in Business Central Europe put it, “the Yugoslav economy has had the blood sucked out of it over the past ten years.”

Independent analysts reckon that the economy has slipped back by 50 years, with GDP per head more than halving to $1,200... The reasons for the plunge are not to do with last year’s bombing, but with a decade of war, economic mismanagement and international isolation.

\(^{13}\) Legally known as the Former Yugoslav Republic of Macedonai (FYROM)
Industrial production has plunged by around 70% in the past ten years, but little capacity was lost in the NATO bombing raids... less than 5% of factory space was flattened. The problem is rather that war and sanctions have made it impossible to use that capacity. Serb companies were designed to supply the whole of the old Yugoslavia, but now find themselves stuck in a small home market of ten million (increasingly poor) people. They are far more isolated than companies in neighboring Croatia were, when it was ruled by hardline president Franjo Tudjman. Croatia faced hefty tariffs on its exports to the EU, but half of its trade was still with the West. Serbia simply could not trade at all, except for a few agricultural goods exported to neighboring countries. Add to that the complete lack of money in the economy, and the fact that Milosevic-supporting managers were allowed to drain cash out their companies, and Serb industry has simply withered away. That’s why the economy had been bouncing along the bottom for several years before last year’s bombings. (November 2000)

This is a case of clear disintegration, with almost no trade ties left from the splintering union, and the devastating effects trade isolation has had. However, the various conflicts the rump Yugoslavia was engaged in over the decade and the resultant economic sanctions make it difficult to estimate the exact implications of disintegration alone.

**Case Study: Impacts at the Firm Level in Croatia**

Like most Central European capitals, the streets of Zagreb buzz with activity. The beautiful architecture and well-kept public gardens hint at prosperity. The trams run regularly, the people are dressed in the latest European fashions with their cell phones ringing, and the cafes are full. Yet a closer look reveals some of the economic hardships the people endure. Outside the city center, the buildings show their neglect in recent years. Most people will tell you that they are lucky to have any job with unemployment at 22.5%, even though most feel underpaid and resent the lack of employment choices. (The average monthly wage is $640 according to Business Central Europe, but the Zagreb Chamber of Commerce says it is closer to $400.) Most Croats can only afford to eat out maybe once a month—which may explain why the cafes are full of people just having a coffee. Although their education is good, there is not much opportunity to use what they have learned. The restructuring of the nation’s economy and introduction of competitive forces has revealed that many firms are not efficient, resulting in many closures and reduced employment opportunities. The stability enjoyed in the socialist era has disappeared, creating a stressful situation for many people, and the government now has limited capability to provide a social safety net. There has also been a fall in the quality of public services such as health care and pension plans, which dispelled the illusion that the market would provide a Western standard of living overnight (UN Human Development Report, 1988, p. 75).
After independence, Croatia was faced with the legacy of communist mismanagement, similar to that of most Central and Eastern European countries. The nation suffered from poor infrastructure, inefficient economic structures, uneven regional development, bad environmental legacy, lack of multi-party political structures, and weak local institutions. In addition, there was a lack of small and medium-sized enterprises, which are widely considered to be the building blocks of a strong civil society that facilitates business relationships and reduces transaction costs.

Macroeconomic indicators, including high unemployment, high inflation and decline in production, indicate that the standard of living has decreased considerably after secession (see Table O). The country of 4.5 million people currently has a GDP per capita of $7,090, adjusted for purchasing power parity (Business Central Europe). The purchasing power of Croatian citizens decreased dramatically after Yugoslav disintegration, although it is rebounding, as shown in Table O. While the kuna (the Croatian currency) has stabilized, this has come at the cost of high interest rates. During the conflict in Croatia, the government issued large amounts of debt to finance their military efforts, which contributed to high inflation. Increased fiscal spending to offer the services formerly provided by the Yugoslav government also contributed to the rampant inflation. In October 1993 the government implemented a stabilization program, decreasing the money supply, which caused the real exchange rate to appreciate. (Table O shows inflation rates over the period and the drastic drop from 1149.3% to -3% after the stabilization program was launched.) The real exchange rate appreciation made imported goods cheaper for Croatian consumers. However, their exported goods were more expensive, thereby decreasing the competitiveness in the world market of Croatian

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Source: Business Central Europe

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firms. Many people decried this policy as short-sighted, and some believed that the government was using this policy in order to benefit high-placed politicians, leveling numerous charges of corruption and cronyism against then President Tuđman.

Croatian firms have faced three primary challenges since independence: the War of Yugoslav Succession (locally referred to as the “homeland war”), the economic transition to a market economy, and the establishment of a new national economy. Interviews with three large firms in Zagreb, Kraš, INAS-TAS and Tehnika, helped determine the specific effects of economic disintegration. (See Appendix B for summaries of the interviews.) Three prominent trends emerged from these interviews: businesses are re-orienting their export markets from the former Yugoslav republics and Eastern Europe to the wealthier, more stable markets of Western Europe; the high cost of capital is impeding business growth and competition against foreign firms; and Croatian firms are facing a significant “brain drain” as the most educated look for better opportunities in other countries.

Many Croatian firms were designed to serve the Yugoslav market of 22 million people, but found their domestic market reduced to 4.5 million after independence. Croatia arranged free trade agreements with Slovenia and Macedonia in 1997. Macedonia is not a prominent trade partner for Croatia, likely due to its geographical inaccessibility (see map in Figure 5) and its poor economic conditions. Slovenia is the richest market, although the smallest in the former Yugoslavia. Figure 8 reveals that it is currently the fourth most important market for Croatian firms. It also provides a geographic passageway to the larger and richer markets of the EU. However, trade between the two nations is rather limited. The trade intensity between them was 11 time the normal level in 1992—far less than the other unions that were trading at 40 times the normal level. Further, Figure 7 reveals that the trade intensity between them dropped in the wake of disintegration to about three times the normal level in 1994 (Fidrmuc and Fidrmuc, p. 20). This level is likely partly in response to Slovenia’s anticipated EU accession in the next wave. A free trade agreement was enacted with Bosnia-Herzegovina on January 1, 2001.

14 The Zagreb Chamber of Commerce estimates GDP per capita at $4,482 and the CIA World Factbook says $5,100.
but there remain many social barriers due to the conflict. The rule of law is widely perceived to be very weak in Bosnia-Herzegovina, making business difficult and raising transaction costs. Bosnians also have limited purchasing power due to the poor economic conditions of the country. (Table P shows that GDP per capita is only $1,770.) However, the nation remains the third largest export market for Croatia despite these obstacles, as indicated in Figure 8. The current Federal Republic of Yugoslavia remains one of the largest potential markets for Croatian firms. It offers the advantages of proximity, historical business ties and a common language. Western European countries with common history and/or the same or similar languages trade substantially above the normal level (i.e. between Austria and Germany it is twice the normal level, and is 2.5 times the normal level between the UK and Ireland) (ibid). However, this does not appear to hold true in the former Yugoslavia. Further, the economy in Serbia and Montenegro is so weak after economic sanctions, war and the ensuing slow-down, that there is little demand for services or goods that Croatia could offer (average monthly salary there is $40, *Business Central Europe*, November 2000). Another important deterrent is the residual prejudices that discourage contact of any sort between the groups, although negative feelings are strongest towards the Serbs, who led the war effort against Croatia. Overall, the disintegration of the former Yugoslavia has had much more profound consequences on trade than in other former federations in Eastern Europe (Fidrmuc and Fidrmuc, p 20).

**Figure 8. Croatia’s Main Export Partners (1999) (thousands, in US$)**

Source: Croatian Bureau of Statistics

*Graph showing Croatia’s main export partners (1999) in thousands, in US$.*
With the disintegration of Yugoslavia and the transition to a free market economy, Croatia also lost the markets of Eastern Europe and the Middle East. Entirely new trade arrangements had to be formed, mainly on a bilateral basis. This process is very time-consuming, creating uncertainty for firms, which slowed down the economy. In 1992 Croatian President Tuđman declined to join CEFTA despite an invitation. A free trade agreement was signed with Hungary in February 2001, which should prove to be beneficial due to its proximity, relative wealth and large market size (see Table P). However, it is also part of the first wave of Eastern European countries expected to join the EU and trade intensity between the two will therefore likely drop in the future. The breakdown of Eastern markets forced domestic producers to turn to demanding Western markets, as most former CMEA members did. Table P shows that the Italian and German markets offer the largest opportunity for Croatian firms. They are both accessible and have historical trade relationships as well. Most importantly, they both have very large populations with high levels of purchasing power. Figure 8 reveals that in fact these nations are indeed the most important export partners, with Austria also being a prominent market with its high standard of living and proximity. As there is a trend that western European producers outsource their production into lower labor cost countries, there might be an opportunity for Croatian manufacturers to enter into the production systems of large western companies. It can be an opportunity to acquire expertise and initiate necessary organizational changes (Zagreb Chamber of Economy, p. 72). Further, since the levels of trade between Eastern and Western Europe were far lower than normal levels (roughly 40%)
prior to disintegration and the end of the Cold War, it is natural for trade intensity to increase now that these barriers have dropped (Fidrmuc and Fidrmuc, p. 16).

All three firms interviewed noted that they had reoriented their exports. INAS-TAS, an export-oriented machine tools firm, realized the necessity of refocusing its market to Western European countries after disintegration. While it has always imported the inputs for its products from Germany, it now exports approximately 80% of its finished products back to Germany. Italy and Austria are also large markets for INAS-TAS products, but Russia is no longer a big customer since the economic difficulties in the nation. However, some business ties remain with other Eastern European countries as well as Bosnia and Macedonia, although these are a small portion of the business. Drago Šavora, director of INAS-TAS, did not think that CEFTA would have particular advantages for INAS-TAS since it has already concentrated so much of its market in Western Europe. He did note that CEFTA membership would perhaps facilitate connections or cut paperwork with firms in Central European countries, but he did not expect this to increase his market share.

Kraš, a confectionery company, had a similar situation. While was able to export to Slovenia easily, the other former Yugoslav markets have proved more difficult to re-enter. There is some demand in Bosnia, but the purchasing power of people there is very low, so they must offer the products at a lower price. As a result, some people were re-importing the products into Croatia from Bosnia (a similar problem was faced by Russian companies). With the dramatic decrease in their domestic market resulting from disintegration, Kraš refocused it attentions to the markets in surrounding countries, as well as Australia and the United States, which also have sizeable Croatian populations. However, entering these new markets creates large costs because of the need to promote brand recognition through expensive marketing—a particularly important factor for a cultural good. Damir Žderić, sales and marketing coordinator for Kraš, also noted that CEFTA membership was not desirable, citing the difficulty of competing with much larger foreign firms that are much stronger financially. Kraš now only has 70% of the Croatian market due to increased competition from abroad and the firm does not want its share to drop further.

Tehnika, a design, civil engineering and construction firm, completed numerous projects within the other Yugoslav republics, although the majority of their work was done in Croatia before the break-up. Since then, they too have ended their work in the former members of Yugoslavia. Tehnika has also decreased the number of projects in Western Europe due to changes in the
increasing integration of the EU, which makes it more cost effective to hire labor from Portugal or East Germany. The economic turmoil in Russia has decreased demand for Tehnika’s services there. Nenad Koritnik, the assistant general manager of the firm, did not think that free trade agreements with the other republics were necessary right now, but instead believes that these opportunities will come with time and that it was more important to first rebuild the local economy.

The high price of capital was cited as one of their most significant barriers to growth for Croatian firms. Tehnika’s Koritnik observed that the economic conditions in Croatia greatly inhibit firms from accessing sufficient financing to successfully bid on projects and named the high cost of capital as the largest obstacle facing his firm. Koritnik believes that the government could best help his company by creating a better climate for investment. He argued that, as the economy as a whole grows, there will be increased demand for Tehnika’s services. Current President Mesić has made reducing interest rates to below 10% one of his policy goals, yet he also hopes to maintain the exchange rate. Since his election in 2000, the money supply has been increased slightly, which has decreased interest rates. However, they remain prohibitively high at around 20%. Further increases in the money supply could jeopardize the stable exchange rate, which other export-oriented firms like INAS-TAS depend on. Increased competition among Croatian banks, which have been mostly privatized and floated on the London stock exchange, and the introduction of foreign bank branches, has not had the desired effects either. This high cost of capital is not specifically due to the disintegration, but to its downstream effects. In the case of Croatia it resulted mainly from the issuance of war debt, yet many other countries faced similar problems with the crisis period following abrupt economic union break-ups, when fiscal spending is increased to maintain public services. Further, the formation of a new currency requires an adjustment period when uncertainty looms, making investment highly risky and therefore decreasing opportunities for firms and individuals to access capital at affordable prices.

“Brain drain” has also become a significant obstacle for Croatian institutions. As the stability and quality of life enjoyed in the socialist era has eroded, many of the brightest and best-educated Croats look for better salaries and opportunities in other countries. Further, experienced policy-makers often leave the public sector for more lucrative positions in the burgeoning commercial sector, resulting in an “internal brain drain” as public resources dwindle (Kupiszewski, 1996). The decreasing quality of public services, including health care and pension plans, has further encouraged the outmigration of the best educated. Despite the fact that many skilled émigrés are forced to downgrade their professional careers and take jobs with much lower
qualifications than they command (as noted by Kupiszewski and Sabirianova), this trend continues. However, while the attraction of better economic conditions causes long-term migration, the largest push for outmigration usually occurs following periods of political upheaval, such as disintegration, when uncertainty is highest (Drbohlav, 1996). This outmigration poses particular problems for a small nation like Croatia, which has only a limited number of high quality individuals that it cannot afford to educate and then lose. In fact, Croatia has one of the largest diasporas of European countries (third after Ireland and Great Britain) with large communities in the U.S., Canada and Australia (UN Human Development Report, 1988, p. 5). The existence of a large diaspora of nationals abroad can also facilitate and stimulate chain migration (Kupiszewski). Ethnic emigration increases through friendship and kinship links since a safety net is already in place in the new country, greatly facilitating the transition process and easing the navigation of complicated immigration laws.

Šavora, a representative of INAS-TAS, a machine tools manufacturer, noted that some of his most skilled employees had fled Croatia in search of better opportunities. Since Croatian independence, INAS-TAS has contracted considerably and is now only one tenth of its former size, in terms of employees. Šavora believed that many former employees were able to find other jobs or retired, but that many more remain unemployed—many of the more skilled staff went abroad to find better jobs, contributing to the brain drain. Similarly, Tehnika dropped from approximately 4,500 employees in 1985 to 1,500 in 2001. This drastic workforce reduction resulted gradually, according to Koritnik, as the number of projects decreased. The projects in the other former Yugoslav union members were stopped and those in Western Europe slowed, decreasing demand for labor. In addition, many Bosnian laborers and ethnic members of other republics who were working in Croatia were not eligible for Croatian citizenship and were forced to leave. While most Bosnian workers were low skilled, there were many from throughout the former Yugoslavia who were highly qualified that firms had to let go. This ethnic-nationality policy was also damaging to mixed-ethnicity families, who often emigrated en masse since they had no “homeland”. Koritnik also explained that many workers have retired or left for better-paying jobs and that they have not hired replacements. Early retirement was often the manner of laying off surplus workforce, resulting in additional pressure on the budget and higher taxes. Early retirement plans also put people out of the workforce who could still be very productive, further contributing to the group of workers who leave the country in search of employment opportunities. While outmigration eases the pressure of high unemployment, the absence of the educated classes creates difficulties when
firms do grow and need to hire more talent. Ultimately brain drain seriously affects the ability of firms and government to innovate and expand.
PART THREE: CONCLUSIONS

GENERAL LESSONS
Despite the economic theoretical argument against economic disintegration, many regions choose this course mainly for political considerations, including the often-noted desire for self-determination. In an era of increasing trade liberalization, there are likely to be more cases of political devolution (such as even in long-establish nations as Great Britain) and disintegration. Most of these will entail economic disintegration to a certain extent as the relative advantages decrease with new opportunities opening up as trade liberalization spreads. The case of integration in Western Europe has shown that facilitating trade does bring increased welfare, but that in order for convergence to take place transfer payments and effective development programs are necessary. The benefits of integration are therefore political and social as well as economic. However, the constituent members may not benefit from such a close union, particularly if they have significant structural differences that hinder their ability to reconcile their views on economic and monetary policy, as the case of Czechoslovakia vividly depicts. Further, without the widespread political will, transfer payments may not be possible.

The economic cost of disintegration depends upon the level of integration, as well as the policies put in place to mitigate the impact. The level of integration is indicated by the intensity of mutual trade, the diversification of the industrial structure, degree of inter-regional labor mobility, degree of openness of the economy and the amount of inter-regional fiscal transfers. For less developed regions, disintegration means the end of fiscal transfers, which created a significant loss for the Slovak Republic, the Central Asian Soviet republics, as well as Macedonia. “Regions trade off efficiency gains from integration and the cost of not having redistribution policy preferred by the median voter. When income inequality differences across regions and the efficiency gains from integration are small, unions break up” (Fidrmuc and Horváth, p. 3). In general, the less integrated the members are, the less they are disturbed by the disintegration. Further, maintaining some aspects of the union, such as free trade agreements, customs unions or free movement of labor, can also alleviate the economic shocks of a union’s disintegration, although labor movement has proved to be less common than economic theory predicts.

There is a significant cost of nation-building—creating new government ministries and financial institutions, as well as renegotiating foreign treaties, including trade agreements. These fledgling republics have faced numerous challenges in creating a new nation. They must all address political issues of ethnic or civic identity and other considerations about the rights of
citizenship. They must determine “how to reconcile civic identities based on inclusive citizenship and exclusive ethnic identities based on such common characteristics as culture, religion, language and a common ancestor of a dominant nationality, on the one hand, and of ethnic minorities, on the other” (Tolz, 1998). Further, they have to agree upon new borders and monitor them, which has a significant cost. This was especially important for Russia, which had problems with the former Soviet republics re-exporting energy supplies, which they had obtained from Russia at below world market prices (Williamson). Croatian firms also faced this problem in Bosnia-Herzegovina.

The constituent members of a splintering union will go through a restructuring period with regards to their trade patterns and intensity. In the case of post-communist nations, the previous trade arrangements were not necessarily optimal, but in fact were politically enforced as a result of the strains of the Cold War, which made CMEA countries closed to the West. However, even without these East-West boundaries, it is clear that trade between unions is higher than the normal level (i.e. the level as predicted by the economic potential of the respective countries and the distance between them). Further, certain trade arrangements like the CMEA can lead to ‘hub and spoke bilateralism’, which artificially inflates transportation costs and causes neighboring countries to trade below normal levels. These suboptimal links are often ended with increasing trade openness, as well as with the introduction of market forces in transitional economies. The former constituent members of an economic union will initially go through a decline in the level of trade intensity after a break-up. However, trade intensity remains far above the normal level several years after disintegration, likely due to the established relationships between firms and cultural understanding formed over the years of union. After the break-up, the newly-formed nations will re-direct their trade to reach more normal levels with other countries, that had been repressed during the union, creating more advantageous relationships as the incentives to trade with the former partners are reduced relatively. This readjustment might allow countries to find more favorable terms of trade and maximize the benefits of their comparative advantages.

The split of an economic and political union often incites a crisis due to the uncertainty of the future. As firms determine the effects on their supply chains, there is a short-term reduction in output. The former Soviet republics demonstrated this, as many of their firms lacked the needed inputs for their goods in the period directly following disintegration (Williamson, 1993). However, in the case of Eastern Europe this was also tied to the end of the centrally planned system. The chaos of the split in many cases causes governments to go into deficit spending as they struggle to establish the governing infrastructure, often sparking rampant inflation, as the cases of the Slovak
Republic and Croatia demonstrated. Inflation also results with the uncertainty surrounding the introduction of a new currency. This results in a decreased standard of living, as imported consumer goods are no longer affordable. Further, the disruption of the supply chains results in shortages of some goods in the short-term. Additionally, inflation causes the cost of capital to skyrocket, impeding business growth and exacerbating their lack of competitiveness against foreign firms, as they enter their domestic market. The decreased standard of living, although likely short-term, and future uncertainty often lead to population outmigration. Croatian firms noted that they are facing a significant “brain drain” as the most educated look for better opportunities in other countries, which will inhibit future growth of domestic firms as well as result in a loss of potential government leaders.Further, the loss of a common labor market also caused firms to lose valuable employees. Tehnika’s numerous Bosnian workers had to leave Croatia after disintegration, creating a significant loss.

At the firm level, the case study of Croatia demonstrates the challenges posed by economic disintegration on linkages and consumer markets. The loss of the markets of the other republics has drastically reduced demand for Croatian goods and services, forcing most firms to lay off large numbers of their employees. Efforts to enter new markets impose large costs in marketing and creating new distribution relationships, as well as in the negotiating of trade agreements. This has been a particular strain on producers of cultural goods, such as Kraš. The refocus to more developed markets, which have higher purchasing power, creates additional difficulties for Croatian, and other restructuring countries’, firms that are lagging in competitiveness due to the transition to a market economy. They also face increased competition in their domestic markets due to increasing economic openness, at a volatile time. However, Kraš and other firms noted that their linkages were not disrupted since Yugoslavia had a more open economy and looser relationship with CMEA countries. As a result, the firms had already established relationships with suppliers from other countries, notably Germany, which provided access to higher quality inputs. It is probable that the other disintegrating nations of Eastern Europe saw their supply networks more disrupted, as indicated by the drop in output in the wake of disintegration.

Most Croats noted that overall, the costs of disintegration of Yugoslavia were dwarfed by the other two challenges the nation experienced in the 1990s. The transition to a market economy and subsequent privatization of firms, as well as the costs of the War of Yugoslav secession and loss of tourism revenues and population displacements it brought about were far more powerful destructive forces. Trade relationships do change with the formation of new nations and new trade
agreements, but the costs this creates are short-term. Trade openness and unhindered market forces should ultimately bring about optimal links, as long as social barriers are not formed as a result of a traumatic break-up, as is the case with Croatia and Yugoslavia.

**POLICY RECOMMENDATIONS**

The policies recommended here should mitigate the negative effects economic disintegration process. They are intended to foster business growth and competitiveness, as well as the formation of new, advantageous forward and backward linkages following an economic union break-up. As they are based on interviews with business leaders and many were directly requested by them, they should effectively address the needs of firms that arise due to the disintegration process.

If possible, economic unions should be gradually dissolved, rather than abruptly, in order to reduce the economic shock of disintegration. This will allow sufficient time to create a stable monetary system and control inflation, thereby maintaining affordable prices for consumer goods and avoiding interest rate hikes. Further, additional time will enable firms to plan on the break-up and will not disrupt supply linkages to such an extent. However inefficient current practices may be, it is better that any activity that produces positive value added continue until it is possible to make the investments that will permit the factors it employs to be redeployed into new activities (Williamson, p. 600, ). Fidrmuc and Fidrmuc have shown that trade between disintegrating unions often initially dips below the level it settles at in the medium term. Therefore, concerns that intratrade intensity will collapse are not ill founded and the fear that this collapse will further intensify the downward spiral is plausible. Williamson also asserted that it is wrong to argue that, because of the expectation of a long-run decline in intratrade, the sooner the decline comes the better (ibid). Instead, a gradual shift to the most advantageous firm links through new trade relationships would be optimal. The provision of an effective intra-republic interbank system of settlement might avert the danger of a collapse in trade during the shift to a market basis. The primary issue on which that focuses attention is the system for effecting payments between republics (ibid, p. 600). Additional support needs to be given to enable enterprises to trade directly with one another.

The creation and promotion of export assistance programs would help firms establish new relationships in other countries and enter new markets, facilitating the formation of advantageous trade relationships. The need for effective programs of this sort is clear. In Croatia, “domestic producers do not have a defined strategy of marketing their goods on the international market:
neither according to assortment criteria, nor market segmentation, nor any other criteria. They just try to take any opportunity for export, most frequently adopting a low price policy or large assortments” (Baletić, 1995, p. 45). Further, these efforts should be at the local level, perhaps based at the chambers of commerce, so that they can best serve the interests of firms. “The process of decentralization is of key importance for the improvement of competitiveness on a local level. Local communities should be given more freedom and power to organize concrete activities and programs, set up support services, consulting, information centers, training and specialized education and to coordinate and monitor their implementation” (ibid, p. 139). Export assistance programs can help overcome the market failure of lack of information about supply and demand opportunities.

In order to further facilitate firm growth, access to capital is essential. Therefore the government should ensure that its provision at reasonable interest rates is realized. Tehnika cited this as a particular problem to expansion and competitiveness. Capital is also necessary for new business formation. Government programs ensuring loans at reasonable interest rates would therefore be a highly effective manner of promoting domestic firm competitiveness. In addition, venture capital programs and foreign direct investment should be encouraged. Croatia received $3.9 billion in FDI in 1999, which was a dramatic increase over the decade as there was none in communist times (see Table O). While these investments may reduce local control over businesses, the benefits they create in capital-starved regions are significant.

Monetary policy can also be used to assist firms. Export-oriented firms, such as INASTAS, can greatly benefit when the exchange rate is not overvalued. While this makes imported goods more costly, it does allow firms to export more and therefore creates increased economic growth. Firms such as Kraš would also be able to sell their goods in poorer markets such as Bosnia-Herzegovina and Yugoslavia at a competitive price.

Newly-formed nations should engage in free trade agreements with other countries, especially within the region. However, this should be done gradually. Indeed, the Croatian firms all indicated their preference for gradualism and no shock exposure to other competition. In the case of Croatia, the country should prepare for accession to the European Union and work to overcome social barriers to trade with the other countries of the former Yugoslavia, but also move to improve trade relationships with CEFTA nations. However, liberalization of trade alone is not sufficient, particularly for post-communist countries. The refocus to more advanced markets,
which have higher purchasing power, creates difficulties for Croatian firms that are lagging in competitiveness. As a result, accession to free trade agreements, such as CEFTA or the EU, is not desired by many businesses, which fear that they would lose domestic market share as foreign business move in. The consensus among Croatian business leaders was that it was first more important for them to complete reorganization and regain competitiveness before entering these broad agreements, particularly since they already have access to many markets through bilateral arrangements. Trade agreements with countries of similar development levels would provide the opportunity to expand the market available to firms, but not expose them to the competition of far richer and more developed firms. As Trofimov argues, development patterns of transition economies depend on trade patterns and dynamic comparative advantages acquired through specialization in trade, and a disadvantageous initial position of a country may lead to a permanent loss of markets and competitiveness (Trofimov, 1997). Therefore, a certain degree of protectionism may help create and maintain the all-important initial advantages. He also argues that geographically close transition economies, such as CIS countries, should avoid participation in regional economic blocs with new industrial and developing countries that are relatively advanced in manufacturing. This can increase the possibility of wrong trade specialization and cause further loss of competitiveness (ibid). Consequently, trade between CIS or CEFTA countries is preferred because it does not entail such negative effects, as their economies do not differ significantly in terms of initial comparative advantages in manufacturing. Further, lack of trade agreement membership does not stop trade between nations. For example, lack of CIS membership has not stopped trade relations between the Baltics and the other former Soviet republics. Cross-border relations, and indeed, non-regional trade relations, can still be significant. Moreover, trade between similarly developed countries should improve the opportunities for beneficial specialization and may to some extent remedy the negative effects of trade with advanced nations (ibid).

Efforts to maintain other benefits of integration should be made. Notably, the free movement of labor can ease the costs of disintegration. The Croatian firms noted that they lost may workers of other nationalities who were forced to leave Croatia since they were not eligible for Croatian citizenship. The literature on migration has indicated that fears of mass migrations to richer regions are largely unfounded. However, the small amount of migration can reduce pressure on a struggling region and also helps firms who need labor, particularly those with specifically demanded skills. The shared history within a union will facilitate the recognition of qualifications as well as diminish language and cultural barriers, making migration easier. Former constituent members of a union should also endeavor to maintain other common policies, such as standards and

52
technical rules, which will not disrupt linkages. Countries may be economically better off pursuing independent economic and monetary policies, but they should still work to achieve the benefits that increased trade and the free movement of capital and labor provide.
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APPENDIX A: PROTOCOL FOR FIRM MANAGER INTERVIEWS

[These questions are intended for people who have been managing a firm since before Croatia seceded from Yugoslavia. The purpose of this study is to determine what changes firms have experienced through the disintegration of Yugoslavia, NOT due to the conflict or the effects of privatization.]

1) Before Croatia’s independence did you sell your products in the other Yugoslav regions? What portion of your output did you sell there?

2) Do you still sell some of your product to these other countries? How much has this changed?

3) Before independence did you have branches in the other republics? How was this affected by the secession?

4) Before independence did you attract labor or investment from the other regions of Yugoslavia? How was that affected by the secession?

5) Before independence did you import products, inputs or services from the other regions? How was that affected by the secession?

6) If your business has contracted due to the loss of the markets of the former Yugoslavia, what has the impact been on the community? Have your former workers found other jobs easily?

7) If your firm has cut its ties with the other former Yugoslav regions, what has been the primary reason?

8) Do you sell your products in other countries now that you did not before? Which ones? What caused your firm to focus on a new market?

9) What policies could the government implement that would help you overcome the disadvantages created from the erection of these new borders and reach these markets again?
APPENDIX B: SUMMARY OF FIRM INTERVIEWS

INAS-TAS
Drago Šavora, director of INAS-TAS, explained the importance of the machine tool business like this: “If pants are the economy, then machine tools are the belt—the economy would fall down without them.” Rather clever for non-native English speaker, but also disturbing to realize that if that is so, how close the Croatian economy came to collapsing. Since Croatian independence, INAS-TAS has contracted considerably and is now only one tenth of its former size. The firm produces conventional and CNC machine tools, machine centers, flexible machining systems, special purpose machines and automatic production lines. INAS-TAS has existed for over 60 years (before privatization it was known as “Prvomajska”) and prides itself on its long tradition of high quality products and technical solutions, which it has maintained by a commitment to developing new products, providing modern production equipment, and by investing in its own personnel.

Machine tools are an export-oriented business. Before independence, INAS-TAS produced all its products in Zagreb using Croatian labor and sold most of its output in the other Yugoslav republics, as well as to other East European countries, particularly Russia. Because of Yugoslavia’s political position between Western and Eastern Europe, it was able to effectively serve as a bridge for Western technology to the Eastern markets. However, with independence and the economic collapse in Eastern Europe, INAS-TAS refocused its market to Western European countries. While it has always imported the inputs for its products from Germany, it now exports approximately 80% of its finished products back to Germany, whereas this figure was 30-40% prior to independence. However, this may reflect a drop in the total amount produced, rather than a drastic increase in demand in Germany. Italy and Austria are also large markets for INAS-TAS products, and there is some business in Eastern European countries as well. The firm retains good connections in Russia, but their poor economic conditions creates little demand. Currently there is a small market for INAS-TAS’s products in Bosnia and Macedonia, but, again, their struggling economies limits their ability to purchase.

The number of INAS-TAS employees has shrunk from 2,500 to 250 as a result of declining demand for its products in the former Yugoslav republics and Eastern Europe. Šavora believed that many former employees were able to find other jobs or retired, but that many more remain unemployed. He also noted that many of the more skilled staff went abroad to find better jobs, further contributing to the brain drain.
Šavora did not believe that easing trade barriers with Serbia was an optimal government policy, but that better relations would progress slowly. He also did not think that CEFTA would have particular advantages for INAS-TAS since it has already concentrated so much of its market in Western Europe. While INAS-TAS does do some business in CEFTA countries, he does not think joining CEFTA would improve his market share or have much impact except to perhaps facilitate connections or cut paperwork. The most useful government policies for INAS-TAS, Šavora believed to have already been enacted. The previous monetary policy favored imports, but made exported Croatian products expensive. He was optimistic that current government efforts would improve this situation and be more supportive of production for export.

<table>
<thead>
<tr>
<th></th>
<th>Before 1991</th>
<th>2001</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong># Employees</strong></td>
<td>2,500</td>
<td>250</td>
</tr>
<tr>
<td><strong>Source of inputs</strong></td>
<td>Germany</td>
<td>Germany</td>
</tr>
<tr>
<td><strong>Source of labor</strong></td>
<td>Croats</td>
<td>Croats</td>
</tr>
<tr>
<td><strong>Markets for goods/services</strong></td>
<td>Other Yugoslav republics, Eastern Europe and Germany (30-40%)</td>
<td>Germany (80%), Italy, Austria, little in Bosnia, Macedonia and other Eastern European countries.</td>
</tr>
</tbody>
</table>

**Kraš**

Kraš was the largest confectionery in Yugoslavia, and remains the largest and most reputable manufacturer of confectionery products in Southeast Europe. Founded in 1911, the firm has built up its tradition based on the high quality of its products. The company is based in Zagreb, but previously also had a factory in the Serbian-dominated part of Bosnia, as well as many stores throughout the former Yugoslavia. This additional factory was subsequently lost during the conflict, as were many stores. The company was built to serve the Yugoslav market of 22 million people and has consequently suffered greatly due to the loss of the former markets. In the 1980s their output was around 50,000 tons a year, but it is currently half that—24,000 to 25,000 tons a year.

With Yugoslav disintegration in 1991, the firm had the capacity and workforce, but was left with no substantial market to serve. While Kraš was able to export to Slovenia easily, the other markets have proved more difficult to re-enter. There is some demand in Bosnia, but the purchasing power of people there is very low, so the firm must offer the products at a reduced price. As a result, some people were re-importing the products into Croatia from Bosnia at this lower price. With the dramatic decrease in their domestic market resulting from disintegration, Kraš refocused its attentions to the markets in surrounding Western European countries, as well as Australia and the United States, which also have sizeable Croatian populations. However, entering
these new markets creates large costs because of the need to promote brand recognition through expensive marketing. This is particularly important since confectionery is a cultural good, which make brands the most significant factor. Kraš’s efforts to enter the U.S. and Australian markets reveals their intention of capitalizing on the existent recognition of émigrés. They even created products specifically for this market and for souvenirs, such as the Croatian chocolate passport and boxes of chocolates saying “Pozdrav iz Hrvatska” (“greetings from Croatia). Re-entering the markets of the former Yugoslav republics does not create the need for brand introduction, since Kraš is well known there. Improved access to these markets would therefore be desirable. Further, increased purchasing power with hoped-for economic growth in the other former Yugoslav republics would also increase sales and profits for Kraš.

Damir Žderić, sales and marketing coordinator for Kraš, noted the difficulty of competing with much larger foreign firms that are much stronger financially. For this reason, he also does not want Croatia to join CEFTA or other trade agreements yet. Kraš now only has 70% of the Croatian market due to increased competition from abroad and the firm does not want its share to drop further due to increasing economic openness. Kraš is still rather uncompetitive because it is not yet producing to capacity and maintains superfluous workers because it does not want to contribute to further unemployment in Zagreb. Kraš has cut back its workforce drastically in an effort to restructure and become more competitive, yet the commitment to the community and worker welfare brought about in the socialist era still linger. After the privatization process, workers still own 72% of the company. While the provision of jobs does aid the local economy, the firm is hurt by these inefficient policies and less able to compete in foreign or the domestic market.

Žderić did not believe that any other government policies could help the firm. Instead, he believes that the firm will become increasingly competitive on its own over time as it further adjusts to the market economy. Essentially, he indicated that he wanted access to new markets and the former republics, but not the increased competition from general economic openness.

<table>
<thead>
<tr>
<th></th>
<th>Before 1991</th>
<th>2001</th>
</tr>
</thead>
<tbody>
<tr>
<td># Employees</td>
<td>5,000</td>
<td>2,000</td>
</tr>
<tr>
<td>Source of inputs</td>
<td>Mainly Croatia,</td>
<td>mainly Croatia, though some necessary imports (i.e. Cacao from Africa)</td>
</tr>
<tr>
<td></td>
<td>though some necessary imports (i.e. Cacao from Africa)</td>
<td></td>
</tr>
<tr>
<td>Source of labor</td>
<td>Croats (local at other stores or factory)</td>
<td>Croats (local at other stores)</td>
</tr>
<tr>
<td>Markets for goods/services</td>
<td>99% for Yugoslav market, other for Eastern Europe</td>
<td>70% for Croatia, export to mainly Eastern Europe, some to EU, USA and Australia</td>
</tr>
</tbody>
</table>
TEHNIKA
Tehnika is a Zagreb-based firm that provides design, civil engineering and construction services. It was founded in 1947 and has consequently undergone many transformations as the economic situation and system in the nation have changed. The company had social ownership, like all Yugoslav firms, until the free market reforms that independent Croatia enacted. However, the employees still own a considerable portion of the company, a policy that is widely believed in Croatia, and elsewhere, to encourage motivation. (However, many other studies have indicated that it promotes inefficient firm behavior, exacerbating uncompetetiveness.) Nenad Koritnik, the assistant general manager of Tehnika, noted that before this monumental change the primary objective of the company was to find work for all the employees. Profits were invested in improving the company (equipment, etc.) and were used to give additional benefits to the employees. (Tehnika continues to purchase their equipment from Germany, due to their links of 35 years and the high quality of the machinery available there.) After the transition to capitalism, the company became increasingly profit-oriented and there was a great deal of organizational restructuring entailing many changes in the management.

The disintegration of Yugoslavia has deteriorated business conditions for Tehnika markedly. Before 1991, Tehnika completed numerous projects within the other Yugoslav republics, although the majority of their work was done in Croatia. Within Croatia, Tehnika mostly built apartment buildings and industrial complexes. The other republics also had good construction companies to meet their local needs, but there was demand for Tehnika’s more specialized services, particularly in the food industry, such as silos and slaughterhouses. When working in the other republics, Tehnika often hired local unskilled labor and brought in Croatian managers, technical experts and other employees, depending on the situation. The same was true of their projects abroad, which often had a local partner. In 1985, Tehnika had approximately 4,500 employees, but this figure dropped to 1,500 in 2001. This drastic workforce reduction resulted gradually, according to Koritnik, as the number of projects decreased. The projects in the republics were stopped and those in Western Europe slowed, decreasing demand for labor. In addition, many ethnically Bosnian laborers and nationals of other countries who were working in Croatia were not eligible for Croatian citizenship and were forced to leave. He also explained that many workers have retired or left for better-paying jobs and that they have not hired replacements. (Early retirement was often the manner of laying off surplus workforce. This has resulted in additional pressure on the budget and higher taxes. Early retirement plans also put people out of the workforce who could still be very productive.)
There were many factors causing the recent decline in business for Tehnika. The erection of new political borders played a primary role in this decrease. The conflict has left considerable prejudice between the groups, which has effectively created psychological borders, making it more difficult to do business within the other republics even if free trade agreements are put in place. Tehnika has also decreased the number of projects in Western Europe due to changes in the European Union, which makes it more cost effective to hire labor from Portugal or East Germany. Further, increased pension payments in Germany due to EU policies have made work there too expensive and the firm unable to bid competitively. The economic turmoil in Russia has decreased demand for Tehnika’s services there. In addition, the economic conditions in Croatia greatly inhibit firms from accessing sufficient financing at reasonable rates to successfully bid on projects. Koritnik cited the high cost of capital as the largest obstacle facing his firm. He noted that war was not the biggest obstacle to the firm, but the lack of investment that resulted from the economic crisis. Koritnik believes that the government could best help his company by creating a better climate for investment. He argued that, as the economy as a whole grows, there will be increased demand for Tehnika’s services. He did not think that free trade agreements with the other republics were necessary right now, but instead believes that these opportunities will come with time and that it was more important to first rebuild the local economy.

<table>
<thead>
<tr>
<th></th>
<th>Before 1991</th>
<th>2001</th>
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</thead>
<tbody>
<tr>
<td># Employees</td>
<td>4,500</td>
<td>1,500</td>
</tr>
<tr>
<td>Source of inputs</td>
<td>Mainly Germany</td>
<td>Mainly Germany</td>
</tr>
<tr>
<td>Source of labor</td>
<td>Mixture of Croats and local labor</td>
<td>all Croats for domestic projects, some local labor at few foreign sites.</td>
</tr>
<tr>
<td>Markets for goods/services</td>
<td>Mainly Croatia, but some projects in other republics and abroad (Russia, Germany, Algeria)</td>
<td>no projects in other republics, very few in other countries</td>
</tr>
</tbody>
</table>
APPENDIX C: PRONUNCIATION GUIDE

I used many of the Croatian spellings for people and places to keep them as accurate as possible. Here is a rough pronunciation guide highlighting the major differences to assist non-Croatian speakers.

- c like the “ts” in cats
- č like the “ch” in cheese
- ċ like the “ch” in chalk
- đ like the “j” in jug
- g like the “g” in god
- j like the “y” in yellow
- š like the “sh” in sheep
- ž like the “s” in pleasure