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Trade Policies and Institutions in the Countries of South Eastern Europe in the EU Stabilization and Association Process

Regional Report

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Currency Equivalents
(as of December 31,2002)

Albania
Currency Unit = Lek (ALL)
US$1 = 134.0000

Bosnia and Herzegovina
Currency Unit = Konvertible Marka (KM)
US$1 = 1.8864

Croatia
Currency Unit = Kuna (HRK)
US$1 = 7.1770

Former Yugoslav Republic of Macedonia
Currency Unit = Denar (MKD)
US$1 = 61.6000

Serbia and Montenegro
Currency Unit = Dinar (YUM)
US$1 = 59.9428

Abbreviations and Acronyms

ATPs	:	Autonomous Trade Preferences
CEECs	:	Central and Eastern European Countries
CEFTA	:	Central European Free Trade Area
CIS		Commonwealth of the Independent States
EBRD	:	European Bank for Reconstruction and Development
EFTA	:	European Free Trade Area
EU		European Union
EWI	:	East West Institute
FDI	:	Foreign Direct Investment
FTA	:	Free Trade Agreement/Area
GATT	:	General Agreement on Trade and Tariffs
GDP	:	*Gross* Domestic Product
GSP	:	General System of Preferences
HS		Harmonized System
IFIs	:	International Financial Institutions
IMF	:	International Monetary Fund
KM	:	Konvertible Marka
LDCs	:	Least Developed Countries
MFN	:	Most Favored Nations
MOU	:	Memorandum of Understanding
NAFTA	:	North America Free Trade Area
NATO	:	North Atlantic Treaty Organization
NTMS	:	Non Tariff Measures
SA	:	Stabilization and Association
SAA	:	Stabilization and Association Agreement
SECI	:	Southeast European Cooperation Initiative
SEE	:	South Eastern Europe
SFRY	:	Socialist Federal Republic of Yugoslavia
SITC	:	Standard Industrial Trade Classification
SPS	:	Sanitary and Phytosanitary
TBT	:	Technical Barriers to Trade
TIR	:	Transports Internationaux Routiers
TRIPS	:	Trade Related Intellectual Property Rights
TTFSE	:	Trade and Transport Facilitation in Southeast Europe
UN	:	United Nations
UNCTAD	:	United Nations Conference on Trade and Development
UNECE	:	United Nations Economic Commission for Europe
UNMIK	:	United Nations Interim Administration Mission in Kosovo
WTO	:	World Trade Organization

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PREFACE

This report was prepared in the context of the World Bank regional program for South Eastern Europe, with the objective to support the integration in the world economy—and in Europe in particular—of the five countries that are currently engaged with the European Union in the Stabilization and Association Process. This process has important implications for trade policies and institutions; and trade policies and institutions have been recognized by the previous World Bank regional report, *The Road to Stability and Prosperity in South Eastern Europe*, as key priorities for private sector development and economic growth in the region.

Because of the common challenges and opportunities that the Stabilization and Association Process offers, these five countries—Albania, Bosnia and Herzegovina, Croatia, FYR Macedonia, and Serbia and Montenegro[1] [2]—are the focus of the report. The customs territories of Montenegro and Kosovo are included in the analysis. The other countries of South Eastern Europe—Bulgaria, Moldova and Romania—do not form the object of this report but are included in the analysis whenever appropriate.

This report is also aimed at supporting the activities of the Stability Pact Working Group on Trade Liberalization and Facilitation, which has taken a leading role in the policy debate on these issues in South Eastern Europe, and whose members have contributed on various occasions valuable comments regarding the scope of this report and its main conclusions.

The report was prepared under the leadership of Christiaan Poortman, Regional Coordinator for South Eastern Europe. The report benefited from extensive comments from Harry Broadman, Ardo Hansson and Maurice Schiff, who acted as peer reviewers. In addition, numerous World Bank colleagues contributed their comments: Sebnem Akkaya, Uri Dadush, Lloyd Edgecombe, Erika Jorgensen, Eva Molnar, Kyle Peters, Margret Thalwitz, and Marina Wes. Finally, comments from government officials from countries covered in this report as well as from staff of the European Commission and the International Monetary Fund are gratefully acknowledged. Erlinda Inglis supervised the production of the report and Helder Ferreira do Valle provided research assistance.

Generous financial support from the UK Department for International Development and the Dutch Trust Fund is gratefully acknowledged.

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[1] In the spring of 2002 representatives from the Federal Republic of Yugoslavia and the Republics of Serbia and Montenegro agreed on a general framework for a union of Serbia and Montenegro. As a result, a new constitutional charter has been enacted, effective February 4, 2003, which has changed the name of the Federal Republic of Yugoslavia to Serbia and Montenegro. In this report, the term Serbia and Montenegro should be understood to be synonymous with the pre-existing Federal Republic of Yugoslavia.

[2] Where relevant, this report makes reference to the two member states of Serbia and Montenegro—Serbia and Montenegro—and to the province of Kosovo For reasons of brevity and style, these are referred to as Serbia, Montenegro and Kosovo.

1. THE WESTERN BALKANS IN WORLD TRADE

Constantine Michalopoulos[1]

INTRODUCTION

1.1 In the last decade, political and military conflicts led to the economic disintegration of four of the five countries of the Western Balkans, Bosnia and Herzegovina, Croatia, the former Yugoslav Republic of Macedonia (FYR Macedonia) and Serbia and Montenegro. The conflicts and political instability retarded the introduction of market forces and, in some instances, resulted in increased isolation from the world economy. In Albania, although two bouts of violence and internal political instability hampered the transition to a market economy, its problems derived more from decades of orthodox central planning and long isolation from the rest of the world. As the forces of democratization gain strength and prospects for peace and stability improve, the countries in the region can pursue in earnest the much delayed restructuring of their economies and strengthening of their economic institutions. These are necessary for their more effective integration into the world economy, which, in turn, is essential for their long-term growth and economic prosperity. These small economies must depend on international trade and foreign investment to stimulate competition, introduce new technologies and increase productivity in order to raise living standards and reduce poverty.

1.2 Integration in the world economy has three aspects: a regional one, that involves the economic relations between each other and other countries in Central and Eastern Europe, many of which are members of the Central European Free Trade Area (CEFTA); a European one that involves primarily their relations with the European Union (EU), by far their most important trading partner and source of direct investment; and a global one, that involves their trade relations with the rest of the world. While in many respects they are giving the European dimension the highest attention because of the importance of their economic links with the EU, they cannot afford to ignore the other two dimensions: their relations with the EU will yield greater benefits, if they are pursued within a liberal trade environment towards the rest of the world; and the same is true for their relations with their neighbors which are also on a path to integrate in the European structures.

1.3 Each of the five countries finds itself at different stages of these three aspects of integration. They also face different problems and challenges, some of which are unique to each country. But they all face the necessity to strengthen the capacity of their trade related domestic institutions and improve their policies so as to further their integration into the world economy. This study reviews the trade policies and institutions in the five countries (Albania, Bosnia and Herzegovina, Croatia, FYR Macedonia and Serbia and Montenegro) and the challenges they face towards further integration in the world economy, in its three dimensions, the regional, the European and the global. It is based on individual studies of each of the countries, sponsored by

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[1] An earlier draft of this paper under the title 'The Western Balkans in World Trade: An Essay in Memoriam of Bela Balassa' was presented at a conference in memoriam of Bela Balassa held in Budapest, October 17-18, 2001. The author wishes to thank Stanislav Daskalov, Daniela Gressani, Kresimir Jurlin, Bartek Kaminski, and Dana Popovic for helpful comments on this earlier draft and Vasileios Panousopoulos for assisting with the development of the database and preparation of the tables.

the World Bank and carried out mostly by local researchers and institutions and included in the volume of country studies accompanying this report.[2]

1.4 The study is organized as follows: the section following this introduction reviews the economic performance of the five countries with a focus on international trade. The next section discusses their current status regarding participation in the WTO, relations with the EU and relations with each other and countries in Central and Eastern Europe all of which affect the conditions for market access for their exports. The following two sections analyze their policies and institutions related to trade in goods and services, and the main challenges they face in global integration. The last section summarizes the main conclusions and recommendations for the future.

TRADE PERFORMANCE

1.5 The economic performance of the countries in the Western Balkans has lagged behind that of most transition economies. In many respects their performance is similar to that of the countries in the former Soviet Union, such as Armenia, Azerbaijan, Georgia and Tajikistan, which have also experienced significant periods of domestic or international conflict. By 2000, GDP in the whole of Eastern Europe had reached 107 percent of its 1989 level; while in the CIS it was still only at 61 percent.[3] Among the five countries, Albania, has done the best, having reached 103 percent of its very low 1989 level, with growth averaging more than 7 percent the last three years. Croatia experienced sharp declines early on, grew substantially in the period 1994-1997 but its GDP growth has declined in recent periods. FYR Macedonia, after substantial declines in 1992-1995, had seemingly embarked on a steady growth path, only to have the recent conflict jeopardize past achievements. As a consequence, Croatia and FYR Macedonia, had reached only 80 percent and 77 percent respectively of their 1989 level in 2000 (EBRD 2001). Serbia and Montenegro appears to have done even worse, with the GDP in 2000 at less than 50 percent of its 1989 level and similarly for Bosnia and Herzegovina—although for the latter, no comparable data are available for the whole period. Both Bosnia and Herzegovina and Serbia and Montenegro experienced drastic declines in GDP both earlier and during 1992-1995, and in the latter's case again in 1999. Bosnia and Herzegovina has recently resumed growth, albeit from a low base.

1.6 The trade performance of the five countries is summarized in Tables 1.1 and 1.2. Over the period 1992-2000, merchandise exports grew on average only by 0.3 percent per annum. They actually fell during the war years of 1992-1995, when large declines in Yugoslav and Bosnia and Herzegovina exports were not offset by very modest increases in Croatia and FYR Macedonia. Albania's exports grew during all this period very rapidly but from a very small base. The situation improved in Bosnia and Herzegovina and Serbia and Montenegro since 1995, while exports of both Croatia and FYR Macedonia continued to stagnate.

1.7 Imports grew much faster for the period as a whole (6.8 percent per annum) reflecting in most cases (Albania, Bosnia and Herzegovina, FYR Macedonia) the influx of external finance. On the whole this trade performance was also much worse than that of other transition economies in Central and Eastern Europe.

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[2] For Albania, Kaminski (2003); for Bosnia and Herzegovina, Mesinovic, Hurtic, and Suseska (2003); for Croatia, Jurlin and Galinec (2003); for FYR Macedonia, Daskalov et al. (2003); for Serbia and Montenegro, Popovic and Jovicic (2003).

[3] Keeping, of course, in mind the data deficiencies associated with countries in transition noted earlier.

Table 1.1 Merchandise Trade in the Western Balkans (in million US Dollars)

	1992	1995	1996	1999	2000
Albania					
Exports	70	205	229	275	256
Imports	541	680	922	1,121	1,070
Bosnia and Herzegovina					
Exports	339	58	336	649	732
Imports	350	523	1,882	2,502	2,327
Croatia					
Exports	4,597	4,633	4,545	4,394	4,567
Imports	4,500	7,892	8,169	7,693	7,805
FYR Macedonia					
Exports	1,199	1,204	1,147	1,191	1,319
Imports	1,206	1,719	1,627	1,776	2,085
Serbia and Montenegro					
Exports	2,400	810	2,018	1,498	1,923
Imports	3,450	1,400	4,119	3,296	3,711
Total					
Exports	8,605	6,910	8,275	8,007	8,797
Imports	10,047	12,214	16,719	16,388	16,998

Source: The five country studies mentioned in Footnote 2.

Table 1.2 Western Balkan Merchandise Trade—Annual growth rate in percent

	1992—1995		1992—2000		1995—2000	
Countries	Exports	Imports	Exports	Imports	Exports	Imports
Albania	43.1	7.9	17.6	8.9	4.5	9.5
Bosnia and Herzegovina	-44.5	14.3	10.1	26.7	66	34.8
Croatia	0.3	20.6	-0.1	7.1	-0.3	-0.2
FYR Macedonia	0.1	1.9	1.2	7.1	1.8	3.9
Serbia and Montenegro	-30.4	-26	-2.7	0.9	18.9	21.5
Total	-7.1	6.7	0.3	6.8	4.9	6 8

Source: see Footnote 2.

1.8 It should be noted, however, that a lot of the trade data are unreliable and in some cases distorted. The conflicts and sanctions imposed on Serbia and Montenegro, the Greek embargo on FYR Macedonia, the weak customs administration throughout the region, all contributed to a large underground economy, much smuggling and diversion of trade from normal channels. For example the large trade of Serbia and Montenegro with Bosnia and Herzegovina (only Republika Srpska) and FYR Macedonia is due in part to efforts by Serbia and Montenegro to bypass the sanctions imposed on it during most of the period (Popovic and Jovicic 2003).

1.9 Trade in services, e.g., tourism, transport is of actual or potential importance in several of the countries (Table 1.3). Indeed trade in services has been increasing considerably faster than merchandise trade, much as it has worldwide (Table 1.4). While data on trade in services are available only for recent periods for several of the countries and are even weaker than for goods, they show that for all countries annual growth in service exports exceeded 10 percent since 1995.

Table 1.3 Trade in Services in the Western Balkans (in million US Dollars)

Albania	**1992**	**1995**	**1996**	**1999**	**2000***
Exports	19	94	123	253	321
Imports	87	98	134	152	159
Bosnia and Herzegovina	**1992**	**1995**	**1996**	**1999**	**2000**
Exports	n a.	229	322	552	460
Imports	n.a.	252	396	228	196
Croatia	**1993**	**1995**	**1996**	**1999**	**2000**
Exports	2,286	2,455	3,297	3,723	4,084
Imports	1,148	1,410	1,717	2,098	1,827
FYR Macedonia	**1992**	**1995**	**1996**	**1999**	**2000**
Exports	60	185	154	252	298
Imports	30	385	309	323	358
Serbia and Montenegro	**1992**	**1995**	**1996**	**1999**	**2000**
Exports	n.a.	259	688	471	624
Imports	n a.	141	277	243	293
Total	**1992**	**1995**	**1996**	**1999**	**2000**
Exports	n.a.	3,222	4,584	5,251	5,787
Imports	n.a.	2,286	2,833	3,044	2,833

* Estimated on the assumption that the growth rate is the same as for the period 1996-1999.

Source: For Albania, WTO (2000); for the other four countries see Footnote 2.

Table 1.4 Trade in Services in the Western Balkans—Annual growth rate in percent

	1992—1995		1992—2000		1995—2000	
Countries	Exports	Imports	Exports	Imports	Exports	Imports
Albania	70.4	4	44.8	8.3	28.1	11.6
Bosnia and Herzegovina	n.a.	n.a.	n.a.	n.a.	15	-4.9
Croatia*	2.4	7.1	8.6	6.9	10.7	9.7
FYR Macedonia	45.5	24.3	22.2	36.3	10	-1.4
Serbia and Montenegro	n a.	n.a.	n.a.	n.a.	19.2	15.8
Total	n.a	n.a.	n.a.	n.a.	12.4	4.4

* For Croatia the growth rates are for the period 1993-1995 and 1993-2000.

1.10 Though most of the countries have by now installed legislation which is quite friendly to foreign investors, little direct investment has materialized, largely because of the political instability. But the arduous administrative procedures for setting up a firm, whether domestic or foreign, in some cases have not been of much help.

1.11 The openness of the five economies as measured by the ratio of total trade in goods and services to GDP varied considerably—from of a high of around 1.0 for Bosnia and Herzegovina, Croatia and FYR Macedonia to around 0.4 for Albania and Serbia and Montenegro in 2000. In some cases, trade has been rising faster than GDP, resulting in an increasing ratio over time. But the trend is neither strong nor uniform. And these small countries appear less open than other countries of similar size in Central and Eastern Europe, e.g., the Czech and Slovak Republics, Slovenia and Estonia which have much higher ratios of total trade to domestic economic activity. The case of Serbia and Montenegro is again of interest with the impact of the sanctions being felt especially in 1993-1995 which drove the trade to GDP ratio to very low level (Popovic and Jovicic 2003).

1.12 The direction of the five countries merchandise trade is shown in Table 1.5. As in all transition economies of Central and Eastern Europe, the EU is by far the largest market for their exports and source for their imports. But what is of special interest is that, with the exception of Albania, the shift to the European markets has been less pronounced than in other transition economies in Central and Eastern Europe, especially in recent periods. In part this is due to the special situation in Serbia and Montenegro. But in Croatia, the EU trade share has actually declined slightly since 1994; while in FYR Macedonia it has increased only a little since 1992. Indeed, the share of EU in the exports of the former Social Federal Republic of Yugoslavia (SFRY) rose from 35 percent in 1987 to 47 percent in 1990—which was identical to the share of the EU in the combined exports of Bosnia and Herzegovina, Croatia, FYR Macedonia and Serbia and Montenegro in 2000.

Table 1.5 Direction of Merchandise Trade 1992-2000 (in percent)

EXPORTS															
	Albania			Bosnia and Herzegovina			Croatia			FYR Macedonia			Serbia and Montenegro		
Markets	1994	1996	2000	1994	1996	2000	1994	1996	2000	1992	1996	2000	1992	1996	2000
EU	77	86	90	39	44	65	59	51	55	40	43	44	32	38	38
Other Developed	13	2	4	14	7	3	3	4	6	15	10	17	n a	n.a	n a
CEFTA	2	1	1	14	10	10	17	18	14	19*	9	4	4	6	9
Western Balkans	5	3	2	11	34	11	10	14	15	17	28	33	n a	27	29
Russia	0	0	1	17	0	3	3	3	1	n a.	3	1	n.a	5	8
Developing & Others	3	8	2	5	5	7	6	10	10	9	7	2	27**	19**	n a
IMPORTS															
	Albania			Bosnia and Herzegovina			Croatia			FYR Macedonia			Serbia and Montenegro		
Source	1994	1996	2000	1994	1996	2000	1994	1996	2000	1992	1996	2000	1992	1996	2000
EU	77	76	77	18	37	44	59	59	56	36	39	38	44	42	42
Other Developed	10	8	7	6	5	3	8	8	9	11	11	10	n a	n a	n a
CEFTA	1	3	3	10	23	25	16	17	15	34	13	19	8	10	9
Western Balkans	4	3	3	48	32	20	1	1	2	5	14	12	n a	10	11
Russia	0	0	1	16	1	2	3	3	9	n.a	8	9	n a	5	9
Developing & Others	8	9	9	1	2	5	11	12	9	14	15	14	n a	33**	19**

Totals may not add up to 100 percent because of rounding.

* Includes Other Eastern Europe and former Soviet Union

** Includes Other Developed.

Source. Albania and Croatia, IMF (2001), for other countries see Footnote 2

1.13 The CEFTA countries are the next most important trading partners; but their share has not changed significantly in recent periods. Indeed these countries seem to have lost some of their share, especially in FYR Macedonia.

1.14 Trade relationships among the five countries are quite varied. In some cases they are very substantial. For example, each of the Bosnia and Herzegovina entities (the Federation of Bosnia and Herzegovina and Republika Srpska) has strong trade relationships with Croatia and Serbia respectively, and little trade with each other. There is a strong trade relationship between FYR Macedonia and Serbia and Montenegro. But as of early 2001 there was still little trade between Serbia and Montenegro and Croatia, and virtually none between Albania and Croatia and Albania and Serbia and Montenegro.[4]

1.15 Finally, Table 1.6 reviews the composition of merchandise trade for the five countries over the last decade. The data are in some cases incomplete. But two major conclusions are inescapable:

[4] The actual trade of Serbia and Montenegro with Albania was US$0.2 million in exports and US$1.1 million in imports (Popovic and Jovicic 2003). Serbia and Montenegro's trade statistics are especially problematic: the official statistics reported in the IMF 2002 show no trade with FYR Macedonia or Russia, which of course is incorrect.

- These countries' exports are concentrated in manufactures. Indeed heavy manufacturing industries (SITC5-7), such as transport equipment (e.g., shipbuilding in Croatia), machinery and metal processing industries are important export sectors and account for over 50 percent of exports in all countries except Albania, where the manufacturing exports are concentrated in textiles and shoes. Agricultural exports play little role in their trade and they are all net food importers;[5] and

- With the exception of Albania, the composition of merchandise trade by product group has not shifted markedly in the last decade. In the case of Serbia and Montenegro, there has been a reduction in the share of manufactures and an increase in the share of raw materials and other goods with limited degree of processing; the reverse has happened in Albania, thanks mainly to textile processing. The major underlying cause of this is, that with the exception of Albania little economic restructuring has occurred in these economies; and in the case of Serbia and Montenegro some deindustrialization. Conflict has delayed reforms, privatisation and restructuring and this is reflected in the composition of their exports.

Table 1.6 Composition of Merchandise Trade, 1991-2000 (in percent)

	EXPORTS									
	Albania		Bosnia and Herzegovina			Croatia			Serbia & Montenegro	
SITC	1996	1998	1994	1996	2000	1992	1996	2000	1991	2000
0*	9	10	9	9	6	15	8	5	11	15
1	13	2	2	2	2	12	14	10	1	0
2	17	17	5	5	6	5	6	4	3	7
3	4	1	9	9	11	1	1	5	4	0
4	2	0	0	0	0	0	0	0	0	0
5	1	1	13	14	13	4	6	5	9	8
6	14	12	15	13	15	30	31	37	27	37
7	2	3	17	21	27	8	8	6	20	12
8	51	56	30	25	20	26	28	29	23	16
0*	9	10	9	9	6	15	8	5	11	15
	IMPORTS									
	Albania		Bosnia and Herzegovina			Croatia			Serbia & Montenegro	
SITC	1996	1998	1994	1996	2000	1992	1996	2000	1992	2000
0*	32	24	10	10	7	14	13	10	8	8
1			1	1	1	2	1	1	1	1
2	1	5	3	3	2	9	5	3	5	6
3	3	4	11	11	14	12	9	14	18	20
4	3	3	0	0	0	1	1	1	0	0
5	6	10	10	11	13	13	11	9	13	15
6	18	22	15	18	18	17	19	13	14	21
7	23	17	26	27	33	10	22	20	23	22
8	14	15	15	14	12	10	11	5	11	6
9	0	0	8	5	0	12	8	25	7	1

Notes 0=less than 1 percent' SITC: 0-food products; 1=beverages and tobacco; 2-crude materials; 3-mineral fuels; 4-animal and vegetable oils and fats; 5-chemicals; 6-manufactured goods classified by materials; 7-machinery and transport equipment; 8-other manufactures; 9-other Bosnia and Herzegovina's exports in SITC 7 plus SITC 8 in 1996 and 1999 accounted for 69 percent and 74 percent of its total exports, respectively; while its food imports accounted for 16 percent and 19 percent of its total imports in these two years.

Source Albania and Croatia, IMF (2001), for other countries see Footnote 2

[5] Serbia and Montenegro used to be a net exporter of food to the EU as well as to Croatia (Popovic and Jovicic 2003).

1.16 In sum, while the EU has been and continues to be the main trading partner of the five countries, their trade flows have been disrupted and distorted by conflicts; and the delays in structural reforms have also affected the supply side and reduced the opportunities for export product diversification.

TRADE RELATIONS AND MARKET ACCESS CONDITIONS

1.17 Throughout most of the last decade, market access conditions for some of the countries were especially unfavorable due to political factors. None of them were WTO members until recently, and had to rely on voluntary extension of MFN treatment by their major trading partners. Serbia and Montenegro's exports suffered significantly from the embargoes imposed on it first by the UN, then by the EU. FYR Macedonia suffered from an embargo by Greece in the early 1990s. While a number of them were extended preferences by the EU, the preferences used tariff quotas to limit exports in a number of product categories, especially agriculture—each of which were individually negotiated.[6] And the conflicts in the region distorted trade flows: for example, for a time Bosnia and Herzegovina had de facto two separate free trade arrangements: the Federation of Bosnia and Herzegovina had a free trade arrangement with Croatia; and Republika Srpska, a free trade arrangement with Serbia and Montenegro. As of 2002 however, a lot of these problems had been overcome and market access conditions had improved in all respects. The current situation regarding global, EU and regional market access is summarized below.

WTO Membership

1.18 Albania and Croatia became WTO members in late 2000, after considerable delays, some not of their making,[7] and they are thus able to enjoy the unconditional MFN privileges associated with WTO membership. FYR Macedonia's accession has been approved and is awaiting ratification.[8] The other two countries are applying to accede, and working parties have been established to consider their application. The working parties for Bosnia and Herzegovina and Serbia and Montenegro have only been recently set up and membership in the organization is probably at least three years away.[9]

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[6] Although it is fair to note that many of these quotas went unfilled due to supply constraints in the exporting countries.

[7] Their accession was delayed for several months by US-EU wrangling over the acceding countries' commitments in the audio-visual segment of the GATS.

[8] FYR Macedonia had applied to accede to the WTO as early as 1995. But the processing of its application got stuck in disputes over its name. WTO accession documents use the country's initials as part of the document classification. Thus, a document to be considered by the WTO's General Council, on Croatia's accession would be designated WT/ACC/HRV/1. FYR Macedonia insisted on the use of the initials 'MK' in the documents pertaining to its accession. The EC objected because of Greece's concerns over FYR Macedonia's name. It took the WTO and its members four years to come up with a compromise solution of using Arabic numerals (709) instead of letters for the designation of FYR Macedonia's accession documents; whereupon, the accession process resumed.

[9] Serbia and Montenegro had also applied to accede as early as 1996, but for political reasons, its application was not considered.

Relations with the European Union

1.19 In late 2000, the EU established a uniform and generous Autonomous Trade Preference (ATP) scheme, which provides duty and quota free access for practically all exports of the five countries to the EU markets.[10] The scheme actually appears to be even more generous in providing market access opportunities to these five countries than the EU 'Everything but Arms' initiative for market access to the Least Developed Countries (LDCs) and it is certainly more generous than the preferences provided by the EU under the 'Europe' agreements to 'candidate' countries.[11] All in all, the ATP scheme appears to put these five countries at the top of the EU preference pyramid.

1.20 Also in 2000, the EU launched the far reaching Stabilization and Association (SA) process which sets the overall legal framework that will guide the future economic and political relationships between the EU and these five countries. The SA process envisages the establishment of free trade areas (FTAs) between the EU and each of the five countries—as well as between the countries themselves, based on contractual undertakings. The implementation of the FTAs with the EU is supposed to be asymmetric, in the sense that EU liberalization of its markets towards these countries' exports will take place faster and along a broader range of products than the reverse. In the case of the Stabilization and Association Agreement (SAA) concluded with FYR Macedonia, a full liberalization of all markets to EU products is supposed to take place in ten years, while the EU will liberalize its markets for FYR Macedonia's exports much sooner.[12]

1.21 But the SA process involves much more than FTAs. The EU does not initiate negotiations for an SAA unless the EU judges that the political conditions are met and the country would have the institutional capacity (with EU assistance) to implement its commitments under the agreement. These commitments extend beyond trade and cover matters pertaining to investment, competition, the environment, standards, etc. The aim in all these is to bring the institutions, legislation and regulations of the countries to be in line with those in the EU so as to facilitate their future integration into the EU structures.

1.22 The SAAs are very similar to the 'Europe' agreements. The differences relate primarily to the political pre-conditions to be met for starting negotiations, to the more detailed provisions on political matters and harmonization of legislation as well as the firm obligations for regional trade cooperation. Countries with 'Europe' agreements become eligible for EU accession once they meet the 'Copenhagen' criteria—which mention explicitly countries which have concluded 'Europe' agreements. Countries with SAAs, on the other hand, are labeled 'potential candidates' for EU accession. This would suggest that at this point on the part of the EU, there is no formal

[10] There are quota limitations to all the countries at the same time on three minor agricultural products, baby beef, some types of sardines and wine; some limitations on textiles also are present, as all Western Balkan countries, except for Serbia and Montenegro, have signed separate bilateral textile agreements with the European Union which have not liberalized trade entirely. The preferences are also extended to products from Kosovo (EU 2000a). The original scheme was only for 26 months, starting from November 2000 and did not include Serbia and Montenegro or FYR Macedonia; its duration was subsequently extended to five years and included Serbia and Montenegro and FYR Macedonia (EU 2000b)

[11] Based on preliminary findings of work in progress by the author.

[12] See EU (2001). Even so, the ATP offers better access to FYR Macedonia's exports than the SAA; as a result, it has been agreed that this part of the SAA be suspended—until the liberalization under the SAA, which is contractual in nature, catches up with the unilaterally provided preferences of the ATP.

commitment to these countries that they would enter the 'queue' of candidates, but the desire to establish some type of association whose parameters would be decided in the future.[13] As of the time of this writing, an SAA had been signed with FYR Macedonia and Croatia; the decision had been taken to negotiate one with Albania; and preliminary discussions for one with Serbia and Montenegro had started.

Trade Relations with Other Countries in the Balkans

1.23 The five countries have shown different tendencies towards strengthening regional trading relationships, with political considerations dominating the pattern of free trade agreements (FTAs) concluded. FYR Macedonia has been the most active having set up FTAs with Serbia and Montenegro and Croatia, as well as Slovenia and Bulgaria. Bosnia and Herzegovina had the split arrangement with Croatia and Serbia and Montenegro noted earlier. Croatia, in addition had an FTA with Slovenia. Albania had no FTAs (Messerlin 2001).

Box 1.1 Stability Pact and the Stabilization and Association Process

The European Council, commanding body of the EU, approved the proposals for a Stability Pact for South Eastern Europe on May 17, 1999. The Pact was formally adopted by the countries bordering on Serbia and Montenegro (plus Moldova which became a member of the Stability Pact on June 28, 2001), the EU, the US and other governments and international organizations in June 1999 in Cologne. It has multiple objectives ranging from promoting democracy, reducing corruption, preserving multi-ethnicity and fostering economic cooperation that would lead to enhanced prosperity for all citizens in the region.

The Pact has established three "working tables" on democratization and human rights, economic reconstruction, development and cooperation, and on security issues. The "economic" table has been charged among other tasks with the responsibility of promoting free trade areas and economic cooperation in the Balkans and between Balkan countries and the rest of Europe and the world. The EU has launched a Stabilization and Association Process. Its major feature is the EU's commitment to enter into bilateral Stabilization and Association Agreements with the Western Balkans combined with a promised prospect of some type of future association with the EU. The SAAs envisage free trade areas within 10-12 years, reforms of the economy and institutions, cooperation in politics and judicial affairs and harmonization of legislation with that in the EU. As of end 2002, agreements had been signed with Croatia and FYR Macedonia, preparations were made to negotiate one with Albania and consultations were under way with Bosnia and Herzegovina and Serbia and Montenegro.

The EU has explicitly indicated its preference as to the form that regional cooperation among Western Balkan countries should take. As the Council Regulation (No. 2007/2000) of September 18, 2000 puts it, "... the entitlement to benefit from the preferential arrangement (. .) shall equally be subject to their readiness to engage (...) in regional cooperation with other countries concerned by the European Union's Stabilization and Association Process, in particular through the establishment of free trade areas in conformity with Article XXIV of the GATT 1994 and other relevant WTO provisions."

1.24 These agreements typically provided for substantial liberalization of trade in manufactures, with exceptions on a few sensitive products, and much more limited liberalization in agriculture, based on mutually agreed positive lists (Daskalov et al. 2003; Popovic and Jovicic 2003; Jurlin and Galinec 2003). There is little evidence that these agreements did much to stimulate intra regional trade, except to underpin existing patterns, as for example the agreement between Serbia and Montenegro and FYR Macedonia which permitted the former to alleviate in part the burden of the sanctions imposed against it.

[13] The situation regarding present relationships of these countries with the EU in this respect appears to be similar to that articulated in the first 'Europe' agreements in 1991-2, before the Copenhagen criteria were set up.

1.25 The demise of the Milosevic regime ended the isolation of Serbia and Montenegro and ushered a new era of activity to set up more bilateral FTAs. A new FTA which covered the whole country was set up between Bosnia and Herzegovina and Croatia; with the latter also having concluded an agreement with Hungary, and engaging in discussions with Bulgaria and Romania; discussions for FTAs also started between Croatia and Serbia and Montenegro and Albania with FYR Macedonia, and between Bosnia and Herzegovina and Serbia and Montenegro and Bosnia and Herzegovina and Slovenia.[14]

1.26 The countries in the region, have so far eschewed efforts to set up a single FTA area and have opted for setting up a network of bilateral FTAs. The main reason appears to be political: there is no consensus to set up an overall FTA involving the five countries (or possibly including Bulgaria and Romania), as some have recommended or for all of them to join CEFTA;[15] and there are sufficient economic differences in the level of development of each to make it appear that bilateral FTAs is the only way to liberalize trade among each other—recognizing of course that such FTAs would have to be concluded as part of the commitment that these countries have made to the EU in the context of the SAAs they all want to sign.

1.27 This situation raises a variety of problems and challenges: given the commitment to enter into preferential arrangements with the EU, liberalization of trade among the countries in the region would appear desirable in order to avoid the familiar 'hub and spokes' pattern of trade which tends to result in the hub getting the bulk of the benefits especially regarding investment. At the same time, an uncoordinated series of bilateral FTAs involving different product coverage, depth of preference, rules of origin and so forth is an invitation to disaster. This 'spaghetti bowl' of agreements, will be extremely difficult to implement, in light of the tremendous weaknesses in the customs authorities in the region (see below). And, if implemented, it is likely to introduce substantial trade distortions without generating significant benefits in terms of the economies of scale, technology transfer or international bargaining power (World Bank 2000b). As a consequence the preferential arrangements would not lead to dynamic gains which Balassa early on (see Balassa 1961; Balassa and Kreinin 1975) identified as critical to their success.

1.28 It is because of such concerns that the international community through the Stability Pact Working Group on Trade Liberalization and Facilitation and under the leadership of the EU and the World Bank strongly encouraged the countries in the region to reach an understanding that would set minimum standards for the FTAs and to take complementary steps to improve prospects that the FTAs will be beneficial to the participating countries. Such an agreement was reached in June 2001. At that time the five countries were joined by Bulgaria and Romania in signing a 'Memorandum of Understanding' (MOU) on future trade liberalization in the region.[16]

1.29 The MOU was important for both political and economic reasons Politically, it was very important to have an agreement signed by seven Balkan countries on a range of trade issues, at a time when trade relations between some them (for example, between Croatia and Serbia and

[14] The agreement between Bosnia and Herzegovina and Croatia involves asymmetric treatment in favor of the former, a principle apparently also agreed in the arrangements between Bosnia and Herzegovina with Serbia and Montenegro and Slovenia. FYR Macedonia is also negotiating an agreement with Ukraine, while Serbia and Montenegro has concluded one with Russia.

[15] See for example, Bateman (2000); Gros (1999); Steil and Woodward (1999); East West Institute (2000); Petrakos and Totev (2000).

[16] See Stability Pact (2001). Moldova, has subsequently associated itself with the contents of the MOU and is working towards closer trade relationships with the signatory countries.

Montenegro) were completely disrupted by previous conflicts. The process of reaching agreement was important in forging ties between the countries; as is the continuing interaction of the countries in the Working Group, which will monitor the implementation of the MOU.

1.30 On the economic side, the MOU was a mixed success: perhaps its single most important contribution was in laying down standards for product coverage both for existing and future FTAs among the participating countries. The MOU calls for FTAs to cover at least 90 percent of products, measured both in terms of Harmonized System (HS) tariff lines and value of trade. Currently, the standard is met by many but not all of the existing FTAs. The standard may also not be met by other agreements in the region such as those of CEFTA.[17] At the same time, the MOU permits a rather slow six years for attaining the standard.

1.31 The MOU also covers a number of other areas: it commits the countries a standstill on any measures that would adversely affect trade; to reach agreements on FTAs by end of 2002; to standardize the rules of origin they use in the FTAs; to liberalize trade towards third countries; to consider liberalization of services trade; to monitor non-tariff measures that impede trade, and to take steps that harmonize their legislation and regulations on a number of trade related topics, such as competition, investment and standards and bring them more in line with those of the EU. One of the issues that the MOU carefully skirted around was the issue of the relationships of Bulgaria and Romania, who have a different set of relationships with the EU, to the other five countries. Another was what to do about the trade relationships some of the signatories have or are planning to have with CEFTA.

1.32 There has been substantial progress in implementing the MOU provisions concerning the conclusion of FTAs among the countries in the region, especially if one excludes Moldova, which, with the exception of Romania, has very limited trade relations with the Balkans. As of end 2002, excluding Moldova, all but two agreements had been concluded among the countries in the region; these two agreements (Bulgaria with Serbia and Montenegro, and Bulgaria with Bosnia and Herzegovina), are expected to be concluded in early 2003. In addition, Moldova has also concluded some agreements with countries in the region. As of the time of this writing, practically all of the FTAs which had been reviewed had met the 'quality' standards agreed under the MOU.[18]

1.33 While the MOU was a useful step forward, it left a number of issues unanswered. Perhaps the most important is how liberal the overall trade regimes of the countries will be. The more liberal and open the economies, the less the trade distorting effects of the FTAs. The other issue is a strategic one and has to do with the relationships between these countries and CEFTA. There has been some feeling, especially in Bulgaria and Croatia that it may be useful for all of these countries to join CEFTA, as a stepping-stone towards EU association in some form. At the same time the very considerable differences in the levels of income between these countries and those of CEFTA raise a different problem: there is some evidence that in cases of preferential arrangements among developing countries with very different levels of income, the benefits tend to be concentrated in the more advanced of these countries (World Bank 2000b). And, so far, there is little evidence that asymmetric trade relationships, such as those being put in place in the case of Bosnia and Herzegovina—which are important in political economy terms, are sufficient to overcome the polarization of benefits.

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[17] It is fair to note, however, that the members of CEFTA over time also increased product coverage and trade liberalization commitments beyond those originally agreed.

[18] See Messerlin and Miroudot (2002).

TRADE POLICIES

1.34 Starting from the traditional import substituting protectionism of former SFRY and the hermetic isolationism of communist Albania, the policies of the five countries evolved in different directions over the last decade. Under the influence of Western donors and the international financial institutions (IFIs), on whose assistance they were heavily dependent, Albania and Bosnia and Herzegovina established relatively liberal trade regimes (for countries at their level of development), with the former locking in its regime following its accession to the WTO. Croatia and FYR Macedonia, continued for a while the import substituting protectionism of the earlier period, but over time introduced liberalizing reforms—the former more so, also as part of its accession to the WTO. Serbia and Montenegro was a special case. It continued a very distorted, non-transparent, corruption-ridden regime until the end of the Milosevic era, when the new Federal government introduced far-reaching trade reforms. At the same time, Kosovo and Montenegro emerged with different customs administrations and trade policies.[19] This situation has not changed with the enactment in February 2003 of new constitutional charter of Serbia and Montenegro. The main elements of trade policy in these countries and territories as of mid 2001 are summarized below.

Policies on Merchandise Imports

1.35 **Tariffs.** The tariff regimes that have emerged are summarized in Table 1.7. The average tariff rates are lowest in Albania and Bosnia and Herzegovina, (8.1 percent and 6.8 percent respectively) which also have the lowest dispersion of tariffs, with rates in a few bands and no peaks over 15 percent. Kosovo and Montenegro also have relatively low rates and little dispersion, with the UNMIK administration in Kosovo having imposed a flat 10 percent tariff rate on all imports; while Montenegro has five rates with a maximum of also 15 percent.

Table 1.7 Tariff Averages, 2001 (in percent)

	Unweighted	Import Weighted	Bands
Albania	8.1	n.a.	2,10,15
Bosnia and Herzegovina	6.8	n.a	0,5,10,15*
Croatia	7	7	100+ rates
Serbia and Montenegro	9.5	8	1,5,10,15,20,30
Kosovo	10	10	Uniform
Montenegro	3	n a	1,3,5,10,15

* Also specific duties on 250 HS lines of agricultural products (not included in averages)

Source: For five countries, see footnote 2; for Kosovo, Kaminski 2000; for Montenegro, FR Yugoslavia 2001, Vol 2, Ch.3.

1.36 The tariff regimes in the other three countries are more differentiated reflecting the pressure of domestic interests, especially in agriculture and a few other sectors. Croatia introduced a new tariff schedule in connection with its WTO accession which has a low average tariff (7.0 percent), but a more differentiated tariff structure than in Albania and Bosnia and Herzegovina (Jurlin and Galinec 2003). A new and more liberal schedule averaging 9.5 percent (8.0 percent when weighted) was also introduced by the new government of Serbia and Montenegro. Interestingly, FYR Macedonia, with the smallest economy of these three countries has the highest average protection rate 14.2 percent, in both industry and agriculture, a questionable distinction.

[19] For the trade regime in Kosovo, see Kaminski (2000); for Montenegro, see Yugoslavia (2001).

1.37 With the exception of Albania (Kaminski 2003), the structure of protection shows tendencies of escalation, with raw materials and capital goods inputs being protected less than final consumer goods. The resulting effective rates of protection can be considerable, as shown in Croatia (Jurlin and Galinec 2003). As noted above, agriculture is being protected more than industry—following a worldwide and European pattern; and within industry the main protected sectors are textiles and clothing, shoes, and some products of metallurgy.

1.38 In most of the economies, tariffs are of actual or potential importance as sources of revenue. This is especially the case for Kosovo and Montenegro; but, it is also true of Bosnia and Herzegovina where tariff revenues account for perhaps a third of the entities budget. Either because of tariff exemptions or because of tariff evasion due to corruption and weak customs administration and enforcement, actual tariff collections are far below potential, e.g., in FYR Macedonia and Kosovo. On the other hand in Albania, collections are pretty close to what the average tariff rates suggest they should be (Kaminski 2003).

1.39 **Non-Tariff Measures**. There are major differences in the prevalence of non-tariff measures (NTMs) in the trade regimes of the countries. The fundamental distinction is between regimes in those countries that are members of the WTO (Albania, Croatia, and FYR Macedonia) or whose administrations are fully controlled, or heavily influenced by international institutions (Kosovo, and Bosnia and Herzegovina) which have no formal NTMs, except licensing needed for the health, safety and environmental reasons; and Serbia and Montenegro, which is not a WTO member and which has maintained licensing of imports for essentially protective purposes both in Serbia and in Montenegro. In the case of Serbia, this licensing is selective and limited to a short list of steel products (Popovic and Jovicic 2003). In the case of Montenegro, the licensing is substantial, as several product categories in a number of sectors had been subject to licensing by the Ministry of Trade.

1.40 While formal NTMs are not widely applied in these countries, there is evidence that the implementation of some of the controls imposed on sanitary and safety grounds have the effect of inhibiting imports, as for example in Croatia (Jurlin and Galinec 2003). The same is true for delays and corruption that has been endemic in customs clearance.

1.41 **Trade Remedies**. The countries which are WTO members as well as those that are applying to accede, have or are planning to put in place legislation and regulations that permit them to initiate and implement anti-dumping, safeguard and countervailing actions, which are consistent with WTO provisions. As of the present however, only one country (FYR Macedonia) reported taking countervailing action on two occasions.[20]

Policies on Merchandise Exports

1.42 A number of the countries (Serbia and Montenegro) impose controls on a selected number of exports, usually of agricultural products, on the grounds of food security (Popovic and Jovicic 2003). In some cases (FYR Macedonia) some export controls appear to be in place in order to protect domestic processors of domestically produced raw materials.

1.43 At the same time, they appear to have few active or effective supports to exports and there are serious weaknesses in the institutions related to export promotion. In particular, while all the countries have some kind of tariff rebate or exemption regime for exports in place, it

[20] See Daskalov et al. (2003). The actions were taken against Hungary for the export of subsidized milk. It is not clear whether or how the issue has been resolved.

appears that none of the schemes are operational. Despite a tariff structure that favors raw materials and capital goods imports, the potential disadvantages faced by exporters using imported inputs and paying higher than world prices can not be dismissed. Similarly, little export finance or insurance appear to be present either through the regular banking or insurance systems or through specialized programs. Formal export marketing institutions are present in practically all the countries, but their effectiveness in stimulating exports is very much in question.

Policies on Services

1.44 As noted earlier, certain service exports, in particular, tourism and transportation, are of actual or potential significance to the economies of several of the countries. At the same time, their policies vis-à-vis imports of services, e.g., financial services and telecommunications, are of importance to the inflow of foreign direct investment and to the broader operations of their economies.

1.45 There is little systematic information on the policies of the five countries towards their service sectors. But based on the analysis of the five studies, the following are some preliminary conclusions regarding the situation at present.

1.46 First, regarding the tourist sector, which is already a major foreign exchange earner in Croatia, practically all the countries consider it to have large potential. In practice, the tourist infrastructure is basically absent, and even Croatia suffers from considerable weaknesses both in transport and hotels. The situation in the other countries is much worse. In some cases, the infrastructure has been damaged by the internal conflicts and never rebuilt (Bosnia and Herzegovina); in Albania, it was never there. Thus, while all the countries have considerable natural attractions and could be the destination of significant numbers of tourists, large amounts of investments in the sector are needed before it can make a significant contribution to foreign exchange earnings and domestic incomes. At the same time, they need to exercise considerable care in preserving their often fragile environment from the demands of large scale tourism.

1.47 The transport sector is of importance to several countries (Croatia, Serbia and Montenegro, FYR Macedonia) because they are situated in through trucking routes to Europe for Bulgaria and Turkey.[21] The revenues from this source are far below the potential for these countries for a variety of reasons: the conflicts in all the countries, delays at border crossings and the damage to the road infrastructure caused by NATO bombing in Serbia and Montenegro have all resulted in traffic being diverted to other routes.[22] Again, there is potential, which requires both peace and stability and considerable investment to be realized.

1.48 Country policies on the right to establishment, ownership and the conduct of operations of foreign firms, all affect foreign investment in banking, insurance and telecommunications. Foreign investment in these sectors is essential for increasing productivity both through competition and the introduction of new technology. These sectors are critical to the integration of their economies to the world trading system because these service sectors provide important inputs to other sectors and affect the competitiveness of merchandise exports. And foreign participation in these sectors may stimulate other foreign investment flows, especially in industry.

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[21] River transport is also of importance to Serbia and Montenegro; but it too has been damaged, due to the damage in bridges of the Danube which have not been rebuilt.

[22] See Yugoslavia (2001) There are also problems involving air and rail transport.

1.49 Albania and Croatia have made significant progress in the liberalization of these sectors as part of their accession to the WTO. Their commitments in this respect are quite liberal and, overall they are more extensive than the WTO commitments made by Bulgaria and Romania or developing countries at similar levels of development (Michalopoulos and Panousopoulos 2002). In Croatia for example, major sectors such as domestic trade, tourism and restaurants, construction and freight enterprises are subject to considerable competition since there are low barriers to entry by foreign providers. In the financial sector, the majority market share is owned by foreign banks (Jurlin and Galinec 2003). FYR Macedonia's services offer to the WTO in the process of accession, is also quite liberal. The situation in the other countries is somewhat less clear. In principle, they also permit the establishment and operation of foreign firms In practice, in all countries there is room for improvement in simplifying the administrative procedures associated with private investment, whether domestic or foreign.

GOVERNANCE AND TRADE RELATED INSTITUTIONS

1.50 The five countries in the Western Balkans suffer to some degree from serious weaknesses in governance and institutional development. Some of these are general and affect all aspects of government administration and the operations of the market economy.[23] Some are specific to the conduct of international trade. Many are linked to the conflicts that have torn the region which have retarded the transition to a market economy; a few are linked to the way the conflicts have been resolved. All undermine the integration of these economies in the world trading system. We will focus here only on those which are more closely linked to the conduct of international trade.

1.51 Perhaps the most important of these specific weakness are those noted already in customs administration. Both the human resources and the physical infrastructure in Customs are inadequate; the terrain is difficult and demanding: there are many mountain crossings; there are 400 road crossings in Bosnia and Herzegovina and Croatia and only 35 customs collection points. In addition to these there has been extensive corruption which has contributed to large scale smuggling and losses of revenue.[24]

1.52 Partly because of these glaring problems, reform efforts supported through donor assistance are in place in practically all countries. The EU, the US and the World Bank, all have in place or planned (for Serbia and Montenegro) a variety of programs in support of customs reform and strengthening of customs administration in all the countries and territories of the region. Perhaps one of the questions that needs to be looked at in this area is whether there is adequate donor coordination of these efforts.[25] One of the problems is that the best way to coordinate these efforts is through action by the government authorities which receive the assistance. But often these authorities are also weak.

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[23] All the countries achieved no more than a '2' rating (out of a maximum of 4+) in EBRD's ratings on corporate governance, competition and privatization (EBRD 2001).

[24] Popovic and Jovicic 2003, present a detailed discussion of the different methods used to avoid paying customs duties during the Milosevic era; see also Mesinovic et al. (2003).

[25] A joint European Commission-World Bank office has been established in Brussels to help with the overall coordination of donor efforts to assess the needs and mobilize support for the countries in South East Europe.

1.53 The way the conflicts have been resolved has added in some cases to problems of governance in international trade: in Bosnia and Herzegovina the authority to pass trade legislation and issue directives and regulations pertaining to trade policy, the setting of tariffs, and the representation of Bosnia and Herzegovina abroad rests with the State government.[26] But the two entities (the Federation of Bosnia and Herzegovina, and Republika Srpska) have separate customs administrations which implement the collection of tariffs and they are the ones that keep the revenues collected and decide on their use. Recently, an effort is under way to strengthen the authority of the State government, and establish a single customs revenue account, which hopefully will increase transparency and revenue administration (Mesinovic et al. 2003).

1.54 A similar problem has de facto emerged in Serbia and Montenegro with Montenegro, which has established its own customs authority and trade policy; which collects and keeps the revenue from tariffs and has attempted to have some limited representation of its trade interests abroad.[27] This has not been done in Serbia, where the government collects excise taxes, but not tariffs. In both cases the way the system has emerged reflects fundamental political problems, which unless resolved in a transparent, coherent and effective manner, will hamper the accession process of both Bosnia and Herzegovina and Serbia and Montenegro into the WTO.[28]

1.55 The specific weaknesses of export related institutions and policies has already been discussed. Export finance and insurance are absent forcing transactions on a cash basis. There are weaknesses in the transport infrastructure accentuated by the conflicts and the destruction caused by the NATO bombing in Serbia. And the conflicts have made it difficult to establish the credibility of local institutions abroad. For example Bosnia and Herzegovina was not able to participate in the TIR system, which handicapped its land transport business, primarily because of weaknesses in its insurance system and the organization of its trucking association—weaknesses currently being addressed with the assistance of the United Nations Economic Commission for Europe (UNECE).

1.56 In the emerging world trading system, another set of institutions are assuming more importance: those related to the implementation of Sanitary and Phytosanitary (SPS), Technical Barriers to Trade (TBT) and Trade Related Intellectual Property Rights (TRIPS) Agreements under the WTO. These institutions are important in order to help the governments implement the commitments they assume under the WTO. But they are also important in monitoring the activities of other countries, so as to safeguard their export interests. For example a good health and sanitary inspection system is of importance both in order to ensure that harmful imports do not come in; and to make sure that a country's exports meet the standards imposed by its trading partners, and do so fairly.

1.57 The evidence is that all the countries have these institutions in place. Albania and Croatia have had to convince the WTO members that their institutions will enable them to meet their commitments; and the other countries will have to do so, if they are to become members. Yet in all countries, irrespective of whether they are WTO members or not, the country studies suggest moderate to very large weaknesses in these institutions, some of which actually result in them becoming a de facto barrier to trade (Croatia); in other cases (Albania) undermining their capacity

[26] Which is equivalent to a 'federal' level authority.

[27] As noted earlier, Kosovo also is separate customs territory, though formally still a part of Serbia and Montenegro

[28] The recent decision to introduce further constitutional changes and the name change are also causing delays in the WTO accession.

to export to the EU. Many of the countries have received or are receiving assistance from various donors (the US, EU, Switzerland) to strengthen these institutions as part of the WTO accession process. It would seem that such assistance should not stop when WTO accession is achieved, because in many cases weaknesses will persist making the implementation of their WTO commitments problematic.

1.58 Finally, there is little evidence that the countries have in place institutions that provide an adequate safety net that cushion the impact of trade reform or liberalization on those adversely affected. The general literature on the subject suggests that trade reforms most likely entail net benefits for the society as a whole but could result in private costs to groups of individuals and their families who lose their jobs as a consequence of the influx of imports; that private costs are minimized, if the economies are growing and vibrant; and that a general safety net is better in dealing with these problems, rather than one particularly geared to dealing with problems related to imports (Matusz and Tarr 2001).

1.59 There is little evidence that the economies in the region suffered significant dislocation from imports caused by trade liberalization in the aftermath of the transition—though there is some feeling that this happened in FYR Macedonia.[29] Indeed the dislocations in the region have been so vast, that anything that may have resulted from trade would pale into insignificance. Irrespective of what happened in the past, however, it is clear that the whole objective of poverty alleviation in any society requires the establishment of adequate safety nets to deal with economic dislocation and unemployment from whatever source, including through trade.

CONCLUSIONS AND RECOMMENDATIONS

1.60 The trade performance of the Western Balkans during the last decade has lagged behind that of other economies in transition in Central and Eastern Europe. This was due primarily to the interrelated effects of the conflicts in the region and the delay in introduction of market reforms. While market access issues have constrained trade for some individual countries and particular periods, at present, the countries enjoy generous trade preferences in their markets in the EU, towards which most of their trade has been oriented.

1.61 The composition of their exports, however, has not changed significantly in the last decade, primarily due to the delay in restructuring their economies. At the same time their trade policies have not encouraged export expansion. For a considerable period of time, their trade regimes were protective producing disincentives against the development of new exports; and these were not offset by incentives towards exports. Indeed many of the fundamental export support institutions are either absent or totally ineffective; while basic transport infrastructure has been damaged by the conflicts in the region.

1.62 Policies towards merchandise imports have been liberalized in most countries and territories, in particular Albania, Bosnia and Herzegovina, Croatia and Kosovo. The trade regime has also been liberalized in Serbia and Montenegro, though there are a few residual restraints on steel imports which would have to be eliminated as part of the accession to the WTO. The situation was worse in FYR Macedonia where there was a much longer list of products under licensing from the Ministry of the Economy for protective purposes which is being terminated before WTO accession.

[29] Daskalov et al. (2003). It is unclear whether a significant liberalization of the trade regime did occur in 1996 and if it did whether its effect on domestic producers was not cushioned by the parallel depreciation of the exchange rate.

1.63 Many of the countries in the Western Balkans have shown a great proclivity to sign bilateral free trade arrangements. But for political reasons, they have been unwilling to engage in efforts to establish a single free trade area. The establishment of a hodge podge of bilateral free trade arrangements, especially in the context of extremely weak and sometimes corrupt customs services is not likely to enhance trade prospects or increase incomes and employment in the region. On the contrary it may lead to significant efficiency losses.

1.64 The recent agreement, in the form of an MOU among the countries on future regional trade liberalization and co-operation is of importance because it lays some standards on existing and future FTAs. If these standards are met, the ensuing agreements are less likely to be trade distorting. At the same time the MOU commits the countries to harmonize their policies and regulations in a number of trade related areas to those of the EU thus making it easier to promote closer economic relations with the EU in the future. But while the MOU is a useful step, the countries in the Western Balkans need to consider how in the future they can consolidate their individual FTAs to fewer and larger groupings or even a single one with common rules, exceptions, etc. or as an alternative whether to join CEFTA. Both alternatives or a combination of them would be better than a large number of individual FTAs.

1.65 Although the relations within the region are of importance, the fundamental trade relationship will be that with the EU. The linkages here are going to create the more significant prospects for increased foreign investment, improved technology and enhanced productivity and incomes. The SAAs provide a useful vehicle for strengthening the overall economic relationships with the region. On the trade side one element of caution needs to be introduced. As the SAAs are negotiated individually, there will be a tendency for the EU to tailor each one in response to the protective pressures felt by the individual governments in the region. This could result in a very dissimilar pattern of preferences with each country with different depths of cuts, different degrees of asymmetrical treatment, product coverage and exceptions. This would again lead to a 'spaghetti bowl' of preferences, which has been avoided by the ATP scheme, which, besides providing generous market access, has a uniform list of exceptions that apply to all the preference receiving countries.

1.66 There are three other areas where the EU can help trade prospects of the countries in the Western Balkans through the SA process: first and foremost, the SAAs already contain provisions which, with EU assistance, will enable these countries to align their policies, legislation and regulations and institutions to those of the EU; second, it would be desirable that through the SAAs, the countries' exports should become eligible for treatment under the principle of 'diagonal accumulation' in determining origin; and third, the EU should consider easing requirements for issuance of visas for business related travel to nationals of the countries in the region, and thus respond to a common complaint heard among exporters in these countries.

1.67 At the end of the day, however, it is important to keep in mind that the benefits that will accrue to the countries from both the preferential relationships with each other and those with the EU would be greater, the greater the overall openness of their economies. Here, there are two vehicles that can be pursued. First, the countries which are not WTO members need to use the process of WTO accession as a means of reducing further their existing trade controls. In the case of NTMs, they will have to do so in any case. But there are also opportunities in the case of tariffs as well as in the area of services. The political economy of reducing trade controls is difficult especially, if it is to be done on an autonomous basis. The accession process gives governments a vehicle they can use to push forward reforms that would be otherwise difficult to implement. Second, WTO members, need to take the opportunity of the new Round of

multilateral trade negotiations agreed at the WTO Ministerial meeting in Doha to reduce existing trade barriers further, both in merchandise trade and in services.

1.68 All these policy reforms will not yield the desired benefits unless there are parallel efforts to redress the glaring weaknesses in trade related institutions, in customs, in export finance and insurance, in transport infrastructure and in many other areas detailed above. Here the governments cannot do the task by themselves. They need donor assistance, which is well coordinated, timely as well as long lasting. Institutions take time to build and cannot be built by technical assistance alone. They require long-term human resource development as well as a great deal of financial support in several areas, including transportation and other infrastructure which has been either destroyed or has always been inadequate.

1.69 Finally, it is important to pay attention to strengthening the institutions for regional cooperation. The Stability Pact can provide an important framework in this respect. Its Working Group on trade can be a useful forum for cooperation on trade policy. Other for a such as SECI and the coordination on transport infrastructure set up under the World Bank's Trade and Transport Facilitation in Southeast Europe (TTFSE) projects are useful as well. Perhaps the key issue that needs to be addressed here is to ensure better communication among the various groups already set up by arranging for participation in each other meetings, exchange of documents and the like.

1.70 The countries in the Western Balkans have lost a lot of time in their transition to the market and in their integration in world trade. Their governments and the donor community have a lot to do. Stability and the introduction of democratic processes provide the only hope that the commitments needed for this purpose will be forthcoming.

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2. POLICY-INDUCED INTEGRATION IN BALKANS: POLICY OPTIONS AND THEIR ASSESSMENT[*/]

Bartlomiej Kaminski and Manuel de la Rocha

INTRODUCTION

2.1 There is consensus among policy makers and experts alike that the solution to the decade-long crisis in the Balkans lies in their economies. All agree that establishing institutions supporting competitive markets together with integration into European markets is the key to economic recovery and regional stability. So is regional integration, although this has much less political support through the region than integration into the European Union. Some even predict faster liberalization in trade between the individual countries and the EU than between the countries in the region (Bartlett and Samardzija 2000).

2 2 Yet, regional cooperation is indispensable not only to address such problems as environment, transportation infrastructure including special issues related to the Danube River, movement of goods through borders (customs procedures), joint activities in the fields of education and training but also to take full advantage of opportunities offered by integration into the EU. Some of these clearly cannot be solved without cooperation among governments and external financial support. While mere coordination may be sufficient in some areas (e.g., building roads), other projects may call for active cooperation at various levels of public administration in respective countries.

2.3 The commercial logistics of trading that has emerged following the dissolution of the former SFRY levy huge costs on importers and exporters. The five South East European countries that are in the EU Stabilization and Association Process (hereafter SEE-5[1]) still have weak political institutions and, except for Albania, a fresh history of cross-border animosity. Newly established borders messing up the movement of goods and complicating the coordination of cross-country infrastructure accentuate the costs already imposed by geographical conditions. Consider for instance FYR Macedonia. FYR Macedonia, while it had been a republic of SFRY, had unfettered access to seaports. Now this is a landlocked country facing huge shipping costs due to the reliance on shipping by land as a rule around seven times more expensive than by sea (Hausmann 2001), which, in turn are magnified by border crossings. Its goods destined for instance to Italy crossed the border only once before the dissolution of former SFRY whereas now they transit through at least three sovereign states with often highly taxing border controls. If shipping goods across the U.S.-Canadian border is equivalent to adding from 400 to

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[1] SEE-5 include the following states: Albania, Bosnia and Herzegovina, Croatia, FYR Macedonia, and Serbia and Montenegro. Within the latter, Kosovo and Montenegro are autonomous customs areas with independent trade policies, border controls and customs administrations. Bulgaria, Romania and more recently Moldova, i.e., countries that also are direct beneficiaries of the Stability Pact, are treated separately. Bulgaria and Romania have already begun accession negotiations, while Moldova's trade with the region is essentially limited to Romania.

1,600 kilometers (Ibidem), then the magnitude of extra costs for SEE-5 traders and ultimately exporters and consumers of imports is infinitely greater.

2.4 The *Stabilization and Association Process* launched by the EU seeks to address the broad issue of the European integration of these countries and, within this framework, the problem of this new remoteness as well as weaknesses in economic regimes of SEE-5 countries. The process, committing a less developed partner to upgrading its institutions to European standards and governance, serves as both an anchor making the reforms more credible and a guide to institutional reforms. This is especially relevant in SEE-5 region where most countries had only reluctantly implemented liberal reforms. Except for Albania, other SEE-5 governments had initially rejected radical approach to economic reforms and pursued gradualist policies. Although some have launched comprehensive privatization programs, owners of privatized companies were too often successful in establishing quasi-monopoly positions thanks to political contacts. Entry to many sectors has remained limited and so has been competition with negative implications for their economic growth performance. In consequence, over-regulation of business activity together with onerous tax burdens have led to the expansion of shadow economy and thwarted the development of a competitive market environment (EWI 2000).

2.5 As a means for promoting European integration of the SEE-5, the SA process seeks also to reduce the complexity of the current commercial logistics through promoting simplification and greater transparency in customs procedures and free trade among SEE-5 as well as between them and the EU. Important steps have already been taken. These include granting as of September 2000 of Autonomous Trade Preferences to SEE-5 countries (except Serbia and Montenegro which obtained them two months later in November), and the inclusion of a time-bound schedule for the reciprocal removal of trade restrictions in the two Stabilization and Association Agreements concluded to date (FYR Macedonia and Croatia). SEE-5 governments together with those from other Stability Pact countries have already agreed to extend a network of bilateral free trade agreements. These two taken together have set the stage for policy-induced integration along two dimensions: regional Balkan integration and integration with the EU.

2.6 The paper focuses on the five countries of South Eastern Europe in the EU Stabilization and Association Process—the SEE-5—and argues that the two dimensions are inseparable in order for trade liberalization to succeed, as only when these are pursued together do they offer the greatest opportunity for gains. But there are two important caveats. First, integration along these two dimensions without addressing the third dimension of multilateral, MFN-based liberalization may be counterproductive leading to trade diversion and losses in national economic welfare. Second, gains from integration into the EU do not come by default, as the experience of some Central European 'associates' of the EU demonstrates (Kaminski 2001). They require strong political commitment to liberal reforms aimed at improving business climate and cooperation to remove barriers to wider markets. The other SEE countries do not form object of this study but are included in the discussion whenever relevant.

2.7 The remainder of this paper is organized as follows. The next section briefly discusses the SA dimension of regional integration, i.e., policy parameters of trade liberalization as they pertain to EU-SEE-5 regional integration drawing on the literature on North-South integration. The central question is about conditions under which SEE-5 would maximize unique benefits that poorer partners usually obtain from integrating into a rich partner. The following section assesses implications of establishing a free trade area among SEE-5 countries without both multilateral and preferential (vis-à-vis the EU) tariff liberalization. We then turn to issues relevant to the assessment of the second dimension of trade liberalization efforts, i.e., FTAs among SEE-5 economies. It seeks to assess the scope for short-term export response to bilateral liberalization

of trade among SEE-5 countries by examining developments in their trade, the composition of intra-SEE-5 trade and the extent to which this trade remains below its potential. If it is the case, then the removal of trade barriers would have a strong positive impact on economic growth. The following section traces welfare effects of various variants of trade liberalization. We then conclude and sketch the policy implications.

TRADE DIMENSION OF STABILIZATION AND ASSOCIATION PROCESS: POTENTIAL RETURNS AND PITFALLS

2.8 Policy-induced integration into the EU is the most important aspect of the overall SA process, as it commits SEE-5 countries to upgrading institutions and policies to European standards and governance. It also serves as an anchor assuring greater public support and, thereby, facilitating implementation of structural reforms. In addition, various EU-funded programs of bilateral assistance tied to the progress in convergence of respective SEE-5 economic regimes to EU institutions and policies provide an extra incentive to implement structural reforms. While potential returns are huge to all participants of this process, they do not come by default and require a number of complementary policy measures. This section identifies benefits as well as points to dangers associated with the trade component of the SA process, if not accompanied by a simultaneous movement in two other dimensions of trade liberalization—FTAs among SEE-5 countries and MFN liberalization.

2.9 The SA process yields several benefits to SEE-5 countries usually associated with the 'North-South' integration. In general, it provides strong incentives to a 'South' country to become gradually like a 'North' country in terms of institutions and policies. These incentives derive not only from aspirations to accede to the EU, which calls for the convergence of domestic regimes to the *acquis communautaire* but also from opening of the economy to competition from imports from the EU and better access to EU markets. The latter may contribute to the increase in foreign investment inflows.

2.10 In contrast to countries that signed Europe Association Agreements with the EU, until recently SEE-5 countries had experienced little, if any, external pressure to open their economies to competition from imports and introduce business friendly regulations. The weakness of ATPs[2] offered by the EU to some Balkan countries prior to the introduction of the SA process was that they did not contain any mechanisms that would induce politicians to liberalize their economies and establish business friendly environment. In a nutshell, prior to the introduction of the SA process, ATPs created new opportunities for trade expansion on a bilateral basis but did not provide direct incentives to change the domestic business environment. The SA process changes it, as SEE-5 will be entitled to take advantage of the benefits offered only in so far as their policies meet certain criteria.[3]

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[2] The EU—having repealed the 1980 Cooperation Agreement with the former Socialist Federal Republic of Yugoslavia, which offered the SFRY preferential access to its markets under ATP regime—continued providing ATPs to some countries of the former SFRY. Bosnia and Herzegovina and Croatia were under the ATP regime reviewed annually, while FYR Macedonia has benefited (as of January 1, 1998) from preferential market access under bilateral Cooperation Agreement. For the discussion of concessions offered under the ATP regime, see Box 3.2 (p. 60) in World Bank (2000b).

[3] For a more detailed discussion, see Michalopoulos in this volume.

2.11 The introduction of the 'conditionality-ridden' SA process has very important positive implications for their reforms and in particular for foreign trade and investment regimes' liberalization. First, it provides guidance and incentive to SEE-5 governments to undertake measures that would align their economic regimes with the EU *acquis communautaire*. While full harmonization with the *acquis* requires rather sophisticated administrative capacities, starting the harmonization process, for instance, with customs procedures and streamlining the barriers to entry to business activity does not require substantial resources. These are 'win-win' cases, as the introduction of these measures has the potential to improve governance, business and investment climate and, thereby, boost domestic and foreign investment and increase competition in local markets.

2.12 Second, the SA process also compels governments to lower tariffs on imports from the EU. The trade component of the SAAs concluded to date, while retaining the ATP provisions extended in 2000-01 to the SEE-5 countries,[4] envisages the establishment of free trade areas between each SEE-5 and the EU with the former dismantling its tariff barriers only gradually over time. Since imports from the EU account for more than half of their total imports, this will significantly increase domestic competition for tradables and consequently competitiveness of domestic products in international markets.

2.13 However, leaving aside the absence of structural reforms that should accompany the implementation of the SAAs, pursuance of liberalization focused solely on the conditions of access for products originating in the EU engenders two additional pitfalls. First, if preferential treatment envisaged in the SAAs is not extended to intra-regional SEE-5 trade, SEE-5 risk to be victimized by the 'hub-and-spoke' syndrome that offers higher benefits to EU firms at the expense of SEE-5. The 'hub-and-spoke' pattern as a rule favors rich and large countries while impoverishing small and poor (Baldwin 1991). Firms located in 'spokes' are likely to have larger costs for two reasons: they face higher barriers than hub firms when importing inputs from the other spokes; and they tend to be penalized by lower demand from other spokes due to trade barriers. The hub and spoke arrangements may further exacerbate the 'agglomeration economies' effect, i.e., investments tend to be attracted to regions with already high intensity of investments thus contributing to deepening of regional differences in the level of economic development. Last but not least, FTAs confined only to the EU would discourage intensification of trade ties among SEE-5 economies, which is one of the objectives of the SA process.

2.14 Second, in the absence of both multilateral liberalization and SEE-5 regional liberalization, suppliers from the EU may crowd out more efficient suppliers from countries subject to MFN tariffs as well as charge a higher price than in international markets. Since the EU is already the major trading partner for each SEE-5, the scope for the switch in supply-sources of SEE-5, that is trade diversion, would appear limited. But, in spite of the fact that costs and prices of EU industrial suppliers are mostly in line with costs and prices in the rest of the world, this cannot be entirely excluded. Similarly, EU suppliers, especially those from sectors where competition from imports assures high levels of competition in EU markets, may charge SEE-5 importers prices higher than in EU markets to take advantage of preferential margins offered by SEE-5 MFN rates, which are significantly higher than those in the EU.

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[4] The Council Regulation (No. 2007/2000) of September 18, 2000 improved market access for all countries under ATP as well as extended the ATP coverage to Albania, Kosovo (under UNMIK administration) and some Montenegrin products. Following the demise of the Milosevic regime, ATP has been extended to the rest of Serbia and Montenegro, and restrictions on some products originating in Montenegro removed

Integration Into EU: Potential Returns

2.15 Advocates of regional integration point to dynamic gains, that is, its favorable impact on country's economic growth over the medium and long term. Dynamic gains are due to the decrease of the 'costs of trading' combined with generation of foreign direct investment and technology spillovers. They may be offset by the emergence of 'hub and spokes' patterns and the rules of origin—both discussed below. While neither theoretical analysis nor empirical evidence offers conclusive evidence as to growth effects of integration (Schiff and Winters 1998a), gains are more likely to transpire in the case of 'deeper' integration as it contributes to lowering of transaction costs. The theoretical argument is built around the proposition that integration by increasing trade leads to a temporary increase in growth. But this only applies to the deep integration lowering real trading costs. Deep integration puts an economy on a trajectory of higher levels of output per capita with growth rates returning to steady state unless the growth is endogenized thanks to 'knowledge content' of increased imports. Furthermore, traditional trade models suggest that capital and/or labor mobility brings convergence. This is so thanks to changes in relative prices brought about by lower import prices and improved export prices, and a higher marginal product per capita attracting higher investment and growth (Baldwin 1989).[5]

2.16 Similar investment and growth benefits may transpire thanks to multilateral liberalization. Circumstantial empirical evidence suggests that preferential arrangements, which are regional rather than global, are not intrinsically advantageous to development. Take, for instance, East Asian economies. In their spectacular economic success special arrangements with 'Northern' countries and institutions of regional integration were conspicuously absent. Their impressive economic growth performance was due to domestic policies of observing market-oriented 'fundamentals,' superior accumulation of physical and human capital, and the ability to exploit opportunities offered by international markets. Neither is the participation in a regional arrangement a necessary condition to attract foreign direct investment (FDI). The case of Greece shows also that this is not a sufficient condition. Similarly, not each among Central European 'EU associates' has been successful in attracting FDI (Kaminski 2001). If anything, this seems to confirm the importance of sound policies at home and access to wider markets.

2.17 Yet, inclusion in regional economic arrangements usually entails the adoption of rules of conduct, commitments and obligations that go beyond trade issues. The argument in favor of participating in reciprocal preferential arrangements is strong if this involves North-South integration as exemplified by the SA process. The institutional design of SAAs favors deeper integration (i.e., lowering 'trading costs') into the EU—a highly developed regional bloc. This offers unique opportunities especially to less developed SEE-5 partners by creating pressures to implement efficiency enhancing institutional and policy reforms (World Bank 2000a).

2.18 Hence, the SA process may provide an extra incentive to SEE-5 governments to launch sound economic policies encouraging openness and integration into international markets as well as introduce institutional changes strengthening business-friendly environment. More importantly, considering that general public in SEE-5 countries regards accession to the EU as remedy to regional instabilities and economic malaise (Steil and Woodward 1999), there is another potential policy-related return from the SA process. Namely, the perception that implemented policy measures are necessary for accession to the EU may tip the political balance

[5] Note that since the share of SEE-5 trade with the EU is higher than that for the EU, trade will be of more benefit to a SEE-5 country.

in favor of reforms, albeit this outcome is not automatically assured, as the experience of several Central European candidates amply illustrates.

2.19 The general point is that SA process commits SEE-5 governments to converge their respective economic regimes to those in the EU and weakens domestic political resistance to structural reforms. The combination of credible government commitment to reforms and better and better conditions in access to large EU markets will stimulate domestic and foreign investments and economic growth.

Pitfalls: Hub-and-Spoke Pattern and Rules of Origin

2.20 The 'hub-and-spoke' pattern is potentially harmful as it may produce significant distortions in allocation of resources. There are two sources of distortions: differences in market access and rules of origin. Distortions due to market access are mainly at the expense of 'spoke' countries, as the 'hub-and-spoke' situation puts 'spoke' firms in disadvantage vis-à-vis 'hub' firms simply because the latter have better market access than 'spoke' firms to other spokes. Firms, especially those operating in increasing returns-to-scale industries, may seek to exploit advantages offered by differences in trade barriers and relocate or expand their activities at hub at the expense of spokes. Although preferential access to hub markets and low wages in spoke economies may offset significant relocation of industrial activity to hub and generate dynamic growth effects in spokes,[6] the 'hub-and-spoke' pattern reduces benefits of integration to a 'Southern' partner.

2.21 The choice of rules of origin impacts the spatial distribution of production activities within FTA and may frustrate the objectives of economic development. The distinction should be made between preferential (as stipulated in FTA) and World Customs Organization nonpreferential rules of origin. The latter tend to be more restrictive than the former, simply because they go beyond the usual 'change-of-heading' approach typical for nonpreferential rules of origin (see for instance, Krueger 1999, Panagariya 1999). Their impact on distribution of production activities within FTA depends on the kind of a cumulative system that is used.[7] Flexible rules of origin encourage sourcing of inputs outside FTA countries, whereas "... strict rules of origin (...) may affect upstream, side-stream or downstream third-country producers of inputs" (UNCTAD 1998, para. 47).

[6] Empirical evidence corroborates this possibility. In large part thanks to FDI, relocation of higher value-added industries from CEECs to the EU has not occurred. To the contrary, most FDI in Hungary, for instance, have gone to sectors at a higher end of the technology spectrum (Hamar 1998, Kaminski and Riboud 2000). This phenomenon was also observed in Ireland albeit after accession to the EU (Barry 1996).

[7] Cumulation, i.e., the requirement that sufficient processing of the product occurs in any of the FTA countries, can be bilateral (i.e., between two signatories of FTA), diagonal or partial, and full. Full cumulation reduces the potential for trade diversion implicit in FTA. For an extensive discussion, see UNCTAD (1998). Needless to add that non-cumulation is more restrictive than cumulation.

2.22 The preferential rules of origin,[8] an indispensable component of any FTA to avoid trade deflection as well as often to take into account interests of domestic industries,[9] tend to offer extra advantages to 'hub' firms for three reasons. First, 'spoke' firms operate within much smaller economies and, therefore, tend to rely more on 'externally' imported inputs including other spokes. This often puts a hub firm in a better position that a similar spoke firm in meeting the conditions for preferential access.[10] Since the industrial base of the EU or EFTA is dramatically larger than that in any of a single (or combined) SEE-5, this arrangement will offer strong advantage to EU firms at the expense of SEE-5 firms. It will be easier for the former to claim preferences in access to SEE-5 markets, simply because more inputs are available locally, i.e., in the EU. In contrast, similar SEE-5 firms are more likely to rely on imports not necessarily from the EU. Even though FTAs among SEE-5 countries may limit the 'hub-and-spoke' effects, the bilateral cumulation between the EU and each SEE-5 would provide disincentive to regional trade in intermediate products.

2.23 Second, 'hub' firms are more likely to have all necessary accounting devices to meet the necessary rules-of-origin requirements and not incur extra administrative costs.[11] Because of a large network of bilateral free trade agreements of which the EU is a party, many EU exporters have already incurred administrative costs associated with proving that their products meet the requirements of the rules of origin. This does not seem to be the case for most of 'spoke' firms lacking the capacity to demonstrate the geographical breakdown of the inputs used in their production. With customs procedures poorly developed in most SEE-5 countries, the EU customs authorities may be unwilling to accept their respective proofs of origin.

2.24 Third, 'spoke' countries in North-South integration scheme tend to specialize in unskilled labor-intensive products such as textiles, clothing and footwear. These 'sensitive' products, accounting for the bulk of SEE-5 exports to the EU (see Appendix Table 2.1), face much more difficult conditions in access to markets in highly developed countries including the EU than other industrial products in which EU firms specialize. Even though the Europe Association Agreements and the Stabilization and Association Agreements that had been so far signed include the removal of tariffs and other restrictions on sensitive products, the rules for assessing their origination are more complex and more difficult to meet than for other industrial products. While

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[8] Rules of origin spell out the conditions that a product must satisfy in order to be eligible for preferential access to markets as determined in a regional agreement. The rules of origin defined in the SAAs and Europe Association Agreements are identical. While the agreements use change of tariff heading at the four-digit level of the Harmonized System to define origin, they also use technical requirements especially for such products as footwear, textiles, and clothing.

[9] 'Trade deflection' describes a situation when an importer in a high-duty country imports a product through a low-duty country and then re-export it to the importer's duty-free. Rules of origin are used to prevent it. However, preferential rules are often specified in ways minimizing competition from imports and/or enhancing export prospects to the FTA partner.

[10] Note also that meeting the requirements of the rules of origin increases the costs. These are huge amounting—according to an estimate for EFTA-European Community trade (Herin 1986)—to between 3 percent and 5 percent of the transaction value. Although under preferential access granted by the EU SEE-5 exporters already have to meet the rule-of-origin requirements in order to take advantage of preferential treatment under GSP or ATP, other firms interacting now solely with non-preferential markets will have to adopt special accounting procedures to trace origins of each input.

[11] Cost relates to administrative activities that the 'rules of origin' impose on an exporter. Empirical evidence from intra-EFTA and EFTA-EU trade show that many exporters preferred to pay non-preferential tariff rather than incur costs necessary for qualifying for preferential treatment (Herin 1986).

for other industrial products an exporter has to demonstrate that local processing resulted in a new product in terms of 'change in tariff heading,' that is, an imported product is differently classified than the exported one, the criteria for sensitive products are different. Instead of 'change in tariff heading', they are subject to technical requirements.[12] These are more difficult to fulfill than the 'change in tariff heading' requirement used for most other products and they are often used as a tool of protection (Hoekman 1993).

2.25 The combination of 'hub-and-spoke' pattern and restrictive rules of origin favors EU firms while offering limited advantages to firms operating in SEE-5 economies. An important question, to which we shall now turn, is what, if anything, can be done about it.

Possible Remedies: Intra-Regional FTAs, Diagonal Cumulation, and Customs Union

2.26 Since potentially negative effects resulting in significant cost advantage to hub firms are mostly not structural but policy-induced, the change in policy should improve the competitive position of spoke firms. Disadvantage of spoke firms due to more limited market access can be addressed by the removal of trade barriers among spokes combined with the introduction of diagonal cumulation across SEE-5 economies. Negative effects of exporters from SEE-5 facing more restrictive rules of origin, because of their specialization in products regarded as sensitive in EU markets, than those from the EU can also be addressed through change in policy. Theoretically, two options are possible: first, one might get rid of technical rules and extend the requirement of change in tariff heading at four-digit combined nomenclature to sensitive products, i.e., footwear, textiles and clothing; and second, one might get rid of the need to use the rules of origin by replacing the free trade component in SAAs (as well as in FTAs among SEE-5 countries) with a customs union.[13] These two options would constitute radical change from the current policy stance and are thus not explored further. Instead, two alternative means to at least reduce the negative impact of restrictive rules of origin on the 'spokes' are discussed in detail below: the creation of a 'virtual' free trade area in South Eastern Europe, and diagonal cumulation.

2.27 Trade liberalization efforts in South Eastern Europe go beyond bilateral integration between the EU and each SEE-5 country, and trade liberalization among SEE-5 countries, as envisaged by the SA process. The Memorandum of Understanding on Trade Liberalization and Facilitation in South Eastern Europe—signed by the governments of the SEE-5, Bulgaria and Romania on June 27, 2001, in Brussels, and subsequently adopted by the government of Moldova—extends trade liberalization to include all eight members of the Stability Pact. While a major objective of the MOU is to boost regional stability by triggering the process of building trust through intensive commercial interaction, it will also reduce the potential negative impact of a hub-and-spoke pattern. The MOU in fact envisaged the creation of a 'virtual' free trade area in

[12] Annexes to the Europe Association Agreements specifying technical requirements deal almost exclusively with footwear, clothing and textiles. Brenton and Manchin (2002) note that 86 percent of textile headings and 95 percent of clothing headings require satisfying specific working and processing conditions. Consider that exports of clothing have been excluded from the scope of Pan-European cumulation rules (Driessen and Graafsma 1999). For a more general discussion of the rules of origin and their impact on trade, see UNCTAD (1998).

[13] While without a more detailed analysis it is impossible to assess whether benefits of a customs union to SEE-5 would prevail over costs, especially if agricultural products are included, this would seem to be a policy alternative worth exploring.

the region by establishing a network of bilateral FTAs between the signatory countries.[14] The MOU set the framework for a network of FTAs to be established by the end of 2002.[15]

2.28 However, intra-regional policy-induced integration will not start from scratch as several countries that emerged from the collapse of the former SFRY had established bilateral free trade arrangements with each other even before signing the MOU. There were six pre-MOU FTAs in the region. FYR Macedonia had made the largest strides in that direction. Prior to the MOU it had FTAs already in effect with Bulgaria, Croatia, and Serbia and Montenegro.[16] Former Yugoslav republics have also signed or are negotiating FTA with other countries in Central and Eastern Europe.

2.29 The MOU, while a remarkable political achievement in itself, is only the first step in the unfolding dynamics of a two-dimensional process of intra-regional integration and integration into the EU. Two risks that may reduce gains from trade integration in the framework of the SA process loom large on the horizon. First, regional liberalization may erode incentives to pursue multilateral liberalization recommended in the MOU (Article 11). While the economic logic would suggest the reverse, the experience of Central European EU candidates points in other direction (see Kaminski 2001, Messerlin 1997). On economic grounds, it would seem the establishment of free trade in industrial products with the EU would provide a strong incentive to lowering MFN tariff rates to EU levels. There would be no fear of adjustment pains, as existing domestic firms having demonstrated their ability to compete with EU firms are likely to withstand competition from MFN imports. The possible loss in customs revenue would be more than offset by consumers' gains thanks to expanded access to a wider variety of products. Yet, the shift to free trade in industrial products between the EU and Europe Association countries has failed so far to trigger any action to align MFN tariffs on industrial products with those in the EU. The latter, however, is indispensable to offset negative effects of the hub-and-spoke pattern and maximize gains from both dimensions of regional integration.

2.30 Second, there is a risk that the MOU will be implemented in an inconsistent and limited manner, keeping markets fragmented, denying SEE-5 firms economies of scale effects and thereby reducing potential FDI inflows. The decision to follow the track of bilateral FTAs rather than establishing a single free trade area in a 'big bang,' as suggested by Messerlin and Maur (2001), appears to indicate still lingering political resistance to the SEE dimension of regional integration.[17]

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[14] The Memorandum requires that their trade policies vis-à-vis each other meet three conditions: the removal of quantitative restrictions on imports and exports together with export duties or charges having the same effect; "zeroing" of tariffs on at least 90 percent of the mutual trade and of Harmonized System tariff lines by the end of a maximum transitional period of six years; and abolishment of tariffs and other charges on a large majority preferably upon entry into force of each free trade agreement with those on sensitive goods within a period of not more than six years (Articles 1.2 1-1.2.3, Stability Pact 2001).

[15] The vast majority of the bilateral FTAs envisaged by the MOU have been concluded by end-2002, as discussed in Gressani and Michalopoulos in this report.

[16] Until 1999 both Croatia and Serbia and Montenegro had FTAs with entities of Bosnia and Herzegovina—Bosnian Federation and Republika Srpska. These were revoked and subsequently new agreements with Bosnia and Herzegovina were re-negotiated in the context of the MOU. They all envisage gradual removal of tariffs by Bosnia and Herzegovina and the immediate removal of tariffs on imports originating in Bosnia and Herzegovina.

[17] Economic literature on integration suggests that a single regional trading area encompassing SEE-5 economies as well as other members of Stability Pact would have been a superior economic solution

2.31 In the absence of strong commitment to intra-regional trade liberalization by the SEE-5 and given the dominance of inter-industry trade, governments may turn to the rules of origin and contingent protection to control imports. Rules of origin not only can lead to trade diversion and extra costs for both authorities and exporters but also to restrictions in imports. In fact, they are not only costly but have been extensively used as protectionist devices (Krueger 1997 and 1999). Although the MOU requires development of an "...appropriate common set of preferential rules of origin furthering the objectives of this Memorandum" (Article 3), a large number of bilateral overlapping FTAs does not augur well to meet this objective. The danger is that different sets of preferences over different periods with varied product coverage and different tariffs and rules of origin will emerge in bilateral agreements. This in turn will further complicate customs administrative tasks and exacerbate corruption already endemic in several countries of the region (World Bank 2000b).

2.32 The possible abuse of the provisions of the MOU allowing for contingent protection—provided the measures implemented be consistent with the WTO rules[18]—may have a depressing effect on trade further fragmenting markets. WTO-compatibility does little to mitigate protectionism inherent in antidumping and other restrictive non-tariff measures. The crux of the matter is that contingent protectionism provides a major barrier to trade, as its mere existence has a 'chilling' effect on trade and undermines competition from imports (World Bank 2000a, p. 80). For this reason, the European Economic Area (EU-EFTA), the Canada-Chile FTA and the Australia-New Zealand FTA do not have provisions allowing for contingent protection measures.

2.33 While the SEE-5 countries can design their intra-regional trade liberalization at their own discretion, other measures reducing costs of EU-SEE-5 trade liberalization—cumulation of the rules of origin and the rules of origin themselves—are beyond their control. One important weakness of the SA process is that its trade component envisages bilateral cumulation of origin between the EU and each respective SEE-5 country. From this perspective, SAAs, once in place, will establish five separate free trade areas between the EU and each SEE-5. Bilateral cumulation in the network of FTAs creates disincentives to use inputs originating in separate free trade areas. It will discourage SEE-5 firms from developing mutual production links oriented toward supplying EU markets, simply because inputs from other SEE-5 countries are treated as 'external' imports. In consequence, a product may fail to qualify for preferential treatment in the EU eroding the value of a trade component of the SAAs.

2.34 Another consequence of bilateral cumulation of rules of origin is that they erect a barrier to the development of trade based on fragmentation of production, i.e., moving across border various fragments of a supply chain. Trade in parts and components induced by production fragmentation has been the most dynamic component of international trade over the last decade (Feenstra 1998, Yeats 1998). Bilateral cumulation discourages moving production of parts to various SEE-5 as the assembled product might fail to qualify for duty-free entry into the EU. These arrangements may thus prevent large multinational corporations from establishing production networks across SEE-5.

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provided that MFN tariff rates on industrial products are aligned with the EU (Messerlin 2001). Lowering tariff rates would minimize static costs and the creation of a large FTA would maximize dynamic effects.

[18] The MOU retains contingent protection with signatories agreeing that "... the provisions in the Free Trade Agreements regarding the application of antidumping, countervailing and safeguard measures, are consistent with WTO rules" (Article 4, Stability Pact 2001).

2.35 One way to address this problem would be replacing bilateral cumulation with diagonal cumulation of the rules of origin applying to at least SEE-5, and preferably to all signatories of the MOU. The same rule could be applied not only to SAAs but also to bilateral FTAs. After all, it would be difficult to find a compelling reason why a product assembled in, for instance, Albania from inputs originating in other SEE-5 should have duty-free access to EU markets and not to markets of other SEE-5 countries. But solving this problem is not within the purview of SEE-5 countries: the EU only can meaningfully address it. Moreover, diagonal cumulation would considerably increase administrative burden on exporters as well as on customs administrations of SEE-5 countries. In consequence, without a detailed analysis of situation in respective countries, it remains unclear whether benefits of diagonal cumulation of the rules of origin would offset administrative and transaction costs.

Conclusion

2.36 Although FTAs as well as other types of regional agreements are usually 'second-best' policies to multilateral liberalization, the SA process has the potential to offer unique benefits to its participants. It promises significant returns to SEE-5 countries, but these returns will not come by default. The SA process offers the opportunity to anchor liberal reforms and move quickly towards 'deeper' integration, i.e., convergence to efficiency-enhancing components of the *acquis communautaire*. The latter however requires structural reforms extending to all aspects of 'state-market' interaction. The resulting improvement in business environment may trigger increased investments, both domestic and foreign.

2.37 However, benefits directly related to trade are not as easily identified as those arising from 'deeper' integration. First, 'trade-related' benefits would often be higher under unilateral MFN liberalization. Consider that the increase in competition from imports in domestic markets would be higher under MFN liberalization, as improved access would not be limited to preferential partners—EU and Stability Pact countries. For the same reason, imports would be even cheaper than under preferential arrangements, and—barring free trade—customs revenues higher. Second, authorities and exporters would not incur costs associated with the rules of origin, and domestic producers would not suffer from negative 'hub-and-spoke' effects. In all, welfare gains might be higher.

2.38 'Trade-related' benefits from the cooperation framework established by the Stability Pact can be maximized in two major ways—multilateral liberalization and modifications in the design of bilateral FTAs with the EU and within the region. First, lowering MFN tariff rates could increase benefits from increased competition in domestic markets and reduce some negative effects of the hub-and-spoke pattern. Given that the goal of SEE-5 is membership in the EU, lowering MFN tariff rates to those applied by the EU would level the playing field for all preferential suppliers to conditions prevailing in EU markets. As we shall see, MFN liberalization would also increase welfare gains from other dimensions of regional integration.

2.39 However, lowering of MFN tariffs does not have to happen immediately. While a strong argument can be made in favor of quicker reduction in tariffs than envisaged in the two SAAs already concluded,[19] reductions of MFN rates could be coordinated with those envisaged in trade components of SAAs. The bottom line would not be zeroing of MFN rates in line with the removal of tariff rates on imports from the EU but only lowering them to the levels of MFN tariff

[19] Stabilization and Association Agreements have been concluded only with Croatia and FYR Macedonia. Their trade component envisages asymmetrical pace in removing tariffs. The EU will dismantle all tariff and non-tariff barriers over a shorter period than SEE-5 partners.

rates applied by the EU. The adjustment would thus end once reduced preferential rates are equal or lower than EU MFN tariff rates. Since this would involve reduction in applied tariff rates, there would be no need to negotiate them with WTO members. For this reason, often expressed fears that unilateral liberalization would erode bargaining position do not seem to be well-founded.

2.40 Second, intra-trade liberalization as envisaged by the MOU offers not only the prospect of building trust in the region but also increasing potential gains from liberalization of trade with the EU. However, in order to achieve these gains, some policy design issues need to be addressed. A 'spaghetti bowl' of FTAs—term originally used to describe overlapping FTAs in Latin America (Schiff 2001a)—that will emerge once all bilateral trade agreements are implemented may become a barrier to mutual trade. Two measures that can be introduced to avoid this outcome include the removal of provisions on contingent protection along the lines of the European Economic Area (EU-EFTA), and the introduction of simple rules of origin based on diagonal cumulation. In addition, as suggested above, SEE-5 countries might lower their MFN tariffs at the pace set in SAAs for the reduction of tariffs on their imports from the EU. Combined with efforts to harmonize taxes on goods and services collected at border, this would encourage development of horizontal links among SEE-5 firms and weaken incentives to trade deflection and smuggling.

2.41 In all, trade liberalization in both dimensions—the European dimension and the intra-regional dimension—calls for a very careful coordination of the pace of liberalization not only between these two dimensions, but also with multilateral liberalization. MFN liberalization, liberalization in trade with the EU and in that with other SEE countries should be regarded as components of integration into global markets. The remainder of this paper seeks to identify measures along these three dimensions of integration into global markets that offer the greatest potential for gains to SEE-5 countries.

DANGERS OF INTRA-REGIONAL LIBERALIZATION: SEE-5 FTAS

2.42 Benefits from FTA depend on who is integrating with whom. Taking into account the level of economic development, two cases are relevant for this discussion—North-South integration and South-South integration. Integration into the EU is the case of North-South integration, whereas SEE-5 intra-regional integration falls into the South-South integration, albeit among countries at different levels of economic development and dependence on foreign markets. The former involves integration between highly developed countries and developing countries, whereas the latter concerns integration arrangements among developing countries. Providing that integration goes beyond trade, benefits to a 'South' country integrating into a 'North' country are huge, as it pushes the former to become like the latter.

2.43 Institutional convergence improves investment climate and boosts investments. The empirical evidence—supported now by theoretical economic geography models—suggests that EU integration has led to an almost ***continuous convergence*** in income per capita among member countries (World Bank 2000a). As a rule, poorer members of the EU have experienced faster economic growth and caught up with the most developed ones as a result of policy-induced integration. The theoretical explanation of this phenomenon is that if a country with capital to labor endowment below the world average integrates with a country with the ratio exceeding the world average, the former country experiences acceleration in industrialization.

2.44 On the other hand, benefits from 'South-South' integration are problematic depending on the design of a regional trade arrangement. No convergence in income per capita occurs in the case of policy-induced integration among less developed countries. In fact, when two countries involved in regional integration have capital to labor endowments below the world averages, the one with a higher average expands at the expense of a less developed partner. The scope of this effect depends on the level of preferential tariff margins—high external tariffs exacerbate the move of manufacturing production out of a less developed to a more developed 'Southern' country. Ultimately, the extent of divergence depends also on the level of preferential tariff margins; the higher they are the more pronounced relocation of economic activity to a more developed partner is. In fact, the empirical evidence from the South-South integration provides strong support to the finding that integration among developing countries leads to ***divergence*** in economic performance.[20]

2.45 Although the unique feature of trade liberalization in the SA framework is that it simultaneously embraces both a European and an intra-regional dimension, interesting insights can be gained by focusing on SEE-5 intra-regional trade liberalization. In fact, these insights reinforce the earlier conclusion that the simultaneous pursuit of liberalization in its three dimensions—multilateral, European and intra-regional—would maximize economic gains for the SEE-5 countries. Moreover, ill-designed SEE-5 FTAs may bring about greater harm than the earlier discussed negative effects of the hub-and-spoke pattern.

2.46 There are arguments suggesting that regional integration moving much faster than European integration would not make economic sense, as it would lead to divergence in economic growth. Although SEE-5 is a very heterogeneous region, not a single country qualifies as high-income economy. Croatia, the most developed among SEE-5 economies, with the GDP per capita at around 30 percent of the average EU level has capital/labor ratio well below the EU average. In consequence, it may not have comparative advantage in most industrial products in world markets. But many of its products may become highly competitive within a SEE-5 free trade area. Simultaneously Croatia has the GDP per capita around four times higher than that of Albania and Bosnia and Herzegovina and around three-times as high as in remaining SEE-5 economies. Its total GDP of US$20 billion accounts for 40 percent of the aggregate region's GDP (Table 2.1).

Table 2.1 Population and GDP in SEE-5 in 1999

	Population (in million)	Share (in total %)	GDP (million US$)	Share (in total %)	GDP per capita	Croatia =100	Trade as % of GDP[1/]
Albania	3 4	14	3,665	8	1,102	25	52 (63)
Bosnia and Herzegovina	4 2	17	4,387	10	1,027	23	77 (95)
Croatia	4 5	18	20,211	46	4,467	100	114 (143)
FYR Macedonia	2 0	8	3,401	8	1,701	38	82 (99)
Serbia and Montenegro	10.5	43	12,020	28	1,562 (98)	35	52
Kosovo	*1 6*	7	*1,562*	*3*	*868*	*18*	*85*
Montenegro	*0 8*	3					
Total	24.5	100	51,033	100	2,017	42	58
Memorandum							
Bulgaria	8 2		12,403		1,513	34	150 (176)
Romania	22.5		34,027		1,512	34	107 (116)
Grand Total	55 2		97,463		1,766	40	

[1/] Including services in parentheses.
Source World Bank, *World Development Indicators 2001*; Michalopoulos and Panousopoulos (2002), and World Bank and IMF staff estimates

[20] A number of FTAs among developing countries in Africa were terminated because of benefits accruing to a more developed partner at the expense of a less developed one (World Bank 2000b).

2.47 While GDP per capita alone may not fully capture the diversity in the levels of their economic development, other indicators corroborate this diversity. Despite similar levels of the GDP in Albania and Bosnia and Herzegovina, agriculture generated 53 percent of the GDP in the former and only 15 percent in the latter (Table 2.2). On the other hand, differences between Croatia and FYR Macedonia in terms of the composition of GDP are much smaller despite huge discrepancies in GDP per capita.

Table 2.2 Composition of GDP in SEE-5 countries in 1999

	Albania	Bosnia and Herzegovina	Croatia	FYR Macedonia	Serbia and Montenegro
Agriculture	52.6	14.5	8.5	9.2	18.1
Industry	11.9	22.1	20.4	21.5	38.9[1/]
Services, of which	35.5	63.4	71.1	69.2	43.0
Construction	13.5	6.7	6.7	6.3	
Transportation and communication	3.2	8.0	9.2	7.2	
Other services	18.8	48.7	55 2	55.7	

[1/] includes construction

Sources. Albania, FYR Macedonia, and Croatia: IMF data; Bosnia and Herzegovina· National Office of Statistics; Serbia and Montenegro: UNECE, *Economic Survey of Europe,* No. 1, Geneva (2001).

2.48 Heterogeneity in economic development combined with the fact that even its most developed economy is well below the level of a least developed EU member raises the risk that intra-regional integration will lead to relocation of industrial activity to Croatia at the expense of poorer members in the regional FTA. If this were to happen, there would be a danger that de-industrialization pressure in some countries would exacerbate rather than relieve regional tensions.

2.49 The case of intra-regional liberalization without concurrent integration into the EU and/or multilateral trade liberalization falls into the South-South framework with all its potential pitfalls. This applies only to SEE-5 preferential trade arrangements, as other MoU signatories—Bulgaria and Romania—are already part of a single European market for manufactures fully in place since January 1, 2002. Duty-free access of firms from the EU, EFTA, CEFTA and a host of other countries effectively wipes away potential distortions inflicted by a South-South FTA. For SEE-5 economies, however, liberalization in intra-regional trade would lead to a South-South trap unless they significantly reduce MFN tariff rates and open to EU imports at a similar pace as to those from other preferential partners within the region.

2.50 One should also note that the South East European region is rather small in both economic and population terms, which has potentially negative welfare implications. The aggregate GDP of US$50 billion amounts to around 40 percent of the GDP of Greece. It is merely 2.5 times larger than that of a small former Yugoslav republic of Slovenia while their total foreign trade turnover of about US$30 billion is lower than that of Slovenia. Inclusion of Bulgaria and Romania—two countries already on a different track of pan-European integration—does not significantly alter the picture. The combined size of the region in terms of GDP is still well below that of the Greek economy. The danger inherent in the small size is significant from the point of view of preferential trade arrangements. The empirical evidence suggests that FTA among small economies usually lead to welfare losses as they result in trade diversion and little trade creation.

2.51 Should then regional trade liberalization among SEE-5 economies be a policy priority? If this were the only dimension of trade liberalization being pursued, the answer would be unequivocally negative unless accompanied by strong MFN liberalization.

2.52 This analysis points to the importance of designing the pace of SEE-5 mutual trade liberalization in ways that would both reduce incentives to shift industrial activity from poorer to richer countries of the region and to trade diversion due to SEE-5 small economic size. Openness to the external world is the best solution to both negative outcomes, as it scales down preferential margins enjoyed by SEE-5 producers in SEE-5 markets. Low MFN tariff rates lessen the level of protection given to firms including those from more developed SEE-5 countries. So do lower preferential tariff rates on imports from the EU.

2.53 Hence, two practical policy recommendations follow from this analysis. First, the time during which firms from SEE-5 and other MOU signatories would enjoy preferential tariff margins over suppliers from the EU should be shortened. This would suggest a faster reduction of tariff rates on imports from the EU. Second, high MFN tariff rates on industrial products should be significantly lowered with the entry in force of FTAs. This would reduce the level of protection accorded to SEE-5 firms that may be competitive in other regional markets thanks to high tariffs.

INTRA-SEE-5 TRADE: POTENTIAL FOR GROWTH AND IMPLICATIONS FOR FTA

2.54 Developments in intra-SEE-5 trade, its composition and the extent to which this trade remains below its potential because of the legacy of political tensions are relevant for an assessment of FTAs among SEE-5 economies. Will the proliferation of FTAs elicit strong trade response from new participants? What is the potential for the increase in trade among countries some of which were part of the same state only a decade ago? These are among main questions addressed in this section.

2.55 Geographical proximity, the size of economies entering into the FTA and the level of trade among them influence the balance between benefits and costs to its participants. If countries entering an agreement are closely located and already have significant trade turnover, i.e., they are 'natural' trading partners, then positive effects are likely to exceed negative ones. Similar positive effects would seem to prevail if mutual trade, despite geographical proximity, was suppressed for non-economic reasons, as was the case of several former Yugoslav republics.

2.56 What is the current potential for the expansion of this trade? In other words, the question is whether SEE-countries under-trade among themselves. Because of the inherited distortions and the low quality of available trade data, there is no single method to obtain an unequivocal answer to this question. Consider first the available data. As can be seen from Table 2.3 comparing SEE-5 export statistics with mirror statistics for the same flows, differences between the values of exports to other SEE-5 countries and corresponding imports from these countries are huge. They are well over 10-15 percent usually regarded as reflecting differences in counting respective values of exports and imports. Differences in valuations or the standard inclusion in the value of imports of cost, insurance and freight cannot explain them. These usually do not account for more than ten percent. Moreover, the values of exports should be lower than the value of corresponding imports. Except for Albania and Croatia (see corresponding columns in Table 2.3), the values of export to import indices are significantly larger than unity. While this is the case of all other SEE-5, these values are particularly high for Serbia and Montenegro. As can be seen from the last column of Table 2.3, Serbia and Montenegro import statistics tended to give much lower values of imports than respective exports. For instance, the value of Albania's

exports to Serbia and Montenegro was four times larger than the value of Serbia and Montenegro imports from Albania; the values of Croatia and FYR Macedonia exports to Serbia and Montenegro were more than twice larger than the values of imports from Croatia and FYR Macedonia as reported in Serbia and Montenegro trade statistics.

Table 2.3 Ratio of exports reported by exporter (rows) to these exports as reported by importer in 2000 (in percent)

From/to	Albania	Bosnia and Herzegovina	Croatia	FYR Macedonia	Serbia and Montenegro
Albania	x	0	0	167	400
Bosnia and Herzegovina	0	x	93	172	117
Croatia	92	118	x	104	249
FYR Macedonia	60	136	87	x	256
Serbia and Montenegro	30	132	61	111	x

Sources· Albania. IMF; Bosnia and Herzegovina: National Statistics and IMF; Croatia: National Statistics, FYR Macedonia: National Statistics; Serbia and Montenegro: National Statistics.

2.57 Since no border charges are levied on exports from SEE-5, there is little reason for exporters to circumvent border controls. For importers, however, there is incentive to 'convince' customs officials not to register imports especially strong in the presence of high levels of tariffs, sales tax and excise tax rates.[21] By this measure, it would be tempting to conclude that Albania and Croatia emerge as countries with relatively low levels of the incidence of corruption in customs administration, whereas customs administrations in other SEE-5 countries do not pass this test. This may be the case. But the fact that Serbia and Montenegro controls economic border only of Serbia may lead to discrepancies, as statistics may report exports destined to Montenegro or Kosovo as exports to Serbia and Montenegro whereas these are beyond the reach of Serbia and Montenegro customs.

2.58 Another source of distortion with potentially significant impact on the pattern of trade is that for the better part of the 1990s, that is, until the EU extended the new set of ATPs to Serbia and Montenegro on November 1, 2000, the trade of Serbia and Montenegro with highly developed economies was subject to severe restrictions and economic sanctions. In consequence, Serbia and Montenegro diverted its trade to the region.[22] Its trade in 2000, the latest year for which trade statistics are available, with other SEE-5 countries was much higher than it would have been the case had Serbia and Montenegro had access to EU markets.

2.59 Leaving aside the low quality of trade statistics in most SEE-5 countries, the problem is also that some portion of it goes unreported. Different and high excise tax rates and tariffs certainly provide powerful incentives to smuggling. But this is not the only reason suggesting that reported trade flows are lower than the actual ones. Other reasons may stem from the unwillingness to report (e.g., trade between the two entities of Bosnia and Herzegovina and Croatia and Serbia and Montenegro), the absence of border points (e.g., between Kosovo and Serbia until 2001), and trade going through 'no man's land' (e.g., through the Brcko area, which

[21] Mirror statistics do not allow capturing the scope of smuggling activities, as neither customs services of an originating country nor those in the country of destination report them. Hence, the difference between the corresponding values of trade flows cannot be explained by smuggling.

[22] As Christie (2001, p. 14) notes, foreign trade of Serbia and Montenegro "... displays a very irregular pattern, with massive redirecting of trade to specific 'friendly partners.' "

is not part of any of two entities constituting Bosnia and Herzegovina). Some of these reasons might have disappeared with the improvement in cooperation among SEE countries, but these are not necessarily captured by the latest available statistics for 2000. In all, while it is anybody's guess how large unrecorded trade is, the point is that actual trade is larger than reported in available statistics.

2.60 Considering all these limitations, we shall resort to a variety of approaches including a very simple variant of a gravity analysis. The overall conclusion from the analysis of historical and current trade flows, gravity estimates, the composition of this trade, and comparative assessment of trade flows among founding members of CEFTA and former Soviet republics suggest that the potential for the expansion of intra-SEE-5 trade within the existing productive structures is rather limited.

Intra-SEE-5 Trade: Geographic Pattern

2.61 Intra-SEE-5 geographic pattern of trade displays three interesting features (Table 2.4). First, this is a more important market for SEE exporters taking up around one-fifth of their total exports than for their imports accounting only for less than 10 percent of their aggregate imports. The point worth noting is that the value of total exports of goods amounted to around 50 percent of the value of total imports in 2000.

Table 2.4 Regional Trade in Southeast Europe in 2000 (in million of US dollars and percent)

Imports (2000)	Albania		Bosnia and Herzegovina		Croatia		FYR Macedonia		Serbia and Montenegro		Total SEE-5	
(Millions of US$)	*Amount*	*%*	*Amount*	*%*	*Amount*	*%*	*Amount*	*%*	*Amount*	*%*	*Amount*	*%*
Total imports	1,063	100	2,893	100	7,922	100	2,084	-	3,710	100	17,672	100
Imports from:												
Albania	-	-	0	0 0	0 4	0 0	3	0 1	1	0.0	5	0 0
Bosnia and Herzegovina	0	0 0	-	-	82	1 0	5	0 2	174	4 7	261	1 5
Croatia	11	1 0	418	14 4	-	-	57	2 7	43	1 2	530	3 0
FYR Macedonia	21	2 0	17	0 6	55	0 7	-	-	130	3 5	222	1 3
Serbia and Montenegro	1	0.1	193	6 7	31	0 4	190	9 1	-	-	414	2.3
SEE-5	33	3.1	628	21.7	168	2.1	255	12 2	348	9.4	1,432	8 1
EU. of which	817	76.9			4,405	55.6	749	35 9			5,971	33 8
Greece	281	26 4	24	0 8	20	0 2	200	9 6	132	3 6	656	3 7
Bulgaria	26	2.4	10	0 3	7	0.1	97	4 7	324	8 7	464	2 6
Romania	11	1.0	14	0 5	19	0.2	16	0 8	145	3 9	205	1 2
Total Balkan	351	33 0	676	23 3	214	2 6	568	27.3	949	25 6	2,757	15 6
Exports (2000)	**Albania**		**Bosnia and Herzegovina**		**Croatia**		**FYR Macedonia**		**Serbia and Montenegro**		**Total SEE-5**	
(Millions of US$)	*Amount*	*%*	*Amount*	*%*	*Amount*	*%*	*Amount*	*%*	*Amount*	*%*	*Amount*	*%*
Total exports	281	100	1,028	100	4,431	100	1,617	100	1,722	100	9,079	100
Exports to												
Albania	-	-	0	0.0	10 1	0.2	12 6	0 8	0.3	0.0	23	0 3
Bosnia and Herzegovina	0	0 0	-	-	495	11 2	23 1	1.4	254	14 8	772	8 5
Croatia	0	0.0	76	7 4	-	-	47 6	2 9	19	1 1	143	1 6
FYR Macedonia	5	0 5	9	0 8	59	1 3	-	-	210	12 2	283	3 1
Serbia and Montenegro	4	0.4	204	19 8	107	2.4	333	16 0	-	-	648	7 1
SEE-5	9	0 8	289	28 1	671	15 1	416	21.1	483	28 1	1,869	20 6
EU. of which	261	24 6			2,415	54 5	561	34 7	657	38 2	3,237	35 7
Greece	45	16 0	10	1 0	89	2 0	84	5.2	75	4 4	303	3 3
Bulgaria	0	0 0	0	0 0	4	0 1	27	1 7	23	1 3	54	0.6
Romania	0	0.0	10	1 0	3	0 1	2	0.1	23	1 3	38	0 4
TOTAL BALKAN	54	16.9	309	30.0	767	17.3	529	28 1	604	35 1	2,264	24 9

Sources Albania· IMF; Bosnia and Herzegovina· National Statistics and IMF, Croatia· National Statistics; FYR Macedonia· National Statistics, Serbia and Montenegro· National Statistics.

2.62 Second, the significance of intra-SEE-5 trade varies considerably across countries. On the import side, shipments from SEE-5 suppliers accounted in 2000 for 22 percent of total imports of Bosnia and Herzegovina, 12 percent of FYR Macedonia's imports, but only 2 percent of Croatia's and 3 percent of Albania's On the export side, excluding Albania the variation for other SEE-5 economies is low with the shares ranging from 15 percent (Croatia), 21 percent (Serbia and Montenegro), 26 percent (FYR Macedonia) and 28 percent (Bosnia and Herzegovina).

2.63 Third, geographical SEE trade patterns reflect to a large extent the legacy of conflicts accompanying the dissolution of the former SFRY. The legacy of the Croat-Serb conflict seems still to shape trade flows. Links between Croatia and Serbia, the two largest countries of the former SFRY, while previously extensive, were mainly broken by the war of the 1990s and never restored. Despite common borders, trade between Croatia and Serbia and Montenegro remains minuscule. Bosnia and Herzegovina seems to defy this pattern but only in aggregate country statistics. In fact, large flows of trade with both Croatia and Serbia and Montenegro occur at the level of Bosnia and Herzegovina's two entities. Trade with Croatia is still limited to the Federation of Bosnia and Herzegovina whereas that with Serbia and Montenegro concerns flows in and out of Republika Srpska. On the other hand, FYR Macedonia, which succeeded in staying outside the regional conflicts of the 1990s, has relatively significant trade with all other SEE-5 countries.

2.64 Last but not least, there are reasons to believe that trade among SEE-5, especially among former Yugoslav republics, is seriously underestimated. For starters, consider that trade statistics of Serbia and Montenegro do not include foreign trade transactions of independent customs areas—Montenegro and Kosovo. While we have no data for Montenegro, we have an estimate of Kosovo's total commercial imports in 2000 of around US$500 million.[23] This estimate does not include trade with Serbia, as it went unreported. Nor does it include products transiting through Serbia. Furthermore, imports entering Bosnia and Herzegovina through the Brcko region, which is neither a part of the Federation of Bosnia and Herzegovina nor of Republika Srpska, go unreported. Reportedly, these are quite significant, as excise and sales tax levied there are lower than in two entities of Bosnia and Herzegovina. Furthermore, high taxation of trade across the region encourages black market activities (EWI 2000), which in turn provides strong incentive to smuggling. Porous borders in many countries, the absence of language barrier in former Yugoslav republics and corrupt customs suggest that unreported trade among SEE-5 may be quite considerable. Again, there are no reliable estimates, but anecdotal evidence suggests that smuggling is rampant in many areas.[24]

2.65 Bringing into the picture other Balkan economies—Bulgaria, Greece and Romania—does not significantly increase the importance of the region as a market for SEE-5 sales and purchases. These three Balkan economies absorbed merely 4.3 percent of exports originating in SEE-5, but accounted for 7.5 percent of SEE-5 total imports. Geographical proximity and much higher level of economic development seem to explain a very significant share of Greece in Albania's trade,

[23] This estimate is derived from the customs duty revenues (10 percent of the value of imports) corrected by the share of imports through Montenegro (derived from the share of customs duty revenue collected at Tax Collection Point at the Montenegrin boundary of Kosovo).

[24] For instance, the WSJE reported massive exports from Serbia to Kosovo brokered by Muslim Slavs of Sandzak involving food and livestock and construction materials. All transactions are on cash basis. Anecdotal evidence about the dramatic increase in the number of trucks registered in Sandzak to transport products to Kosovo suggests a significant scope of this trade (Robert Block, "'Bosniaks' Dare to Deliver Where Many Fear to Go," *The Wall Street Journal Europe*, 18 February 2000).

and Slovenia's in trade of Bosnia and Herzegovina and Croatia.[25] Common borders and decent transportation network account for a relatively large share of Bulgaria in trade of Serbia and Montenegro and FYR Macedonia. On the other hand, however, Romania's involvement in intra-Balkan trade remains exceptionally low.

Is Intra-Regional Trade Below Potential? Gravity Model Estimates

2.66 The gravity model provides a useful tool to assess regional biases in international trade and predict potential trade flows. It is based on the concept borrowed from physics according to which the gravity force is directly proportional to the mass of two bodies and inversely proportional to the distance between them. In a similar way, the gravity model or equation describes a bilateral trade flow as positively related to the economic size of the two countries and negatively related to the distance between them. Its results are highly sensitive to the choice of variables capturing broadly conceived distance (transport cost, cultural similarities, language, etc.), the economic size of countries (the quality of statistics on GDP) as well as characteristics concerning consumers' preferences (or their absence) among the various trading partners.[26]

2.67 Because of the poor quality of data,[27] we use a very simple gravity equation taken from Frankel, Stein and Wei (1997) that uses standard parameter values:

$$\log T_{ij} = 0.7\log(GDP_i \cdot GDP_j) + 0.3\log(GDPPC_i \cdot GDPPC_j) - 0.7\log(Distance_{ij})$$

where: T_{ij} represents a trade flow from country i to country j; GDP stands for the total Gross Domestic Product and GDPPC for the Gross Domestic Product per capita; $Distance_{ij}$ denotes the distance between capital cities of trading partners.

The model is resolved simultaneously for all countries by inputting the data for each country and solving the equation above. The predicted trade is then compared to the actual trade between dyads of countries.

2.68 The results of the 'gravity' exercise should be treated with extreme caution for two main reasons. First, as discussed above, official statistics tend to underreport existing trade flows. The problem in SEE-5 goes beyond possible sloppiness or corrupt practices at international borders rather common in many developing countries. The problem is that trade statistics of Serbia and

[25] If one includes Slovenia, a republic of former SFRY, the share of the Balkan region in total SEE-5 imports increases to 23 percent and the share in exports to 31 percent. Within the former Yugoslav space, the most active trade occurs in the triangle: Slovenia-Croatia-Bosnia and Herzegovina accounting for 71 percent of all shipments among former Yugoslav republics and the share of Croatia and Slovenia in total exports originating in former Yugoslav republics is 76 percent. Considering their economic weight, this is not surprising But clearly there is potential for the increase especially in trade with Serbia and Montenegro.

[26] For an illuminating discussion of the theory underpinning gravity models and their various applications, see Smarzynska (2001). For a much more elaborate application of a gravity model to estimate potential trade in SEE region, see Christie (2001). It is interesting to note that the results reported there do not significantly differ from ours.

[27] For instance, significantly different data are reported for the same bilateral trade flow between importing and exporting countries. Discrepancies in trade statistics are often huge (see Table 2.3). In order to circumvent this problem, we use—following the approach taken by Fontagne, Freduenberg and Peridy (1999)—the weighted average of two estimates weighing the imports as twice high as those reported by the exporting country.

Montenegro did not include foreign trade transactions of independent customs areas—Montenegro and Kosovo. Neither did they include trade between Republika Srpska and Serbia nor imports entering Bosnia and Herzegovina through the Brcko region, which is neither a part of the Federation of Bosnia and Herzegovina nor Republika Srpska. In consequence, the realization ratios tend to over-estimate trade potential, simply because actual trade is underreported.

2.69 Second, the gravity model used here tends to exaggerate potential trade flows for yet another reason. Consider that distance is proxy for shipping costs. But proximity does not always reduce the transportation costs, time lags, the magnitude of spoilage or the cost of gathering information about the partner's legal and administrative procedures. Although countries located close to each other are more likely to have a long history of bilateral trade giving them a better understanding of each other's customs and tastes, poor infrastructure in most SEE-5 countries (i.e., ports, transportation routes) seems to be a formidable barrier to regional trade. Albania, for instance, does not have good transportation routes to most of Balkan countries excluding Greece.

2.70 For reasons related to the legacy of recent history, we initially focus on former Yugoslav republics. These countries had close ties as parts of the same national economy. As pointed earlier, some observers believe that the removal of trade barriers among them would provide a powerful boost to economic growth and regional cooperation. Our calculations include Slovenia—although not a Balkan country, it was part of former SFRY. It had been not only a gateway of former SFRY to the EU, with most of its exports to EU and EFTA markets originating in Slovenia, but also a significant market for products from other republics especially from Croatia.[28]

2.71 The results calculated for 2000 do not appear to suggest large potential for an increase in intra-former Yugoslav republic trade, albeit with a caveat (Table 2 5). There is significant variation in bilateral trade flows projected by gravity model for regional dyads due to lingering memories of animosities, Western embargo on Serbia and Montenegro under the Milosevic regime and external assistance. Taken together, they continue distorting trade flows among former Yugoslav republics. As the case of Slovenia's trade demonstrates—the only former Yugoslav republic that succeeded to stay out of regional upheavals—they have had profound impact on trade flows. Slovenia's trade with former Yugoslav republics is close to its predicted potential.[29] The Croatian-Serb conflict, which was one of factors contributing to the demise of former SFRY, still looms large over their trade. Croatia's trade with Serbia and Montenegro remains well below its potential (80 percent below the predicted level in 2000). On the other hand, circumstances unique to the emergence of Bosnia and Herzegovina have shaped its trade patterns. As expected, special relationships between Bosnia and Herzegovina's entities, the Federation of Bosnia and Herzegovina and Republika Srpska, with Croatia and Serbia and Montenegro, respectively contributed to significant 'over-trade' with both Croatia (56 percent above predicted trade level) and Serbia and Montenegro (29 percent above predicted). Another factor contributing to Bosnia and Herzegovina 'excessive' trade with respectively Croatia, Serbia and Montenegro and Slovenia is that foreign assistance funded most of its imports. GDP used in generating predicted flows does not include foreign aid. Imports were therefore well above the

[28] Before the split, Slovenia's trade relations with the other former Yugoslav republics were quite intense, especially with Croatia accounting in 1990 to roughly one-eight of its total sales and purchases. Around half of Slovenia's trade turnover with Yugoslav republics was with Croatia (OECD 1997).

[29] The actual level of Slovenia's trade with other former Yugoslav republics of US$1.8 billion was only 14 percent lower than the predicted value of US$2.1 billion.

levels predicted by the gravity model. Last but not least, Western embargo on trade with Serbia and Montenegro appears to be responsible for its actual trade with FYR Macedonia exceeding by 42 percent the level predicted by economic factors alone including transportation costs. Close political relations free of ethnic tensions, created a fertile ground for diverting Serbia and Montenegro's trade to other partners.

2.72 Except for bilateral trade between Croatia and Serbia and Montenegro, there does not seem to be much potential for growth resulting from the removal of existing trade barriers. While some trade may pick up (e.g., as noted above, Croatia's with Serbia and Montenegro), trade triggered by either Western assistance (Bosnia and Herzegovina) or Western embargo on Serbia and Montenegro may actually fall with full normalization of external economic relations in the region. These developments will probably suppress Serbia and Montenegro's 'over-trade' with FYR Macedonia at the expense of the growth in trade with the EU, Croatia and other partners with whom political considerations were responsible for the low levels in trade. As we discuss in the next section, the international experience corroborates the expectation that intra-former Yugoslav republic trade is unlikely to trigger economic growth in the region.

Table 2.5 Realization Ratios in Geographic Patterns of Trade (in percent) [1/]

	Albania	Bosnia and Herzegovina	Croatia	FYR Macedonia	Serbia and Montenegro	*Total with SEE-5*
Albania	-					*4*
Bosnia and Herzegovina	0	-				*102*
Croatia	4	156	-			*53*
FYR Macedonia	11	15	39	-		*58*
Serbia and Montenegro	1	129	18	142	-	*65*
Total SEE-5	4	102	53	58	65	*57*
Greece	64	7	12	49	26	*29*
Bulgaria	12	5	3	41	84	*34*
Romania	4	14	4	6	32	*13*
Total	21	54	28	46	52	*35*
MEMORANDUM:						
Slovenia	3	152	113	58	10	*86*
Total, Slovenia included	**19**	**69**	**48**	**48**	**46**	***44***

1/ Realization ratios = actual trade/predicted trade. Values less than 100 suggest 'undertrade' and those more than 100 suggest 'overtrade.' Predicted and actual data refer to 2000.
Source: Authors' own calculations Data from for Albania: IMF estimate; for Bosnia and Herzegovina: National Statistics and IMF; for Croatia: official National Statistics; for FYR Macedonia: official National Statistics; for Serbia and Montenegro: official National Statistics; and for other countries: IMF directions of trade statistics.

2.73 The inclusion of Albania changes the overall picture in terms of the 'gravity model' results. If one includes Albania, the aggregate intra-SEE-5 trade in 2000 remains roughly the same increasing US$34 million from US$1,549 million to US$1,583 million or merely 2 percent. But the predicted trade increases rather dramatically from US$1.9 billion to US$2.7 billion or 43 percent. In consequence, the ratio of actual intra-SEE-5 trade to potential trade falls from 82 percent to 57 percent indicating the potential for growth of 70 percent rather than 22 percent as in the case excluding Albania.[30] Considering that Albania pursued autarchic policy of national

[30] Its trade in relation to the GDP, one of the major gravity model variable, is well below levels for other countries with a similar GDP per capita—almost 40 percent lower in relative terms than that of Bosnia and Herzegovina. This contributes to much higher predicted levels of trade than the actual ones. Albania's

self-sufficiency throughout most of its period under central planning and had virtually no transportation and commercial linkages with former SFRY, the result does not come as surprise. In fact, as long as there is no adequate transportation infrastructure in place, the expansion in Albania's trade with other SEE-5 economies is unlikely to occur.

2.74 Turning to other regional partners, our estimates of potential trade flows derived from the gravity model show that trade flows between SEE-5 economies and other Balkan countries are well below the predicted levels. The exception is Albania's trade with Greece. It appears that a large presence of Albanian expatriates in Greece combined with much better transportation access than to other Balkan countries explain why its trade with Albania was only 36 percent below its potential level. Romania is at the other extreme. Assessed against its GDP and proximity, trade of Romania with the region is particularly low indicating potential for an almost tenfold increase once barriers to trade are removed. Bulgaria and Greece are more involved in trade with SEE-5 countries but their respective ratios of actual to potential trade (29 and 34 percent) also indicate the potential for a hefty threefold increase (Table 2.5).

2.75 This would suggest that there is huge potential for expansion in trade between SEE-5 and other Balkan countries. However, it is not clear what impedes this trade. Since many countries already have FTAs, there is not much to remove in terms of tariff barriers. In fact, there was no positive correlation between over- or under-trading and the existence of pre-MOU FTAs. Take Bulgaria for instance. In 2000 it had FTA with FYR Macedonia but not with Serbia and Montenegro. Yet the respective realization ratios were 41 percent with the former and 84 percent with the latter. Albania did not have FTA with the EU, yet the realization ratio of trade with Greece was the highest for Albania's trading partners in the Balkans. This is in sharp contrast to other SEE-5 countries, except Serbia and Montenegro, which had had practically duty free access to Greece under the EU ATP regime in place prior to the SA process. Preferential access failed to spur trade. It appears that barriers other than tariffs have prevented trade in the region from reaching its full potential. By the same token, it is far from certain that a network of FTAs would provide a boost to trade of SEE-5 with other Balkan countries.

2.76 For all these reasons, one may conclude that while the potential for trade expansion varies across the region, it overall does not seem to be high in short-term. In the case of former Yugoslav economic space, except for a glaring case of under-trade between Croatia and Serbia, trade among other former republics seems to be at the levels determined by economic factors and geography. Ratios of actual trade to potential trade for FYR Macedonia trade with Bosnia and Herzegovina and Croatia appear to indicate room for significant expansion. But considering that FYR Macedonia is landlocked and separated from these two countries by several border formalities and poor transportation, the distance in a gravity equation alone does not capture real barriers to trade faced by FYR Macedonia with its more distant neighbors. The cost of trading is significantly larger than the distance alone might imply. Even its long-standing FTA has not helped boost its trade with Bulgaria. As for other regional partners, their ratios of the actual trade to potential trade indicate some potential for expansion. But it appears to be limited either because of geography (Albania) or because—as we show below—of the nature of the current trade consisting mainly in exchanges of products of different sectors rather than in a two-way trade of similar products.

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major export following the collapse of communism was labor force. Remittances were the major source of financing imports and domestic consumption. In consequence, the incentive to look for outside markets was somewhat diminished. For more see the study on Albania in the volume of country studies accompanying this report.

Potential for Regional Trade in Historical and Comparative Perspective

2.77 Trade within state borders tends to be more intensive than trade across borders for a number of reasons stemming from the absence of international borders. Firms operate within the same legal framework; they do not encounter foreign exchange risk; their products are subject to the same standards; they do not face red tape usually associated with trading across international borders; they do not fear of contingent protection; etc. In consequence, borders matter even in trade among highly developed countries locked in a preferential trade agreement. For instance, trade among firms in Canadian provinces bordering the United States is almost 20 times larger than trade with US firms, even though both countries are NAFTA members and share the same language and similar institutions (McCallum 1995).

2.78 Another, admittedly extreme, indication of the importance of national borders is trade among republics in the Soviet Union before its dissolution in 1991. Shares of inter-republic exports in republics' total exports in 1989 varied between the lowest of 68 percent (Russia) and the highest of 98 percent (Kyrgyz Republic). Shares of this trade predicted by the gravity model for the former Soviet republics were almost three times lower ranging between 16 percent (Russia) and 37 percent (Kyrgyz Republic).[31] Their high levels reflected not only the anti-external trade bias of the Soviet Union under central planning but also the fact that trade between the former republics was internal trade.

2.79 While Yugoslav inter-republic trade shared both of these features, anti-export bias of Yugoslav import-substitution strategy was markedly weaker and the size of its economy was smaller. Thus one would expect much lower levels of dependence on intra-republic trade. Indeed it appears that by the demanding 'Soviet' standards internal trade among Yugoslav republics was even lower than one might expect. As can be seen from data in Table 2.6, the shares of inter-republic exports in total exports ranged between 43 (Serbia) and 57 percent (Croatia).

Table 2.6 Directions of shipments originating in former Yugoslav republics in 1987 and 2000 (in percent)

	Exports to other republics in 1987	External exports in 1987	Exports to former republics in 2000	Other exports in 2000	Exports to republics, Index 2000 1987=100
Bosnia and Herzegovina	55	45	34	66	62
Croatia	57	43	26	75	46
Macedonia (FYR Macedonia)	55	45	27	74	49
Montenegro	59	41			
Serbia (including Kosovo and Vojvodina)	43	57			
Serbia	46	54	29	71	63
Kosovo	68	32			
Vojvodina	69	31			
Slovenia	48	52	14	86	29
Average	56	44	26	86	46

Source: for 1987 calculated from data in Uvalic (2000) and for 2000. Bosnia and Herzegovina from National Statistics and IMF; and for other countries—National Statistics.

[31] See Table 2 in Kaminski, Wang and Winters (1996, p. 13).

2.80 Hinic (1994) and Uvalic (1993) draw the conclusion that, since the former Yugoslav republics traded with each other more than with the outside world, the level of economic interdependence among Yugoslav republics was "... greater than usually sustained on the basis of purely political arguments."[32] In other words, economic forces bound them very closely together independently of political ones. But considering that they were then part of the same state with the same currency and laws applying across the whole territory, internal trade as measured by the share of exports to other republics in total exports amounting to 56 percent was rather small. In fact, the average share was well below the average for EU-members in the 1990s. Intra-EU exports accounted on average for 60 percent of total exports originating in EU member countries in 1990-95, although the EU was then neither a unitary state nor a fully integrated economic grouping.

2.81 Considering that exports to other former republics are no longer internal trade but foreign trade, much lower current levels of trade among former Yugoslav republics should come as no surprise. The emergence of borders was bound to increase dramatically the cost of trading. Consider that despite FTA the United States-Canada border imposes barriers to arbitrage equivalent to 2,700 kilometers (Engel and Rogers 1996). Inserting more than one border together with less efficient customs services increase these costs rather dramatically.

2.82 In addition, the violent dissolution of the former SFRY was bound to contribute to the suppression of trade going beyond the impact of a shift from internal to external trade. Yet, excluding Slovenia, the share of exports to former Yugoslav republics fell by between 44 percent for Croatia and 37 percent for Serbia (including Vojvodina in 2000). In comparison with other cases of the dissolution of a state, this does not seem to be an unusual or steep contraction. In fact, the average share of this trade in 2000 amounting to 46 percent of its level in 1987 is not particularly striking when set against the same share for the former Soviet Union which stood in 1993 at 51 percent of its level in 1990.[33]

2.83 The case of the former Czechoslovakia sheds comparative light on the assessment of trade among former Yugoslav republics, revealing that the decline in trade among the former Yugoslav republics has been smaller than could have been predicted. Three observations are noteworthy. First, the contraction in mutual trade was dramatic in both relative and absolute terms. Following the 'velvet divorce' of the Czechoslovak federation on January 1, 1993 the trade between the two new sovereign states immediately fell as compared with their 'domestic' sales in 1992—Czech exports to Slovakia declined 24 percent, and imports 26 percent (UNECE 1994, p. 96). This decline continued each year over 1993-99 (Table 2.7). The value of both exports and imports was lower in 1999 than in 1993.

[32] As quoted in Uvalic (2000).

[33] Calculated from data in Michalopoulos and Tarr (1994, p. 6).

Table 2.7 The Share of Slovak Republic in Czech Exports and Imports and the share of Czech Republic in Slovak exports and imports, 1993-99 (in percent)

	1994	1995	1996	1997	1998	1999	2000	2001	Memo: Index 2001, 1994=100
Czech Republic									
Share in exports	16	14	14	13	11	8	7	7	44
Share in imports	14	12	10	8	7	6	5	5	36
Slovak Republic									
Share in exports	37	35	31	31	21	18	17	17	46
Share in imports	30	27	25	22	19	17	15	15	50

Source: Central Statistical Office and Ministry of Industry and Trade and Direction of Trade Statistics Yearbook, IMF, Washington, D.C., various issues.

2.84 Second, the case of Czech-Slovak mutual trade seems to suggest that a more developed country expand its other commercial ties faster than a less developed one. For a more developed Czech Republic, the fall in the significance of its trade with a less developed Slovak Republic was steeper and Slovakia's dependence on trade with Czech Republic has remained much more significant than that of the Czech Republic on trade with Slovak Republic.

2.85 Third, customs union arrangement between these two countries did not prevent the relative and absolute contraction in trade. If anything, this clearly demonstrates that even free trade falls well short of assuring the level of interaction occurring among firms operating within the same state boundaries and using the same currency.[34]

2.86 Hence, neither historical ties nor the experience of other countries that had shared the experience of the dissolution of a 'national' market would justify the expectation of a lower contraction in trade among former republics. Policy attempts specifically designed to engineer recovery of this trade are bound to fail, as there is not much, if anything, to be recovered. Intra-SEE-5 trade will not become in a foreseeable future a lever of economic growth of countries of the region any time soon.

Dominance of Inter-Industry Trade: Implications For Expansion and Pressures for Protection

2.87 Three observations can be derived from data on the composition of trade among SEE-5 countries (Table 2.8).[35] First, manufactures account for a relatively low share of intra-SEE-5 trade, although there are differences among countries reflecting their uneven level in industrialization. Except for FYR Macedonia's exports to a more developed Croatia and Croatian exports to Albania and Bosnia and Herzegovina, the share of manufacture exports is below 50 percent. Agricultural products make up almost half of the bilateral trade recorded between FYR Macedonia and Albania, and Bosnia and Herzegovina and FYR Macedonia.

[34] A quick disappearance of a monetary union, which barely lasted for five weeks (between January 1, 1993 and February 8, 1993) exacerbated the decline in trade. So did the devaluation of the Slovak koruna against the Czech koruna as well as establishment of a complicated payment system. For more, see UNECE (1994).

[35] Serbia and Montenegro is not included because of the unavailability of disaggregated foreign trade data.

2.88 Second, some dyads exhibit the traditional division of labor linking least developed and highly developed countries through exchanges of raw materials and low processed goods for processed ones. For instance, take the dyads: Albania-Croatia and Albania-FYR Macedonia. Albania specializes in exports of production inputs to these economies, which in turn process them and export some portion back. These inputs include items, which—unlike components and parts—have no discernible use in their present form and are basically unprocessed. Agricultural raw materials, ores, minerals and nonferrous materials regarded as traditional production inputs, i.e., not processed in their present form, account for a dominant share of Albania's exports to Croatia (96 percent) and FYR Macedonia (88 percent). Manufactures account for 72 percent and 56 percent of Albania's imports from these two countries, respectively (Table 2.8). Thus Albania seems to be locked in a traditional division of labor as a supplier of production inputs in return for manufactures, albeit with a caveat. The share of production inputs in exports from higher developed Croatia and FYR Macedonia remains quite significant pointing to some processing within Albania. The situation in other dyads is even less clear with a mixture of production inputs and final products dominating mutual trade.

Table 2.8 Composition of trade among SEE-5 countries (excluding FR Y) in 1999 (SITC Rev. 2) (in percent)

	1999 Imports from:				1999 Exports to.			
ALBANIA	Croatia	Bosnia and Herzegovina	FYR Macedonia	EU	Croatia	Bosnia and Herzegovina	FYR Macedonia	EU
Food products (0 + 1 + 22 + 4)	10	100	42	21	0	0	33	5
Agricultural Materials (2-22-27-28)	6	0	1	1	12	0	10	7
Textiles fibres (26)	6	0	0	0	0	0	2	0
Ores, minerals & metals (27 + 28 + 68)	0	0	0	1	84	0	7	2
Energy (3)	6	0	0	5	0	0	32	2
Manufacturing (5 to 8 - 68)	72	0	56	72	4	0	16	84
	1999 Imports from:				1999 Exports to			
BOSNIA AND HERZEGOVINA	Albania	Croatia	FYR Macedonia	EU	Albania	Croatia	FYR Macedonia	EU
Food products (0 + 1 + 22 + 4)	No imp	30	32	18	100	15	41	2
Agricultural Materials (2-22-27-28)	No imp	0	4	1	0	15	13	19
Textiles fibres (26)	No imp.	0	3	1	0	0	0	0
Ores, minerals & metals (27 + 28 + 68)	No imp	1	3	1	0	30	6	17
Energy (3)	No imp	15	0	1	0	10	0	0
Manufacturing (5 to 8 - 68)	No imp	53	58	78	0	31	39	62
	1999 Imports from				1999 Exports to			
CROATIA	Albania	Bosnia and Herzegovina	FYR Macedonia	EU	Albania	Bosnia and Herzegovina	FYR Macedonia	EU
Food products (0 + 1 + 22 + 4)	0	15	18	7	17	30	28	3
Agricultural Materials (2-22-27-28)	12	15	1	2	6	1	1	8
Textiles fibres (26)	0	0	0	0	6	0	0	0
Ores, minerals & metals (27 + 28 + 68)	84	30	5	2	0	1	2	5
Energy (3)	0	10	0	2	6	15	23	4
Manufacturing (5 to 8 – 68)	4	31	75	86	72	53	47	80
	1999 Imports from:				1999 Exports to			
FYR MACEDONIA	Albania	Bosnia and Herzegovina	Croatia	EU	Albania	Bosnia and Herzegovina	Croatia	EU
Food products (0 + 1 + 22 + 4)	33	41	28	12	42	36	18	9
Agricultural Materials (2-22-27-28)	11	13	1	2	1	4	1	2
Textiles and fibres (26)	3	0	0	1	0	3	0	0
Ores, minerals & metals (27 + 28 + 68)	7	6	2	1	0	3	5	9
Energy (3)	33	0	23	19	0	0	0	0
Manufacturing (5 to 8 - 68)	12	39	46	66	56	52	75	80

Source UN COMTRADE database.

2.89 Third, both import and export baskets in trade among SEE-5 diverge rather significantly from those that they have in trade with the EU (Appendix Table 2.1). In both exports to and imports from the EU of each SEE-5 economy manufactured goods account for a dramatically larger share than in their mutual trade. Contrary to expectations, Albania's trade is no exception

to this pattern with manufactures accounting for more than 80 percent of their exports to the EU. The composition of SEE-5 exports to the EU is quite similar with textiles and clothing, footwear and wood accounting for between 30 percent (Serbia and Montenegro) and 54 percent (Albania). These shares for other countries were 40 percent in Croatia's exports, 51 percent in Bosnia and Herzegovina exports and 45 percent in FYR Macedonia exports. In contrast, textiles and footwear represent only a small fraction of intra-regional trade compared with its weight in the total exports for most of SEE-5 countries. For instance, while for Albania, Croatia, Bosnia and Herzegovina, and FYR Macedonia exports of textiles represent around one-third of their total exports to the EU, they account for a much smaller share of their exports to the region. The only exception is Bosnia and Herzegovina with exports of textiles to Serbia and Montenegro accounting for 30 percent of its total Serbia and Montenegro-oriented exports (Appendix Table 2.2). Serbia and Montenegro appears to be an important outlet for final consumer goods including footwear from Croatia and FYR Macedonia. Wood products are an important item in Bosnia and Herzegovina exports to Croatia and FYR Macedonia and iron and steel account for a significant portion of FYR Macedonia's exports.

2.90 In all, intra-SEE-5 trade remains mainly of inter-industry type with limited exchanges occurring within the same sectors. Table 2.9 tabulates the share of intra-industry trade, i.e., two-way trade in similar products in trade with other SEE-5 countries, as measured by the G-L (Grubbel-Lloyd) index (values of G-L indices are above the diagonal).[36] Because of large discrepancies in data reported by SEE-5 countries on their mutual trade, we averaged the data on imports and exports as reported by respective partners.

Table 2.9 Values of Grubbel-Lloyd indices (above diagonal) and ratio of exports (reporters in rows) to imports from other SEE-5 countries in 1999 (in percent)

	Albania	Bosnia and Herzegovina	Croatia	FYR Macedonia
Albania	N/A	0	1	15
Bosnia and Herzegovina	*0*	N/A	23	15
Croatia	*2378*	*474*	N/A	19
FYR Macedonia	*474*	*209*	*80*	N/A

Source: Own calculations based on data from WITS database.

2.91 The values of G-L indices for intra-SEE-5 trade are extremely low, and probably overestimated given a high level of aggregation of trade data, not only for Albania's trade but also for trade among former Yugoslav republics. There are also huge imbalances in this trade (values below the diagonal in Table 2.9). For instance, Croatia's exports to Albania are 24-times larger than its imports from Albania. Croatia's and FYR Macedonia's exports to Bosnia and Herzegovina and Albania are almost five-times larger than their respective imports from these countries.

2.92 The low levels of intra-industry trade in trade among SEE-5 countries have two important implications. First, they point to a limited potential for growth at least in the short term, i.e., until new industrial capacities are established. At present the differences in factor endowments rather than economies of scale associated with supplying a larger market and fixed costs of production

[36] The Grubbel-Lloyd index is the difference between unity and the quotient of the absolute difference between exports and imports of a given sector and the total of imports and exports for this sector. Calculations here are based on 2-digit SITC, Rev. 3 data. The index assumes the value of 100 percent in the presence of two-way trade across all sectors and zero when exports do not overlap with imports across sectors.

continue driving this trade. Low values of G-L indices usually indicate limited trade in similar differentiated products, which, in turn, points to low levels of interaction among firms operating in the same networks of production and distribution as suppliers of parts and components. Since previous ties among industrial firms within the former SFRY were weak and a decade of turmoil in the region wiped them away, these would have to be built from scratch. While one may hope that the SA process will lead to the creation of a regional market, the crux of the matter is that investment response to these new opportunities offered by a larger market will not happen overnight.

2.93 Second, the low levels of intra-industry trade, as captured by the values of G-L indices, suggest not only the low potential for growth, but also considerable potential for protectionism and trade friction.[37] The dominance of inter-industry trade has serious implications for regional trade liberalization effort. Inter-industry trade, which is driven by gains from differing factor proportions, may produce significant inequalities in regional development and income distribution. Conforming upon this trade preferential treatment would have serious income-distributional ramifications threatening incomes of unskilled labor force in more developed countries and those of skilled labor force in less developed areas. To be sure, liberalization among partners mainly engaged in intra-industry trade also imposes adjustment costs. The difference is, however, that adjustment triggered by liberalization does not affect whole sectors, as is the case with inter-industry trade, but rather individual firms.[38]

2.94 In consequence, the danger is that instead of creating foundations for regional cooperation and security, preferential trade arrangements among these countries linked mainly in inter-industry exchanges might create new areas for tension mainly between more and less developed partners, but not only. Thus, the policy dilemma can be phrased as follows: while the development of a larger regional free trade area may offer incentives to investments leading to the development of intra-industry trade driven by comparative advantage operating within products,[39] it may also exacerbate existing inequalities in regional development and income distribution. In order to avoid the latter outcome, SEE-5 trade liberalization should accompany their trade liberalization with the EU. The two pursued together will lead to the emergence of markets offering new opportunities. But without structural reforms aimed at establishing business/ investment friendly environment, they may not be tapped.

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[37] There are some exceptions, however. As discussed below, profiles of economic structures and trade indicate some complementarity, which would suggest lower adjustment cost of trade liberalization. The examples are the following dyads: Albania-Croatia and Albania-FYR Macedonia.

[38] The theory holds that intra-industry is a win-win situation for all, as consumers in countries involved in this trade enjoy an expanded range of products, and nobody suffers a loss of income, either relative or absolute.

[39] The force driving two-way trade in similar differentiated products is economies associated with supplying a larger market, whereas the reason a country cannot produce a complete range of products is fixed costs of production. This trade does not involve relocation of whole industries. In consequence, specialization in differentiated products associated with intra-industry trade poses fewer adjustment problems than inter-industry trade (Krugman 1994, p. 38-51).

Conclusion

2.95 The economic rationale behind moves encouraging SEE-5 countries to engage in free trade negotiations with one another is the belief, albeit not always explicitly stated, that the network of regional FTAs will contribute to sustained economic growth. Kovac[40] (1998) argues that trade liberalization could increase regional trade flows, and if foreign trade were to increase sufficiently, it could create exceptionally strong impulses for economic development, with both static and dynamic gains accruing to each SEE. This argument assumes that trade among SEE-5 countries is suppressed due to non-economic reasons.

2.96 But the empirical analysis of this section does not give support to this conclusion. The results of our gravity exercise indicate that intra-regional trade is well below its equilibrium level, mainly due to low intra-regional trade of Balkan countries that ***were not*** part of the former Yugoslav space. As for trade among former Yugoslav republics, excluding trade between Croatia and Serbia and Montenegro, there is no much room for the increase. While the share of trade among the former Yugoslav republics declined, it still remains at a relatively high level for most countries. The contraction in the share of mutual trade of former Czechoslovakia was much larger despite preferential treatment under customs union and the respective shares are lower. On the other hand, Albania, Bulgaria and Romania not only under-trade with each other but they also under-trade with former Yugoslav SEE countries. Here the potential for expansion is much larger, albeit with a caveat. The caveat is that this potential will not be realized without better road network (especially so in the case of Albania), investment regimes and trade liberalization—as argued earlier—along two other dimensions: vis-à-vis the EU and MFN partners.

2.97 Hence, two practical policy recommendations follow from this analysis. First, the time during which firms from SEE-5 and other Stability Pact countries would enjoy preferential tariff margins over suppliers from the EU should be shortened. This would suggest a faster reduction of tariff rates on imports from the EU. Second, high MFN tariff rates on industrial products should be significantly lowered with the entry in force of FTAs. This would reduce the level of protection accorded to SEE-5 firms that may be competitive in other regional markets thanks solely to high tariffs.

POTENTIAL FOR TRADE DIVERSION AND TRADE CREATION: WELFARE EFFECTS OF DISCRIMINATORY TARIFF REDUCTIONS

2.98 Jacob Viner (1950) introduced a seminal distinction between two static effects of FTA—trade creation and trade diversion. Both stem from the fact that FTA, by definition implying discriminatory liberalization, artificially changes relative competitiveness of goods from countries entering the FTA. The cost of trade diversion is due to the fact that after the discriminatory liberalization, the country purchases from a higher-cost international supplier. Trade diversion represents static costs, as it suppresses imports from more efficient industries in excluded countries. Trade diversion entailing the switch in supply source from internationally competitive to more expensive FTA suppliers occurs only if partner country's costs are out of line with costs and prices in the rest of the world. The EU's Common Agricultural Policy provides an extreme

[40] Quoted in Uvalic (2000). The East West Institute report (EWI 2000) does not seem to share Kovac's view pointing to behind-the-border measures as having far more depressing effect on trade than tariffs. Uvalic (2000) in turn shows that this trade would have to be built from scratch. Hence, it seems that the removal of border or behind-the-border measures would have only a marginal impact on intra-SEE-5 trade. Further, the increase may result from trade diversion.

illustration of a trade diversion effect. It increases the 'regional' trade at the expense of trade with outside countries.

2.99 In contrast, trade creation has positive effects similar to those obtained under non-discriminatory tariff cuts.[41] It generates trade at the expense of inefficient suppliers in the member countries. Since trade creation results in a partner country's production displacing higher cost domestic production, it does not increase 'regional' trade at the expense of outside countries and yields static benefits to FTA participants. The FTA has the potential for increasing welfare of both partners only insofar as trade creation exceeds trade diversion. In other words, a country can lose when it liberalizes on a discriminatory basis, if the cost of trade diversion outweighs the benefits from trade creation.

2.100 Large theoretical literature on bilateral trade integration offers many rules of thumb as to when FTA is likely to result in welfare loss. The most important and enduring ones concern MFN tariffs and the fraction of imports that come from other participants in FTA. High and dispersed external tariffs and low mutual trade are conducive to trade diversion. High preference margins provide a strong incentive to home consumers to switch from a low-cost supplier outside the FTA to a high-cost one from a FTA partner country. The level of pre-FTA trade with an FTA partner affects the size of trade diversion effect. If initial pre-FTA imports are low, the likelihood of replacing a low-cost MFN supplier with a higher-cost FTA supplier increases.

2.101 This section seeks to answer the question about the potential for trade diversion as a result of discriminatory liberalization. The logic underlying this analysis is as follows. Level of imports and MFN tariffs provide glimpses into this issue. Intra-SEE-5 trade, examined in previous section, is in line with their respective economic 'weight' with the possible exceptions of Serbia and Montenegro with Croatia, and of Albania with other SEE economies. However, the shares of SEE-5 imports in their respective total imports are low, which may suggest the potential for diversion.[42] We focus below on MFN tariffs. We begin with the examination of distortions related to their tariff structures followed by the analysis of tariffs in their mutual trade. Linking major exports from SEE-5 with MFN tariffs in SEE markets sheds light on the scope of their distortionary impact independently of whether exporters face tariffs or have a duty-free access. We conclude with a formal welfare analysis of FTA between some SEE countries, which had not at the time signed FTAs, i.e., the following dyads: Albania-Croatia, Albania-Bosnia and Herzegovina, and Albania-FYR Macedonia.[43]

[41] These positive effects include lower domestic prices thanks to increased competition from imports and closing down of some high-cost firms replaced by lower-cost imports.

[42] This observation does not contradict the conclusion about the low potential for growth in intra-SEE-5 trade. The point is rather that domestic products that are not competitive in international markets will expand their sales to partner countries solely thanks to protection. Moreover, because inter-industry trade prevails in intra-SEE-5 trade, whole sectors of the economy may bear costs of adjustment to bilateral trade liberalization.

[43] Not all future FTAs among SEE-5 are examined, as no trade data disaggregated at six-digit HS level are available for Serbia and Montenegro and Bosnia and Herzegovina. For similar reasons, we disregard two customs areas—Kosovo and Montenegro.

MFN Tariff Structures In SEE-5 Countries

2.102 Tariff structure can be the source of two types of distortions in domestic production and distribution patterns: those related to dispersion in tariff rates and those caused by differences between MFN applied rates and preferential or zero rates on imports from FTA countries. First, dispersion in tariff rates frequently lead to prices that seriously distort production and consumption patterns. Low and uniform tariff rate minimizes the net welfare cost.[44] The four-band MFN tariff structures of Albania and Bosnia and Herzegovina with a maximum rate of 15 percent are the closest among SEE-5 to the 'ideal' of the uniform tariff schedule (Table 2.10). The higher the dispersion in tariff rates, as measured by the standard deviation (absolute dispersion between items), the larger are potential distortions—as the variance in tariff rates causes the variation in imported product prices. By this measure, the tariff structures of Albania and Bosnia and Herzegovina seem to be the least distorting among SEE-5 countries. The overall standard deviation of their MFN rates—5.7 and 4.7 percent, respectively—are larger than that in the EU but lower than in external tariffs of many other transition economies. For instance, Bulgaria's MFN tariffs have the standard deviation of 9.3 percent.

Table 2.10 Characteristics of MFN tariff schedules in SEE-5 countries (2000)

MFN Tariff Schedules	Albania	Bosnia and Herzegovina	Croatia	FYR Macedonia	Serbia and Montenegro***	Memorandum Serbia and Montenegro 2001***
Simple average tariff	8 1	6 2	10.6	15	14 4	-9.2
Percent of tariff lines above 15%	0	0				
Agricultural products (HS 1-24)	10 9	4 9	15.3	21 8	23	n a
Industrial products (HS 25-97)	7 3	6 2	9 6	13 2	13	n a
Weighted average tariff*	11 6	n a	9	14 2	9 12**	n a
Range/Maximum tariff rates	0, 2, 10,	0, 5, 10, 15	0-25%	0-60%	0-40%	0-30%
Standard deviation	5 7	4 7	7 4	12.4	10 8	n a
Coefficient of variation	0 7	0 8	0 7	0.8	0 8	n a
Specific rates	No	No	592	No	420 agricultural	n a

Source. *Own calculations from national tariff schedules*

** / Albania IMF; Croatia· IMF; FYR Macedonia. Daskalov et al (2001).*

***/ Calculated from 2000 tariff schedule and total imports without considering imports from FTA countries*

***/ In May 2001, the government introduced a new tariff schedule reducing levels of protection

2.103 The second type of distortions is generated by FTAs. These preferences and exemptions from uniform MFN treatment of external suppliers implicit in FTAs can be highly distortionary. The granting of a preferential treatment to suppliers may be purely trade diverting if this merely compensates for their cost disadvantage. Consider the following: importers will often choose product originating in a preferential country although the same product may be available at a lower cost from a firm facing an MFN rate. Furthermore, an exporter from a preferential area—even though otherwise competitive in world markets—may price its products to capture the rent up to a margin below the MFN applied rate. Whatever the case, the loser is ultimately a local user of imports.

[44] The welfare loss (total deadweight) increases as tariff structure becomes more diversified. A uniform nominal tax minimizes the net welfare cost insofar as two conditions are met: import demand elasticities are uniform across commodities; and cross-price effects are negligible. See Panagariya and Rodrik (1993).

2.104 These losses are somewhat mitigated, as SEE-5 economies have relatively low MFN tariff rates relative to other countries at a similar level of economic development. Serbia and Montenegro and FYR Macedonia have the highest simple average rates of 14 percent and 15 percent, respectively. But even these do not diverge significantly from the simple average rate of 14 percent of all IMF members. Despite different structures of production, the former Yugoslav republics display significant similarities in their respective tariff schedules. The last decade has not significantly impacted the structure of protection inherited from former SFRY, although their level declined in all former republics. They all seem to be protecting the same sectors and products. It is interesting to note that Albania's structure of tariff protection does not diverge largely from those in former Yugoslav republics, while that of the EU is dramatically different.

2.105 However, the differences become more visible once the cascading effects of tariff structures are taken into account. Note that since tariffs are not uniform, protection (or subsidy) offered to domestic producers is not neutral among products at various stages of processing. SEE-5 tariff structure tend to 'discriminate' against low processed products leading to tariff escalation, i.e., tariffs for fully processed products tend to be higher than for semi-processed products and raw materials. But overall the cascading effect is relatively low, as the simple average tariff rates on products in the third stage of processing are not significantly larger than on the first- or second-stage of processing (Table 2.11).[45] The highest relative differential between the final and the first stage of processing was for Albania and the lowest for Croatia.[46]

Table 2.11 Tariff escalation in SEE-5 countries by industrial sector (2000)

	Albania			Bosnia and Herzegovina			Croatia			FYR Macedonia		
Good's category—stage of production[1]	1	2	3	1	2	3	1	2	3	1	2	3
0. Food & live animals	10	10	11	3	5	8	14	14	18	22	18	28
1 Beverages & tobacco	3	-	15	15	-	14	20	-	22	16	-	55
2 Crude materials exl food and fuel	4	5	-	1	2	-	6	5	-	6	6	-
3. Mineral, lubricants, fuels and related materials	8	12	8	1	0	1	5	8	9	4	3	7
4. Animal and vegetable oil, fat and waxes	-	-	8	-	-	3	-	-	12	-	-	7
5 Chemical and related products, n e s	10	4	7	0	3	4	10	7	10	5	6	12
6. Manufactured goods	2	8	13	8	6	9	11	7	14	15	10	19
7 Machinery and transport equipment	-	-	4	-	-	6	-	-	9	-	-	12
8. Miscellaneous manufactured articles	2	11	11	10	10	10	20	15	16	15	24	23
TOTAL	6	8	10	5	4	7	12	9	14	12	11	20

1/ According to WTO classification. 1 raw materials, 2 intermediate products, 3. final products

Source. Own calculations based on national MFN tariff schedules

2.106 At the level of single-digit SITC sectors the differences become more pronounced, albeit not dramatic. Eyeballing the data in Table 2.11 leads to two observations. First, each country has at least one sector with higher tariff protection of either intermediate or low processed products. For instance, Croatia offers higher protection to low processed products than to final products of the miscellaneous manufacture sector (SITC 6). So does Bosnia and Herzegovina but to beverages and tobacco, and Albania to producers of chemicals and related products (SITC 5). Second, while the levels of tariff protection across sectors differ widely (see also Appendix Table 2.3), sector patterns are quite similar.

[45] The classification of different stages of production was calculated according to the WTO classification used in Trade Policy Reviews.

[46] Tariff escalation has not been computed for Serbia and Montenegro owing to unavailability of tariff schedule in electronic form.

2.107 One may thus conclude that the structures of tariffs in SEE-5 will not magnify the effects that discriminatory liberalization of tariffs might have because of high rates of effective protection. While we have no data on the rates of effective protection, the closer the structure of tariffs is to uniformity the lower is their deviation from actual tariff rates. When the rate is uniform, its value equals the rate of effective protection. As we have seen, SEE-5 structures of tariffs are mostly relatively uniform without any discernible deliberate tariff escalation.[47] This suggests that rates of effective protection are not significantly larger than applied tariff rates and will not significantly contribute to trade diversion.

Tariffs on Imports from SEE Countries

2.108 Trade among some SEE countries was subject to several FTAs—albeit with unclear product coverage—even prior to the signing of the MOU. How significant are then tariff rates faced by SEE exporters in SEE markets? While the general MFN conditions can be easily derived from the analysis of tariff structures, they do not tell much about the scope for trade diversion implicit in the composition of their mutual trade. Some more detailed insights can be derived from examining the average MFN tariff rates that the 25 major exports (6-digit HS items) from each SEE-5 country would face in other SEE-5 countries. The rationale behind this exercise is that these are their most competitive products in which each SEE-5 has comparative advantage. The results that we obtain below suggest that, while the potential for FTAs to lead to trade diversion was high in the recent past, tariff cuts already implemented in Albania and Serbia and Montenegro have significantly reduced it, and further expected MFN tariff reductions by the WTO-acceding countries will reduce it further.

2.109 Available data do not allow to carry out this calculation beyond 2000, nor to include Bosnia and Herzegovina in a calculation based on 2000 data. This limitation is important, because since 2000 both Albania and Serbia and Montenegro have reduced their import tariffs. Noting this limitation, and the fact that it results in overstating the potential for trade diversion, we present in Table 2.12 the average MNF tariff rate that would be faced by the top 25 exports by SEE-5 countries in their respective markets.

2.110 As can be seen from data in Table 2.12, in 2000 the tariff rates facing SEE-5 most competitive products in SEE-5 markets were quite high, albeit there is some variation. In the cases where there is a bilateral FTA (marked with asterisk), MFN tariff rates simply show the margin of preference rate at which the main exports were entering each other's market. Albania's main exports faced the highest MFN rates in markets of four SEE-5 countries examined here. The average rates on its top 25 products, accounting for 70 percent of its total exports, ranged from 11 percent in Bosnia and Herzegovina to 25 percent in FYR Macedonia. Hence, zeroing these tariff rates would have led to preferential margins in double digit levels, suggesting a significant potential for trade diversion. Note also that that these tariffs were significantly larger than simple average MFN rates in respective markets. This appears to suggest that Albanian main exports would qualify as sensitive in these markets.

[47] Tariff escalation, closely related to the concept of effective protection, occurs if duty rates on raw materials and intermediate inputs are set lower than rates on processed commodities. It reveals the extent to which a government accords preference to activities at down-stream stages of production. With a uniform rate, there is no tariff escalation.

Table 2.12 Average MFN tariff rate (that would be) faced by top 25 exports in respective SEE-5 markets (in percent) [1]

25 main exports of: [2]	Albania	Croatia	FYR Macedonia	Serbia and Montenegro
Albania(average MFN rate, 8%)	----	5	10	8
Croatia (average MFN rate, 11%)	19	----	16*	9
Bosnia and Herzegovina (average MFN rate, 6%)	11	6*	11	7
FYR Macedonia (average MFN rate, 15%)	25	16*	----	13*
Serbia and Montenegro (average MFN rate, 14%)	24	11	21*	----
Percent of total exports of 25 main exports:	70	39	49	37

Source calculated with data from the 2000 Tariff Schedules, UNCOMTRADE and Federal Statistical Office Yugoslavia See also Table 2.10 for data on average tariff rates.

1/ According 2000 MFN tariff schedules.

2/ Export data for Albania, Croatia, and FYR Macedonia from 1998; export data for FR Yugoslavia from 2000; export data for Bosnia and Herzegovina not available, 25 Main exports at 6-digit-level of the HS Code

*/ FTA in effect.

2.111 Croatia's top exports faced double digit tariff rates in Serbia and Montenegro, albeit below Serbia and Montenegro's simple MFN average rate, and low tariff rates of 5 percent in Albania. The latter suggest low potential for trade diversion once a FTA is in place. The highest MFN rates on exports originating were in FYR Macedonia, but these were not applied because of the FTA. FYR Macedonia exports would have faced similarly high tariff rates in Croatia. These suggest that the FTA between these two countries has probably resulted in significant trade diversion. The same observation applies to FTA between Serbia and Montenegro and FYR Macedonia. Serbia and Montenegro's main exports faced the lowest rates, the highest being with FYR Macedonia with whom they have signed a FTA.

2.112 In general, these calculations indicate that trade diversion has been a significant factor of FTAs effective in the recent past. These calculations also indicate that, in the future, bilateral FTAs could lead to similar problems unless MFN rates on major exports from SEE-5 countries are reduced. The potential for trade diversion in the future will however be by far lower than indicated by tabulations in Table 2.12. MFN tariff rates for Albania and Serbia and Montenegro have significantly declined since 2000; and further MFN tariff reductions are expected to take place in the context of the WTO accession process for FYR Macedonia.

2.113 These are merely suppositions based on major exports from SEE-5 and MFN tariff rates applied in their respective markets. Moreover, they only indicate the possibility of trade diversion without examining the potential for trade creation as well as welfare effects of FTA. The incoming expansion of bilateral FTAs among SEE-5 countries raises the question of their likely impact on regional trade and welfare to which we will now turn. Will FTAs result mainly in trade diversion or trade creation would exceed trade diversion? How will they affect prices and government revenues? What would be their impact on welfare?

Estimates of Welfare and Revenue Consequences of Trade Liberalization with EU and Region

2.114 The welfare loss from FTA depends on the level of MFN tariffs and the fraction of imports that come from other participants in FTA. Low and uniform external tariffs do not lead to substantive preference margins. The incentive for trade diversion is low, and so is the loss in customs revenue. On the other hand, high and dispersed tariffs provide a powerful incentive to home consumers to switch from a low-cost supplier outside the FTA to a high-cost one from a FTA partner country. The size of this switch (trade diversion) will be particularly large if pre-

FTA imports were low. Then the likelihood of replacement of a low-cost MFN supplier with a higher-cost FTA supplier increases leading to substantial welfare losses.

2.115 The loss is twofold: the government loses customs revenue whereas consumers lose because they will be paying higher price for these imports than in international markets. In other words, the government loses its revenues to regional producers and its consumers gain nothing. As can be seen from Table 2.13, the stakes are high as import duties accounted over 1996-98 for between 8 percent (Croatia) and 33 percent (Albania) of total government revenue. Revenues from import duties in terms of GDP were particularly high in Bosnia and Herzegovina (almost 6 percent), FYR Macedonia and Croatia (3.7 and 3.5 percent, respectively). The last two columns report two estimates of revenue losses caused by the elimination of duties on imports from SEE countries[48]—one based on international taxes collected in 2000 (Demekas et al. 2002), and another based on import duties as reported in Table 2.13. Except for Albania, the estimates are almost identical. The cost of a web of FTAs among the SEE-5 countries is the largest for Bosnia and Herzegovina and FYR Macedonia.

Table 2.13 Significance of import duties in tax revenues (average over 1996-98)

	Total tax revenue	Sales turnover or VAT	Excises	Import duties	**Memorandum:** Import duties in total tax revenue	**Memorandum:** Direct revenue loss from SEE FTAs (in percent of GDP)	
	(in percent of GDP[1/])				(in percent)[2/]	IMF-WB[3/]	Own[4/]
Albania	15.0	4 7	1.2	2.7	18.0	0.5	0.2
Bosnia and Herzegovina	42.9	11.3	5.2	5.9	13.8	1.3	1.4
Croatia	41.6	13.6	4.5	3.5	8.4	0.1	0 1
FYR Macedonia	36.1	5.4	7.2	3.7	10.2	0.6	0.5
Serbia and Montenegro (1999)	n.a.	n.a.	n.a.	n.a.	32.8	0.4	n/a
Kosovo (2000)	6.7	3.5	1.3	1.7	25.4	n/a	n/a
Memorandum: CEFTA	32.8	7.9	2.6	1.8	5.4		

[1/] Average share of GDP during 1996-98, excluding Romania (1996-97) in calculations of the average for CEFTA, Bosnia and Herzegovina (1998-99), and Kosovo (2000).

[2/] For Serbia and Montenegro, in percentage of union-level tax revenues only.

[3/] Estimate based of the share of international taxes paid on imports from SEE countries (IMF-World Bank 2001, Table 9).

[4/] Estimate based on the average share of import duties as reported in this Table multiplied by the share of SEE countries (with which a country had no FTA in 2000) in total imports.

Sources: IMF, Government Finance Statistics Yearbook (Washington, various years); and IMF staff estimates.

2.116 However, the weakness of these estimates is the underlying assumption that geographic patterns of trade remain unchanged. This may be the case, albeit unlikely as MFN tariff rates on many products offer a significant margin for preferential suppliers. One may thus expect trade creation as well as trade diversion effects with different impact on customs revenues (than in the case discussed above) as well as on consumer surplus.

[48] In addition to SEE-5, the group includes all other Balkan countries except for Greece (EU member), that is, Bulgaria, Romania and Slovenia.

2.117 In order to assess the full impact of regional FTAs in terms of trade flows and welfare changes, we use a slightly modified version of a model developed in Hoekman, Ng and Olarreaga (2001).[49] This is a simple partial equilibrium model of total import demand and export supply disaggregated at a 6-digit HS level. Since each six-digit HS item represents only a small share of the economy, the effects of change in tariff rates on other markets can be disregarded. Import demand and export supply is assumed to be isoelastic. They are calibrated for each country using trade value, unit prices, tariffs and preference margins at the six-digit tariff line level in 2000. Due to the lack of data, Bosnia and Herzegovina and Serbia and Montenegro are not included in the simulation exercise. In the case of Croatia and FYR Macedonia their bilateral trade is already duty-free under pre-MOU FTA. Therefore the effects of various scenarios of bilateral liberalization are only estimated for the dyads: Albania-FYR Macedonia and Albania-Croatia.

2.118 The model has been run for four different scenarios, which reproduce policy recommendations already suggested in various publications (e.g., Daskalov et al. 2000, EWI 2000). The policy variants examined are as follows:

- ***Scenario1:*** It assumes a full-fledged FTA between Albania and FYR Macedonia and Albania and Croatia with their respective MFN rates at applied levels in 2000.

- ***Scenario 2:*** It adds to Scenario 1 the assumption that Albania, Croatia and FYR Macedonia adopt the EU MFN tariff schedule on industrial products as their MFN tariff schedules with one caveat. Wherever the EU tariff rate is higher than the current MFN tariff applied by one of these countries, the lower tariff rate is used. It also assumes that FTAs that these countries had in 2000 are in effect.[50]

- ***Scenario 3:*** It assumes that three SEE economies adopt a uniform tariff of 10 percent on their MFN imports and, as above in Scenario 2, their respective preferential partners in 2000 have a duty free access.

- ***Scenario 4:*** It examines the effects of 'zeroing' tariff rates on imports of industrial products from the EU while retaining their 2000 tariff arrangements on other imports.

2.119 Considering assumptions and the quality of foreign trade data, the estimates summarized in Table 2.14 should be treated with a great deal of caution. They are not counterintuitive, however. In fact, they fully corroborate expectations derived from a standard analysis of geographically discriminatory barriers imposed by FTAs.[51] The model tends to exaggerate the impact of FTA on trade flows, because of the assumptions about perfectly competitive and integrated markets, and full substitutability and homogeneity of products. The latter in particular tend to overestimate both the potential for trade creation and trade diversion and therefore net

[49] The model, presented in Appendix 2, was used to examine the impact of the elimination of tariff peaks in highly developed Quad (EU, Canada, Japan, and the US) countries on their imports from developing countries.

[50] In terms of the modeling exercise, this means that imports coming from preferential partners are not subject to tariffs. This does not apply to Albania, which—as of January 2002—has no FTA. In the case of Croatia, duty-free treatment applies to imports from Bosnia and Herzegovina, FYR Macedonia, Hungary and Slovenia. For FYR Macedonia, duty-free access applies to imports from Bulgaria, Croatia, Serbia and Montenegro, Slovenia and Turkey.

[51] Although based on different methodology, they are similar to results obtained by Green (1999).

change in welfare. Moreover, the effects are larger for Albania, as they stem from two rather than one FTA, as is the case of Croatia and FYR Macedonia.

2.120 Yet, the results of estimates of welfare implications of various scenarios of tariff policy confirm earlier observations. First, in order to minimize trade diversion and the resulting loss in welfare, unilateral liberalization should accompany FTA. Under Scenario 1 Albania has a loss in welfare because of FTA, and so does Croatia and FYR Macedonia. The trade diversion effect of FTAs among them exceeds that of trade creation for each of them. The loss in welfare is smaller for Croatia and FYR Macedonia than for Albania for two reasons: first, the estimates capture the total for Albania's two FTA and of only one FTA for the other two countries and, second, export offer of Albania is much smaller and less diversified. The potential for diverting exports to preferential partners is thus smaller. The negative net change in welfare of each country stems mainly from the fall in tariff revenue. This is the classic example of FTAs between small countries where the Agreement has barely any impact on the consumer surplus because the prices are not affected, but there is loss of tariff revenue.[52]

Table 2.14 Estimates of welfare effects of FTAs between Albania and FYR Macedonia and Croatia with various scenarios of reductions of MFN rates (in million of US dollars and in percent)

SCENARIO 1 (FTA)	**Albania[1/]**	**FYR Macedonia**	**Croatia**
Increase in total imports[2/]	71 (7%)	11 (1%)	14 (0%)
Tariff revenue (minus—loss; plus—increase)	-57	-8	-33
Change in net consumer surplus	15	1	1
Change in country welfare	-19	-1	-21
Change in country welfare (percent of GDP)	-0.52%	-0.03%	-0.10%
SCENARIO 2 (FTA and EU MFN for industrial products)	**Albania[1/]**	**FYR Macedonia**	**Croatia**
Increase in imports[2/]	130 (12%)	17 (1%)	158 (2%)
Tariff revenue (minus—loss; plus—increase)	-86	-104	-396
Change in net consumer surplus	111	122	434
Change in country welfare	36	20	52
Change in country welfare (percent of GDP)	0.98%	0.59%	0.26%
SCENARIO 3 (10% uniform MFN tariff rate)	**Albania[1/]**	**FYR Macedonia**	**Croatia**
Increase in imports[2/]	19 (2%)	27 (1%)	330 (4%)
Tariff revenue (minus—loss, plus—increase)	-10	-38	-187
Change in net consumer surplus	6	18	75
Change in country welfare	-4	-20	-112
Change in country welfare (percent of GDP)	-0.10%	-0.59%	0.58%
SCENARIO 4 (elimination of tariffs on industrial imports from the EU)	**Albania**	**FYR Macedonia**	**Croatia**
Increase in total imports from the EU	202 (19%)	528 (28%)	4,020
Tariff revenue (minus--loss, plus—increase)	-54	-126	-705
Change in net consumer surplus	73	140	511
Change in country welfare	19	-13	-191
Change in country welfare (percent of GDP)	0.49%	-0.41%	-0.95%

[1/] For Albania the total change caused by FTA with FYR Macedonia and Croatia

[2/] In parentheses the change in imports in relation to total imports in 2000 in percent.

[52] For a technical explanation of this phenomenon, see Schiff (1997).

2.121 Second, unilateral liberalization combined with bilateral liberalization usually leads to gains in welfare. Simulation of Scenario 2 indicates welfare gains due to lowering of applied MFN tariff rates on industrial products to EU levels but free of tariff peaks in the EU MFN tariff schedule. A large increase in net consumer surplus more than offsets the fall in tariff revenue for all countries. Croatia has a relatively small welfare gain under Scenario 2 due to a huge fall in tariff revenue.[53] Albania gains most when reducing tariff rates to EU levels—an equivalent of 1 percent of its GDP.

2.122 What is then the best policy option in terms of gains in welfare? It is strikingly clear that the worst policy option is FTA without lowering MFN tariff rates. The only policy option under which three of them have welfare gains is that of combining FTAs with the adoption of EU MFN tariff rates on industrial imports. As argued earlier, adoption of the same external tariffs has significant advantage, as it reduces the administrative burden of running rules of origin to deal with 'trade deflection'[54] and distortions in incentives to allocate resources. Albania—the only country among SEE that did not conclude FTAs with its neighbors until very recently—has the most to gain from combining regional FTAs with elimination of tariffs on industrial imports from the EU, i.e., Scenario 4.

Conclusion

2.123 Free trade area encompassing all non-EU member Balkan countries promises gains to all its participants. Although the aggregate GDP of SEE economies, including Bulgaria and Romania, of around US$100 billion may not strike as particularly high, this is a relatively large market offering economies of scale with a great potential for significantly reducing transaction costs. Consider also that SEE-5 have duty free access to geographically close Greece with the GDP of around US$130 billion, more than doubling the aggregate size of the Balkan market. Moreover, the elimination of barriers to trade is likely to lead to its expansion. The absence of cultural and linguistic barriers may contribute to it. Paradoxically, ethnic diversification that had fueled regional conflicts may become an asset in a new environment, once the lines of communication across borders are allowed to develop.

2.124 The preceding analysis provides ample evidence that there is a danger that potential gains from regional integration may turn into losses without accompanying MFN liberalization. The only way to avoid this outcome is to combine regional liberalization with 'synchronized' MFN liberalization across SEE economies. Static welfare analysis leaves beyond any doubt that the best policy option is to combine all dimensions of trade liberalization. A 'big-bang scenario' would involve simultaneously zeroing tariffs in intra-SEE-5 trade and on imports from the EU, while reducing MFN applied tariff rates on industrial products to EU levels. Our calculations suggest that this is the only scenario providing welfare gains to Albania, Croatia and FYR Macedonia.

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[53] Croatia has high tariff rates on industrial products imported mostly from the EU. Increased imports magnified by the contraction in imports of these products from MFN products produced the contraction in tariff revenue of US$286 million (see Table 2.14).

[54] As mentioned earlier, 'trade deflection' describes a situation when an importer in a high-duty country imports a product through a low-duty country and then re-export it to the importer's duty-free. Rules of origin are used to prevent it.

POLICY IMPLICATIONS

2.125 The challenge facing the SEE-5 countries is to exploit opportunities offered by the EU-driven SA process. Opportunities are huge and whether they will be fully exploited depends largely on their economic policies. While this analysis has focused on identifying the best policy moves that would maximize benefits from trade liberalization, the task goes well beyond issues related to the design of a foreign trade regime in the context of the SA process. In fact, even the best-designed scheme of trade liberalization will fail to elicit trade response unless accompanied by complementary reforms in the investment climate, and by cooperation in addressing regional problems including the removal of barriers to commercial interaction.

2.126 The SA process offers unique opportunities to SEE-5 governments to upgrade their institutions to European standards, serving as both an anchor making the reforms more credible and a guide to institutional reforms. The SA process provides also incentives to move quickly towards 'deeper' integration, i.e., convergence to efficiency-enhancing components of the *acquis*. It is this 'deeper' integration that holds the greatest promise for SEE-5 countries: improved market access alone is unlikely to yield large benefits, partly as a result of the restrictive EU rules of origin for sensitive products, which dominate SEE-5 exports, but also because EU MFN tariffs on industrial products are low and so are tariff margins for preferential suppliers. However, achieving 'deeper' integration is in the hands of SEE-5 rather then the EU.

2.127 The SA process sets the stage for policy-induced integration along two dimensions: liberalization in trade with the EU and intra-regional trade liberalization. The two dimensions are inseparable, and must be pursued together to yield the greatest opportunity for gains. The caveat is that trade liberalization along these two dimensions without addressing the third dimension of multilateral, MFN-based liberalization may be counterproductive. First, European and intra-regional liberalization without complementary multilateral liberalization would lead to trade diversion and losses in national economic welfare. Second, the restrictive rules of origin applied by the EU to sensitive products limit the preferential access to EU markets for many SEE-5 producers and require that they compete on the same footing as non-preferential suppliers; in these cases, low external MFN tariffs offer access to more competitive sources of supply of inputs used in the production of products sold in preferential markets, thus increasing their competitiveness.

2.128 In this light the paper offers empirical support to the view that fast liberalization should proceed along three rather than two dimensions as envisaged in the SA process. Three conditions for maximizing welfare are of particular importance.

2.129 First, intra-regional trade liberalization should be accompanied by multilateral liberalization. Since a common objective of the SEE-5 governments appears to be accession to the EU, the bottom line of MFN liberalization is alignment of their MFN applied tariff schedule to that of the EU, especially for industrial products. SEE-5 tariffs on industrial products are much higher than in the EU and other highly industrialized countries. Free Trade Agreements among SEE-5 without MFN liberalization would lead to diversion of imports to preferential partners at the expense of more efficient MFN suppliers, and to the loss of customs revenue. The extent of diversion depends on the levels of MFN rates as well as on the level and the significance of intra-industry in their pre-FTA mutual trade. The lower are MFN rates and the higher mutual trade together with a high share of intra-industry trade, the lower is the potential for trade diversion and the welfare loss.

2.130 Second, intra-regional trade liberalization should be accompanied by an accelerated schedule of removing tariffs on imports from the EU. With Croatia accounting for almost 50 percent of the aggregate SEE-5 GDP and GDP per capita 2.6 times larger than of the second wealthiest SEE-5 economy, FYR Macedonia, the danger is that intra-regional trade integration divorced from European and multilateral liberalization might lead to most benefits accruing to Croatia at the expense of poorer SEE-5 countries. This would defy the very purpose of SEE-5 integration, as it might trigger extra political tensions.

2.131 Third, the introduction of reforms broadening tax base and improving efficiency of collection of tax revenues are critical to offset losses in customs revenues and ensure fiscal sustainability of trade liberalization. Poorer SEE-5 economies are particularly dependent on tax revenues and without tapping alternative sources of revenue their capacity to provide public services may be severely impaired.

2.132 Yet, even meeting these three conditions together with implementation of strong measures facilitating cross-border movement of goods will not automatically boost trade and growth and improve competitiveness of domestic producers. Domestic environment unfriendly to business and investment activity usually leads to weaker supply response to trade liberalization. So do cumbersome customs procedures and poor infrastructure, which now appear to present probably a more formidable barrier to trade than tariffs alone. The combination of structural reforms and investments in infrastructure is therefore critical to trade expansion.

2.133 Finally, trade liberalization is not the only mode of regional integration that can have large positive economic impacts. For instance, some areas of regional cooperation addressing the supply of regional public goods where everyone loses because of the absence of cooperation always generate huge returns. These include among others the development of infrastructure, sources of energy, water management, the environment, and trade facilitation through smooth border procedures. The latter addresses also barriers that impose real costs on imports such as due to excessive bureaucratic delays, poor telecommunications, and postal and financial services. The sooner they are implemented the better every SEE-5 is, as they all represent 'win-win' situations for all participants.

2.134 Regional and MFN liberalization would be jeopardized if it were to lead to large social costs of adjustment and budget deficits due to the fall in customs revenue. Experience from other countries, including especially the accession countries of Eastern and Central Europe, suggests that these problems can be addressed.

2.135 The loss of customs revenue is clearly inevitable. It can be addressed, however, through measures expanding tax base and improving collection capacity of tax authorities. This is a relatively straightforward task, albeit difficult to implement because of administrative resistance to structural reforms reducing the potential for rents and corruption. If anything, it only underlies the importance of reforms complementary to trade liberalization.

2.136 Social costs of adjustment would arise if the simultaneous switch to EU MFN tariffs on industrial products and free trade within South Eastern Europe were to wipe away whole industries and bring about massive unemployment. Although economic theory does not give an unambiguous answer to this question,[55] empirical evidence from transition seems to suggest that

[55] These fears may have been justified to some extent by findings of the new trade theory and economic geography models. While the new trade theory suggests the overall benefits are likely to be significantly larger than those suggested by traditional approaches economic geography models allow for the possibility

the probability of such an outcome is rather small. In the transition economies of Eastern and Central Europe, it was the collapse of central planning rather than trade liberalization that has brought about industrial devolution and contraction in industrial activity during the initial stages of transition. In fact, countries that adopted a gradual approach to liberalization and macroeconomic stabilization experienced a deeper and more prolonged transformational recession than those that followed the path of radical liberalization. Zeroing tariff rates on industrial imports from the EU had not led to a catastrophic relocation of industries in transition economies that signed the Europe Association Agreements. Even though SEE-5 countries have yet to open their markets fully to competition from imports from the EU, they had already undergone readjustment due to the shift to market clearing prices and the collapse of cross subsidies. Hence, it seems that accelerated liberalization in conditions of market access is unlikely to impose painful adjustment.

2.137 Yet, vigorously pursed structural reforms improving the business climate and the quality of public administration, including tax and customs administration, are indispensable to trigger growth and readjustment of production structures to take advantage of opportunities offered by European and international markets. While this does not guarantee a massive inflow of FDI or surge in domestic investment, it certainly increases their probability. As empirical evidence from Ireland (Barry 1996) or Poland (World Bank 1997) strongly suggests, FDI are particularly important in assuring that engagement in a preferential trading arrangement with the highly developed EU do not lead to a catastrophic relocation of industries.

CONCLUDING COMMENT

2.138 While the SA process provides general guidelines for the development of economic ties among SEE-5 countries, it leaves many issues open to negotiations and different solutions. In exchange for EU assistance, prospect of EU accession, and continuation of preferential access to EU markets, SEE-5 governments have to upgrade their institutions and governance to European standards, engage in mutual regional cooperation including free trade and establish free trade areas with the EU. Respective schedules and details of FTAs among SEE countries have been left to negotiations with the latter already resulting in the MOU and the recent completion of most bilateral FTAs among the signatory countries.

2.139 The paper examined benefits to SEE-5 of trade liberalization along these two dimensions and suggested conditions under which gains could be maximized. These conditions could be summarized as follows: First, SEE-5 countries should implement tariff reductions on imports of industrial products from the EU at the same time when they fully implement SEE-5 FTAs. This would have two important consequences: it would reduce dangers associated with South-South integration (i.e., relocation of industries to more developed partners), and even up conditions in access for EU exporters to those they face in other SEE countries—Bulgaria and Romania.

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that gains—especially during the early stages of integration—will be distributed in favor of a more developed partner—the EU. Traditional trade models suggest that capital and/or labor mobility brings convergence thanks to changes in relative prices brought about by lower import prices and improved export prices, and a higher marginal product per capita attracting higher investment and growth (Baldwin 1989). On the other hand, economic geography models suggest that firms operating under the conditions of imperfect competition and economies of scale, i.e., in increasing returns-to-scale industries, tend to cluster together drawn by the availability of supplies due to the higher concentration of demand (Krugman and Venables 1993). This would point to the inevitability of relocation of industrial activity to highly developed countries with high concentration of demand.

2.140 Second, the implementation of both dimensions of regional trade liberalization should be accompanied by reductions in SEE-5 MFN applied tariff rates on industrial imports, and ultimately bring them to EU external tariffs on these imports. Alternatively, if SEE-5 decide to lower tariffs on industrial products from the EU gradually, then they should lower their MFN tariffs to the rates levied on imports from the EU (unless those exceed EU MFN rates, in which case the EU rates should be adopted). If however they move to free trade in one move simultaneously with their SEE FTAs, then they should all adopt simultaneously EU MFN rates applied to industrial products. This would amount to creating a 'virtual' customs union encompassing the SEE-5 countries and the EU, and thus would reduce the extent of trade diversion.

2.141 Third, while even a 'virtual' customs union encompassing SEE-5 and EU countries would reduce the extent of trade diversion, formalizing a customs union that would also include the other SEE countries would provide an opportunity to eliminate the need to use rules of origin. These appear to be one of the main obstacles to SEE-5 exports to the EU. A 'virtual' customs union with the EU restricted to non-sensitive industrial products may be a better option, both economically and politically, as this would require adopting neither the EU's restrictive policies vis-à-vis sensitive products, especially agricultural ones, nor its preferences to numerous trading partners. The political weakness of a full-fledged customs union might be that it would be perceived as an alternative to membership and thus would reduce pressures towards structural reforms.

2.142 Finally, another way of reducing, albeit not eliminating, the impact of rules of origin would be for the SEE-5 countries to become part of the Pan-European Cumulation of Origin Agreement. The current rules of origin envisaging bilateral cumulation discourage SEE-5 firms from developing mutual production links oriented toward supplying EU markets, because inputs from other SEE-5 countries are treated as 'external' imports. The establishment of 'diagonal cumulation' both in the FTAs with the EU and those with the SEE countries would address this problem. Since this might stress limited administrative capacities of some SEE-5 countries, this should remain as a policy option worth exploring in the near future, i.e., when its benefits in terms of stimulating intra-industry trade become more obvious.

2.143 Trade liberalization, however, is one of many dimensions crucial to the success of the Stabilization and Association Process. While our analysis focused on trade, structural reforms and regional cooperation are of equal, if not greater importance. Trade liberalization along three dimensions alone is unlikely to contribute to economic growth without concurrent efforts to improve infrastructure, trade facilitation, business and investment climate, and governance.

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STATISTICAL APPENDIX

Appendix Table 2.1 Composition of SEE-5 exports to the EU in 1999 (in percent)

	Albania	Croatia	BiH	FYROM	SAM
Agricultural	6	3	2	9	24
Textiles & Clothing	28	25	23	42	17
Footwear	23	7	11	3	5
Wood	3	8	16	1	8
Iron and Steel	4	3	4	16	5
Other products	36	54	44	30	41
Total	100	100	100	100	100

Source: World Bank (WITS).

Appendix Table 2.2 Structure of Bilateral Trade Flows in SEE-5, 1999 (in percent)

	From FYROM to:				From Croatia to:			From BiH to:			From SAM to:		
Exports of:	Albania	Croatia	BiH	SAM	FYROM	BiH	SAM	FYROM	Croatia	SAM	BiH	Croatia	FYROM
Agricultural	51	16	37	24	30	38	6	41	25	5	24	27	32
Textiles and Clothing	5	4	12	0	5	3	1	6	3	30	7	3	5
Footwear	0	1	0	14	0	1	23	0	2	4	1	1	1
Wood	0	0	0	0	2	1	0	15	16	0	5	9	3
Iron and Steel	14	14	14	9	2	3	2	7	12	6	7	12	6
Other products	30	65	37	52	61	54	68	31	42	55	55	49	52
Total	100	100	100	100	100	100	100	100	100	100	100	100	100

Source: World Bank (WITS)

Appendix Table 2.3 Average, Maximum and Minimum MFN tariff rates by sector in SEE-5 countries (2000)

	Albania			BiH			Croatia			FYROM			SAM*		
Good's category[1]/tariff rate	Aver	Min	Max	Aver	Min	Max	Aver	Min	Max	Aver	Min	Max	Aver	Min	Max
0 Food & live animals	11	2	15	5 2	0	15	16	0	25	24	2	60	25	0	40
1. Beverages & tobacco	13	2	15	14	6 3	15	21	5	25	51	15	60	23	10	40
2 Crude mater Ex food/fuel	3 8	2	15	0.9	0	10	6.1	0	25	5.9	0	35	7	0	30
3. Mineral, lubricants, fuels and related materials	9	2	15	0 9	0	5	5.8	0	18	3 9	0	18	4.7	0	10
4.Animal and vegetable oil, fat and waxes	8 1	4 7	10	2 5	0	10	12	5	25	7.4	2	25	12	0	40
5.Chemical and related products, n.e.s	4 8	0	15	3	0	15	7.1	0	25	7.4	0	35	7 7	1	40
6. Manufactured goods	10	0 2	15	7 3	0	15	9 8	0	25	14	0	35	14	1	40
7. Machinery and transport equipment	3.6	0	15	6.2	0	15	8.8	0	25	12	0	35	11	1	35
8. Miscellaneous manufactured articles	11	0	15	9 7	0	15	16	0	25	23	1	35	22	1	40

Source: National Tariff Schedules (2000)

* In May 2001, a new tariff schedule was introduced, which reduced the simple average tariff from 14.4 percent to 9.2 percent and the maximum tariff rate from 40 percent to 30 percent.

APPENDIX 2: PARTIAL-EQUILIBRIUM MODEL SPECIFICATION

The model aims to estimate the consequences of elimination of tariffs in country *i* from imports from country *j*. Import demand for each HS-6-digit product of country *i* = *Albania, Croatia and FYR MACEDONIA* is given by:

$$M_i = \frac{A_i}{[P_W(1+T_i)]^E}$$

where: P_W -- the world price; T_i -- MFN tariff rate in country *i*; A_i -- demand parameter in country *I*; E -- the import demand elasticity (common to all countries in our simulations).

Demand elasticities at six-digit-level were obtained from the UNCTAD Trade Policy Simulation Model (TPSM). Supply elasticity was set at 1 (tests run using supply elasticity of 0.5 did not affect the results).

Export supply of country *j* to country *i* is given by:

$$X_{j\to i} = B_j[P_W(1+T_i\Pi_{i\to j})]^{\Theta}$$

Where Θ is the export supply elasticity (common to all countries) that in the simulation was set at 1. $\Pi_{i\to j}$ is the level of tariff preference granted by country *i* to exports from *j*. Thus, if $\Pi_{i\to j} = 0$ imports of *i* from *j* have to pay country *i's* MFN tariff. Similarly if $\Pi_{i\to j} = 1$ exports from *j* receive the domestic price in *i*. B_j is a supply parameter.

World prices are exogenous and were obtained using a combination of Germany's, USA's and France's prices, by dividing values of each product by its quantity.

All demand and supply parameters are calibrated at 6-digit level of the Harmonized System using WITS's trade data. For the MFN tariffs national tariff schedules at 8-digit level were transformed into 6-digits level by calculating the sample average.

$$B_j = \frac{X_j}{[1+T_i\Pi_{i\to j}]^{\Theta}} \quad ; \quad A_i = M_i[P_W(1+T_i)]^E$$

In order to assess the tffect on bilateral trade of an elimination of tariff rates to partner country, the model calculates P_{wh} or the hypothetical price assuming market clearance among two partners:

$$P_{wh} = \frac{a}{(b)^{(1/(\Theta+E))}}$$

Then the new domestic price P_d in importing country is estimated:

- $P_d = P_{wh}$ if $P_w > P_{wh} > P_w(1+MFN)$; case where clearing prices with partner country are above world prices but below world prices with tariffs => domestic prices would be the clearing prices
- $P_d = Pw(1+MFN)$ if $P_{wh} \geq P_w(1+MFN)$; this is the case when the clearing prices with partner country are higher than the world prices + tariff => the price would be world price + tariff.
- $P_d = P_w$ if $P_{wh} \leq P_w$; Case where the clearing prices with partner country are lower than world prices => the price would be the world price.

Finally using demand and supply equations the model estimates the new import and exports data and estimate changes in tariff revenue and welfare.

3. CONCLUSIONS AND RECOMMENDATIONS FOR THE FUTURE

Daniela Gressani and Constantine Michalopoulos

INTRODUCTION

3.1 The launch of the Stabilization and Association Process by the EU in late 2000 has created a new momentum for trade liberalization in South Eastern Europe. First, by committing the five South East European countries in the SA process to gradually eliminate tariffs on their imports from the EU, it will significantly increase competition for tradables in domestic markets and thus competitiveness of domestic products in international markets. Second, by committing these countries to harmonize domestic policies and institutions to European standards, it will lead to improvements in the business environment, thus allowing domestic enterprises to take advantage of the trade opening. Third, the countries signing Stabilization and Association Agreements accepted the obligation to liberalize trade with the other signatories, as well as with the EU. Lastly—and probably most important—by providing a strong anchor for the European aspirations of the people of South Eastern Europe, the SA process promotes both greater incentives to implement complementary structural reforms and greater public support for them.

3.2 The importance of trade liberalization for the countries of the region cannot be over-emphasized. They are all small economies that need to depend on international trade and foreign investment to stimulate competition, induce new technologies, and increase productivity in order to raise living standards and reduce poverty. Yet two key findings of this report are that (a) trade liberalization vis-à-vis the EU alone will not bring about the full potential benefits that can be obtained from broader liberalization, and (b) trade liberalization alone, without complementary reforms, will also not yield the increase in investment and productivity that is necessary to put the economies of the region on a higher growth path and eventually to converge with the rest of Europe.

3.3 The analysis presented in the studies that constitute this report provides a strong basis for clear recommendations on the scope and phasing of trade liberalization in these countries. On the other hand, issues concerning reforms needed to complement trade liberalization are not explored with sufficient breadth and depth, and thus specific recommendations are not being offered in these other areas.

ACCOMPLISHMENTS SINCE 2000

Trade Performance

3.4 The trade performance of the five SEE countries analyzed in this report—Albania, Bosnia and Herzegovina, Croatia, FYR Macedonia and Serbia and Montenegro, or SEE-5—during the last decade has lagged behind that of other economies in transition in Central and Eastern Europe. This was due primarily to the interrelated effects of the conflicts in the region and the delay in introduction of market reforms. A recovery of international trade has taken place

since the 1999 Kosovo crisis,[1] but this has essentially brought back the economies of the region to their pre-crisis trajectory. While market access issues have constrained trade for some individual countries and particular periods, at present all countries enjoy generous trade preferences in their markets in the EU.

3.5 The composition of their exports, however, has not changed significantly in the last decade, primarily due to the delay in restructuring their economies. At the same time their trade policies have not encouraged export expansion. For a considerable period of time, trade regimes were protective, producing disincentives against the development of new exports; and these were not offset by incentives towards exports.

3.6 Owing to proximity as well as to the preferential regime offered by the EU, the EU is by far the largest market for exports and the largest source of imports for all these countries. However, the importance of regional trade varies considerably: in some cases, such as FYR Macedonia and Bosnia and Herzegovina, it is very substantial. In others, for example Albania, it is very small. Some regional trade has been moving along ethnic lines, as for example between Serbia and Republika Srpska, Croatia and the Federation of Bosnia and Herzegovina, Kosovo and Albania. The results of the gravity model and comparative analysis presented earlier in this report suggest that there is potential to increase trade among some of the republics of the former Socialist Federal Republic of Yugoslavia (e.g., Croatia with Serbia and Montenegro) but not so much among others. The model also suggests that Albania's trade with all the other SEE-5 countries could expand significantly. These results do not take into account the substantial smuggling in the region, which leads to overestimating the potential for trade expansion. Also, one should not underestimate the difficulties in expanding regional trade that result from serious infrastructural deficiencies in the region. Finally, an important characteristic of trade among SEE countries is the prevalence of inter-industry trade with only limited exchanges occurring within the same sectors. Low levels of intra-industry trade suggest that there exists relatively limited potential for growth in trade in the short run, i.e., until new industrial capacity is established. But none of these caveats should be taken to imply that these countries should not aim to further liberalize their trade with each other and with other countries in South Eastern Europe. Rather, liberalization towards regional trade partners should be pursued *pari passu* with broader trade liberalization efforts.

The Regional Strategy for South Eastern Europe

3.7 In early 2000, the World Bank issued a regional strategy paper on *The Road to Stability and Prosperity in South Eastern Europe* (World Bank 2000, hereafter referred to as the 'Strategy'). The paper was prepared in response to the mandate given to the World Bank and the European Commission under Article 41 of the Stability Pact to coordinate a regional approach to South Eastern Europe. The Strategy outlined a comprehensive approach to regional development whose fundamental objectives are increased prosperity and reduction in poverty for all people living in South Eastern Europe (World Bank 2000, p.1).[2] The Strategy was sensitive to the political realities prevailing in the region at the time (for example, Milosevic was still in power in Serbia and Montenegro) and to the fact that the EU had made commitments regarding accession to some of the countries (Bulgaria, Romania) as opposed to the others. Also, it was considered

[1] See Demekas et al. (2002).

[2] Seven countries were originally covered by the Stability Pact: Albania, Bosnia and Herzegovina, Bulgaria, Croatia, FYR Macedonia, Romania and Serbia and Montenegro. In 2001, Moldova was added.

important to maintain flexibility with regard to options on the future form of association between the EU and various countries in the region.

3.8 Trade integration was considered by the Strategy to be an important and probably the leading component of the broader, longer term integration of the countries of SEE into EU structures as called for by the Stability Pact. As with its other elements, so too in trade the Strategy called for a balanced set of commitments from the countries in the region and the international community. In the field of trade the thrust of the recommendations involved policy and institutional reforms to be carried out by the countries in the region, supported by policies by the EU and other developed countries to enhance market access for these countries as well as assistance to strengthen their trade related institutions and infrastructure.

3.9 The main elements of the first phase of trade integration—envisaged by the Strategy to last two to three years, i.e., to 2003-04, for the SEE countries were to include:

- a gradual, but general liberalization of all trade—within the region, with the EU and with the rest of the world;
- an extensive liberalization of regional trade, including:
  - elimination of administrative barriers to trade;
  - a standstill on new measures of any kind that restrict such trade;
  - coordinated reduction in trade barriers towards each other; and
  - the beginning of the multilateralization of existing bilateral trade preferences to other countries in the region;[3]
- strengthening customs administration; and
- regional cooperation in the implementation of trade related projects.

3.10 For the EU, the main element during the first phase was to be the early conclusion of coordinated bilateral agreements with the SEE-5 countries which would provide improved access to EU markets, but also stimulate regional integration. These bilateral agreements—asymmetric free trade agreements or autonomous trade preferences—were also to take into account the separate paths to integration with the EU already decided upon with respect to other Stability Pact countries (Bulgaria, Romania) so as to establish a consistent economic framework covering all SEE countries.

3.11 During the second phase, the SEE-5 countries were to complete WTO accession and establish a full-fledged Free Trade Area with the EU and among each other. It was envisaged that in some cases this may lead directly to full association with the EU; in others, a customs union may be an intermediate step. In both cases, countries would need to implement a convergence of their external tariff to that of the EU; in addition, they would have to make progress in aligning economic policies and institutions in other areas needed to make fuller integration effective; while the EU would need to progressively eliminate remaining restrictions on imports from these countries.

3.12 During both phases, other developed countries were also encouraged to enhance market access for these countries through preferential or other arrangements. And the international institutions were supposed to provide technical and financial assistance to facilitate trade

[3] I.e., if two countries in the region had separate bilateral free trade agreements with each other and a third country, the agreements would be linked by ensuring that the coverage was similar and the depth of preferences, exemptions and other rules as close to identical as possible.

integration. An example of such a project was the Trade and Transport Facilitation (TTFSE) project launched by the World Bank with the participation of several donors and intended to operate originally in six countries (and subsequently expanded to include Moldova and Serbia and Montenegro). The project aims to facilitate trade flows through streamlining customs procedures, reducing transport costs by facilitating processing at border crossings and, more broadly, strengthening trade-related infrastructure.

3.13 In the three years since the Strategy was prepared, a great deal of progress has been achieved.[4] Many of the goals of the Strategy summarized above have been met and others have been exceeded. Trade policies are being shaped by three evolving processes: the SA process with the EU; the implementation of the Memorandum of Understanding on Trade adopted by the SEE countries—including Bulgaria, Moldova and Romania—in 2001; and the accession to the WTO. As a result a solid basis has been put in place which can be used to promote further integration in the future. The following sections review progress the region has made in the three main dimensions of trade integration: the global, the European and the regional.

Global Integration

3.14 In the beginning of 2000, only two of the countries in the region, Bulgaria and Romania, were WTO members. Since then, three more—Albania, Croatia, and Moldova—have become members. FYR Macedonia's accession has been approved and is awaiting ratification, while the remaining two, Bosnia and Herzegovina and Serbia and Montenegro have applied to accede.

3.15 The WTO accession process has resulted in significant liberalization of the trade regimes of the acceding members. This is a consequence of the elimination of non-tariff barriers and the reduction and binding of tariffs on an MFN basis that are required for accession. Albania, Croatia, Moldova and FYR Macedonia have had to liberalize their trade regimes on an MFN basis in the context or in anticipation of WTO accession. In all cases there have been actual or expected reductions in the MFN tariffs (Kaminski 2003; Jurlin and Galinec 2003; Daskalov et al. 2003). In FYR Macedonia, the government has also had to make commitments to phase out the significant non-tariff constraints on its imports that were imposed through licensing. And finally, all four countries have had to liberalize their trade in services by adopting a series of commitments in the context WTO accession resulting in relatively open regimes in many sectors (Michalopoulos and Panousopoulos 2002).

3.16 For the countries which are already members of the WTO the on-going multilateral trade negotiations launched at the Doha WTO Ministerial Meeting provide an opportunity for further liberalization, both in merchandise trade (involving industrial and agricultural products) and in services.

3.17 For Bosnia and Herzegovina and Serbia and Montenegro, which are applying to accede to the WTO, working parties have been established to consider their applications. Both countries will need to liberalize their trade regimes further, as part of their accession negotiations. With regard to tariffs, countries will be required to reduce their applied tariff rates and to "bind" them at levels below those currently applied. Finally, broad liberalization commitments in the services sector will also be required of these two acceding countries. These will involve not only some liberalization of existing regimes, but more importantly the undertaking of legal commitments "binding" governments to adhering to the rules which they have accepted to follow.

[4] For a more detailed discussion of policy reforms in individual Balkan countries see Michalopoulos (2003).

Trade Integration with the European Union

3.18 In the beginning of 2000, trade between the region and the EU was characterized by a complex set of uncoordinated preferential relationships. On the one hand, Bulgaria and Romania were on a path of establishing free trade with the EU and ultimate EU membership on the basis of "Europe" agreements. In the case of Albania, Bosnia and Herzegovina, Croatia and FYR Macedonia the EC provided preferential trade concessions of a unilateral character (Autonomous Trade Preferences, ATPs). The concessions to Bosnia and Herzegovina and Croatia were for a yearly period; while for FYR Macedonia they were 'on a contractual basis in the framework of a bilateral cooperation agreement; and in the case of Albania on a separate autonomous basis'.[5] Moldova enjoyed preferences under the GSP, which typically involves less preferences than any of the arrangements provided by the EU. And there was an embargo on trade with Serbia and Montenegro.

3.19 Each of the four agreements between Albania, Bosnia and Herzegovina, Croatia, FYR Macedonia and the EU covered virtually all trade in manufactures but had different exemptions and separate ceilings and tariff quotas for various products, especially in agriculture. While the exceptions from free trade included in the ATPs covered only a relatively small proportion of products (5 to 20 percent of the tariff lines), the products involved tended to be important exports for the SEE countries. This was more the case in Albania, where the 5 percent of products (by tariff line) subject to 'managed' trade covered 62 percent of exports to the EC. In Bosnia and Herzegovina, Croatia and FYR Macedonia, whose coverage was very similar, the 9 to 12 percent of the 'managed' products accounted for 26 to 43 percent of their exports, and even greater amounts, if the products subject to 'surveillance' were included (World Bank 2000).

3.20 Since that time there has been a very large improvement in the conditions of access to the EU markets for the SEE-5 countries. The EU introduced two separate initiatives that have both enhanced market access for these countries and made it more secure: (a) the introduction of a system of liberalized and uniform ATPs that applied to all five countries; and (b) the launch of the Stabilization and Association Process.

3.21 In late 2000, the EU established a uniform and generous ATP scheme, which provides duty and quota free access for the bulk of the exports of the five countries to the EU markets. There are very few quota limitations (only on three agricultural products, baby beef, some types of sardines, and wine) which apply to all the countries at the same time; some limitations also exist on textiles which continue to be covered by different EU arrangements with each of the countries.[6]

3.22 The new ATPs are not only more liberal than the ATPs previously available to the five countries; they are being provided with assured market access for five years[7]—which is a longer period than most of the ATPs provided previously; and by having an identical set of common

[5] The discussion of EU relations with SEE countries in this section is based on the discussion paper prepared by the European Commission, 'Trade Relations between the European Community and Southeastern Europe', prepared for the meeting of the Economic Working Table, October 8, 1999.

[6] In textiles, the countries which have signed SAAs (FYR Macedonia and Croatia) have duty and quota free access while the others do not.

[7] The original scheme was only for 26 months, starting from November 2000 and did not include Serbia and Montenegro. Its duration was subsequently extended and its coverage expanded to include Serbia and Montenegro. The preferences are also provided to products from Kosovo (EU 2000).

exemptions (except in textiles), they improve the competitive environment and reduce the incentives for transshipment across porous regional borders that individual country quotas give rise to.[8]

3.23 But while the ATPs provided immediate access to the EU markets, the main instrument that would lead to the longer term integration of these countries into the EU structures was the far reaching SA process. In 2000, the EU launched this initiative which sets the overall legal framework that will guide the future economic and political relationships between the EU and these five countries.

3.24 The Stabilization and Association Process guides the broad relations between the five countries analyzed in this report and the EU, including in particular trade. This process involves the establishment of FTAs between these countries and the EU on a contractual, bilateral basis. The implementation of these FTAs is asymmetric, in the sense that the EU liberalizes access to its markets for the SEE-5 countries faster and for a broader range of products than the reverse. The two SAAs already concluded—with FYR Macedonia and Croatia—envisage a period of ten and six years, respectively, to achieve full liberalization. The SA process envisages the establishment of FTAs between the EU and each of the five countries—as well as between the countries which sign SAAs themselves.

Regional Integration

3.25 The SA process explicitly links liberalization of trade with Europe to regional cooperation and liberalization among SEE-5. As the Council Regulation (No. 2007/2000) of September 2000 puts it, "... the entitlement to benefit from the preferential arrangement shall equally be subject to their readiness to engage in regional cooperation with other countries concerned by the European Union's Stabilization and Association Process, in particular through the establishment of free trade areas in conformity with Article XXIV of the GATT 1994 and other relevant WTO provisions." This commitment has given a boost to regional trade liberalization among the Stability Pact countries and has resulted in a coordinated effort to avoid the 'hub and spokes' problem that characterizes some preferential trade arrangements between developed and developing countries (Kaminski and de la Rocha 2003). The regional cooperation effort in turn was underpinned by the development of an institutional framework formed by the countries of the region within the framework of the Stability Pact. This involved the Memorandum of Understanding on Trade Liberalization and Facilitation signed by the SEE-5 countries plus Bulgaria and Romania, to which Moldova later acceded, and which is playing a major role in promoting regional cooperation efforts among all eight countries.

[8] This was a specific recommendation of the Strategy (see World Bank 2000, p. 67).

THE STABILITY PACT WORKING GROUP ON TRADE LIBERALIZATION AND FACILITATION

A key ingredient in the success of regional co-operation efforts worldwide has been the establishment of an institutional framework underpinning preferential trade agreements. One of the accomplishments of the countries in the region which was not envisaged by the original Strategy was the establishment of a Working Group on Trade Liberalization and Facilitation under Working Table II of the Stability Pact which has been used to coordinate regional integration efforts. The Working Group (WG) was set up in early 2000 and has since been chaired by a senior official from FYR Macedonia.

The WG is composed of representatives of the countries in the region (usually from the Ministry of Trade) at a senior level plus representatives from the major developed countries and international institutions.[9] The WG meets regularly, four times a year, and has a small secretariat which has been supported from its inception by grants from the UK. Subsequently, other donors such as the Germany, Sweden, Switzerland and the US have also provided financial support for the activities of the group. The group has been the forum for co-ordination and the driving force for trade integration efforts in the region.

Early in the WG's existence a variety of topics filled its agenda including the consideration of projects aimed at trade facilitation which were submitted to the group for its endorsement and support. Late in 2000, however, the group started to focus primarily on issues of trade policy coordination and integration, while keeping on its agenda topics on trade facilitation primarily for informational purposes. At that time, the WG started developing a substantial agenda for regional cooperation which culminated in a ministerial meeting in June 2001 at which a Memorandum of Understanding on Trade Liberalization and Facilitation was signed by the seven SEE countries. Moldova indicated that it wished to associate itself with the provisions of the MOU and has subsequently participated in the meetings of the WG.

The preparatory work and the actual negotiation of the commitments governments undertook in the MOU was done in the WG. Since then, the MOU has become the centerpiece for trade integration efforts in the region; and the WG has been focusing on monitoring the implementation of the commitments made by the countries and in exploring ways to deepen their integration efforts.

The Memorandum of Understanding

3.26 The Memorandum of Understanding on Trade Liberalization and Facilitation aimed at promoting free trade among the SEE countries, while recognizing the political difficulties surrounding the creation of a single FTA in the region. For this reason, the MOU settled for the less ambitious goal to create a series of bilateral FTAs, aiming to create a "virtual" free trade area that covers all SEE countries.

3.27 The MOU contains commitments in a large number of areas: first, it commits the countries to reach agreements to establish FTAs with each other by end the of 2002, and lays down standards for product coverage both for existing and future FTAs among the participating countries as well for the rules of origin they use in the FTAs; second, it commits the countries to a standstill on any measures that would adversely affect trade, and to monitor non-tariff measures that impede trade; third, it recognizes the importance of liberalizing trade towards third countries; fourth, it invites countries to deepen their trade liberalization with each other through further opening up of their trade in services; and finally, it commits countries to take steps that harmonize their legislation and regulations on a number of trade related topics, such as competition, investment and standards and bring them more in line with those of the EU.

3.28 The MOU was important for both political and economic reasons. Politically, it was very important to have an agreement signed by SEE countries on a range of trade issues, at a time when trade relations between some them (for example Croatia-Serbia and Montenegro) had been

[9] In addition to the eight SEE participants, other members of the WG are the EC, France, Germany, Hungary, Switzerland, Turkey, UK, US, UNECE, World Bank, and WTO.

disrupted by previous conflicts. In addition, the MOU goes beyond the SA process as it involves not only the SEE-5 countries, but also Bulgaria, Moldova and Romania. Finally, the process of reaching agreement was important in forging ties between the countries; as is the continuing interaction of the countries in the Working Group, which will monitor the implementation of the MOU.

3.29 On the economic side, perhaps the single most important contribution of the MOU was to establish both an ambitious timetable for the conclusion of FTAs among the countries in the region and to lay down the standard that these FTAs are supposed to cover at least 90 percent of products, measured both in terms of tariff lines and value of trade. If rigorously enforced, this standard would result in the bulk of merchandise trade moving freely among the countries in the region, as the exemptions would be quite small. At the time of the conclusion of the MOU, the standard was met by some, but not all of the pre-existing FTAs in the SEE region.[10] On the other hand, the MOU permits a rather slow six years for attaining the standard. Moreover, the list of exempted products varies for each pair of countries, thus raising the opportunities for distortions, and in this way falling short of establishing a 'virtual' FTA.

3.30 Also, the MOU meets a number of the objectives of the Strategy by establishing a standstill on new protection and recognizing the importance of liberalization towards third countries. Equally, the MOU provides an opening both to deepen regional integration of the countries with each other and to collaborate in moving their trade regimes towards those of the EU in a number of regulatory areas. Progress in implementing the MOU provisions concerning the conclusion of FTAs among the countries in the region has been impressive. By the end of the 2002—excluding Moldova, who started negotiations later—all but two of the bilateral FTAs have been agreed. These two agreements (Bulgaria with Serbia and Montenegro, and Bulgaria with Bosnia and Herzegovina) are expected to be concluded with a delay of only a few weeks; and Moldova itself had concluded FTAs with a number of countries. Also, as of the time of this writing, practically all of the FTAs which had been reviewed had met the 'quality' standards agreed under the MOU.[11] Finally, consistent with the MOU, there is no evidence in the region of increased trade restrictions of a non-tariff nature; and there is increasing collaboration among the countries, in a variety of trade-related facilitation measures pursued primarily in the context of the SECI private sector initiative and the World Bank led TTFSE multi-country project.

3.31 The Ministers of the eight countries signatories of the MOU meeting in Sofia in June 2002 provided an important additional impetus for further regional integration by committing to an extended program of action, which includes two main components: implementation in full of the commitments made in the MOU and further deepening of the integration and alignment of policies with those of the EU. In particular, efforts will be made to liberalize trade in services and to harmonize policies on standards and competition.

CHALLENGES AND RECOMMENDATIONS FOR THE FUTURE

3.32 This is an impressive list of policy accomplishments in a short period of time. Progress has been made toward integration at the global level, with the EU and within the region. As noted earlier, the timetable and targets set out in the Strategy were met in many areas and

[10] This standard also did not apply to CEFTA. It is fair to note, however, that the members of CEFTA over time also increased product coverage and trade liberalization commitments beyond those originally agreed.

[11] See Messerlin and Miroudot (2002).

exceeded in others. It is too early for this progress on the policy front to show results in terms of increased actual trade. And, of course, a lot more needs to be done.

3.33 As discussed earlier, integration of the SEE-5 countries in the world economy has three aspects: a European dimension that involves primarily their relations with the EU; a regional one, that involves the economic relations between each other and other countries in Central and Eastern Europe, many of which are members of CEFTA, and some of which will soon become members of the EU; and a global dimension, that involves trade relations with the rest of the world. Several studies in this report argue that, while the SEE-5 countries are giving the European dimension the highest attention because of the importance of their links with the EU, they cannot afford to ignore the two other dimensions.

3.34 Trade liberalization vis-à-vis the EU alone could bring important benefits, by exposing the SEE-5 economies to greater competition from a large and advanced trading partner, and by committing the countries to the important structural reforms that are needed to harmonize their regimes to the EU. However, lack of complementary trade liberalization vis-à-vis the SEE countries could give rise to negative hub-and-spoke effects: if liberalization were limited to that between the EU (the hub) and each of the countries (the spokes), its benefits would tend to accrue primarily to the hub and less to the spokes. This would also greatly discourage domestic and foreign investment in the SEE-5 countries, and lead to the potential relocation of investment toward the EU. And lack of complementary multilateral trade liberalization would lead to more significant trade diversion, reduce the benefits from increased competition in domestic markets, and again discourage investment.

3.35 Intra-regional trade liberalization alone is of course not a policy option practiced nor considered in the region, but it is illuminating to examine what its implications would be. The examples analyzed in the report suggest that, if liberalization were limited to the SEE countries—i.e., not accompanied by concurrent deep integration with the EU and the rest of the world through reduction of MFN tariffs—it would not generate significant benefits in terms of trade creation and could lead to divergence in economic growth within the region. In particular, this mode of liberalization pursued in isolation may provide incentives for economic activity to shift from poorer to richer countries of the region and to significant trade diversion, due to the small size of the SEE economies. On the other hand, the benefits that will accrue to countries in the region both from the preferential relationships with each other and those with the EU would be greater, the greater the overall openness of their economies. In particular, the benefits arising from increased competition in domestic markets will be larger, and the potential for trade diversion and hub-and-spoke effects reduced. The inescapable conclusion is that trade liberalization will need to be pursued on all three dimensions—global, European, and regional—for its full potential benefits to be realized.

Global Dimension

3.36 In order to liberalize further on a multilateral MFN basis, two approaches need to be pursued. First, the countries which are not WTO members should use the process of WTO accession as a means of reducing further their existing trade controls. In the case of non-tariff measures, they will have to do so in any case. But there are also opportunities for liberalization in the case of tariffs as well as in the area of services. The political economy of reducing trade controls is especially difficult when undertaken on an autonomous basis. The WTO accession process gives governments a vehicle to push forward measures that would otherwise be difficult to implement. Second, WTO members need to take the opportunity of a new round of multilateral trade negotiations—launched by the WTO at the Doha Ministerial Meeting—to

reduce existing trade barriers further, both in merchandise trade and in services. Of course, it is important to realize that, as countries that have recently acceded to the WTO have made a number of substantial liberalization efforts as part of the accession, the scope for more liberalization as part of the Round would be politically difficult.

3.37 In the context of multilateral liberalization, an important additional challenge for the future is the gradual reorientation of external tariffs on industrial products of all these countries towards that of the EU, which on average tends to be substantially lower.[12] Doing this will have several benefits: first, it will facilitate the future adjustment resulting from the association with the EU; and second, it will reduce the trade diversion costs that will result from the preferential arrangements established both with the EU and among the countries themselves. The net effect of such convergence would be for the countries to create a 'virtual' common external tariff, from which it would be easy to move to a common external tariff which is a key requirement for EU accession.

3.38 The SA process would not drive the countries towards further multilateral trade liberalization nor the adoption of a common external tariff. Indeed, EU businesses would benefit more from a situation where their exports would face reduced tariffs in the SEE-5 markets while tariffs on exports from competing countries are maintained at the present higher levels. Approximating the EU external tariff will reduce the margin of preference that EU firms would enjoy in the SEE-5 countries, and thus reduce their excess profits in those markets. But the benefits from moving toward adopting the EU external tariff on industrial goods for the SEE countries themselves would be substantial. For example, the analysis in the paper by Kaminski and de la Rocha presented earlier in this report shows that the welfare losses in the case of the bilateral FTAs are converted into gains, if countries adopt the EU external tariff on industrial imports.

European Dimension

3.39 The importance of European integration goes well beyond trade liberalization. The harmonization of policies and institutions to European standards that is the ultimate goal of the SA process will yield great benefits in itself. Together with complementary policy reforms, such harmonization will lead to the improvement in the business environment that is necessary for expanded trade opportunities to translate in higher investment, productivity and employment in the SEE-5 countries.

3.40 Trade is the leading component of this process of integration. The future direction of trade integration with the European Union will be governed by the agreements concluded by the EU with the SEE-5 countries in the context of the SA process. In this context, one of the future challenges that will need to be addressed is what to do once the ATPs expire. If the EU were to provide differentiated market access as a result of different agreements negotiated with the individual countries, the situation in the region could revert to the patchwork of preferences that prevailed before the uniform ATP scheme was established. This would have the drawbacks that were discussed earlier and which ultimately were one of the reasons for establishing uniform preferences. On the other hand, judged from the two SAAs concluded so far (with Croatia and FYR Macedonia), few differences in market access to the EU appear to be present, as in both cases the EU has front-loaded liberalization to its markets.

[12] The complexity and extent of EU farm support, of which the tariff is only one component, imply that convergence to EU tariffs on agricultural products may not be beneficial.

3.41 Another area that will require further attention is the implementation of preferential rules of origin. There are two issues here. First, the rules of origin applied by the EU appear to pose difficulties for exporters in all countries, because of complexities in the documentation needed. UNCTAD has estimated that roughly half of eligible EU imports actually utilize available preferences (UNCTAD 1994). Small and medium enterprises from the SEE-5 countries—with limited experience in selling in international markets—could greatly benefit from simplification in this area.[13] Second, there would be significant benefits to the SEE-5 countries if the EU were to make their exports eligible for treatment under the principle of "diagonal cumulation" in determining origin. This will reduce the risk of hub-and-spoke effects as well as foster greater regional integration. The technical difficulties to be overcome in implementing diagonal cumulation for the SEE-5 countries are likely to be similar to those encountered by the CEFTA countries, so that lessons learnt there could be usefully applied; and the actual impact on EU producers of this measure is likely to be miniscule, given the small overall size of the SEE-5 economies.

3.42 There are two other areas where the EU can help the trade prospects of the countries through the SA process. First and foremost, EU assistance—as already foreseen—will be necessary to enable these countries to align their policies, legislation and regulations and institutions to those of the EU. And second, the EU should consider easing requirements for issuance of visas for business-related travel to nationals of the SEE-5 countries, and thus respond to a common complaint heard among exporters in these countries.

Regional Dimension

3.43 The benefits that would accrue to the SEE countries from trade liberalization would be enhanced through the establishment of more liberal trade regimes toward one another. Having signed bilateral free trade agreements with one another, the countries in South Eastern Europe now face several new challenges in advancing their future economic integration.

3.44 **Implementation.** The first challenge is to implement both in letter and spirit the bilateral free trade agreements signed. This will require many things: providing the preferences as agreed and not interfering with the flow of goods and services; adhering to the standards of the MOU regarding the coverage of the agreements both in terms of the volume of trade and the tariff lines liberalized; eliminating non-tariff impediments to trade and not introducing new ones; and, finally, deepening the agreements by developing cooperation in other areas, for example services.

3.45 **A Free Trade Area for the Region.** The second challenge is to create a true free trade area among all the countries that signed the MOU. The recently concluded bilateral agreements should be seen as an important step in the integration process but not as an end in themselves. Implementing these agreements is important, but maintaining them as they are may not be in the long-term interest of the countries that have signed them: the benefits in terms of trade creation are likely to be small and the dangers in terms of trade diversion high (Kaminski and de la Rocha 2003). The more complex the system, the less transparent it is and the more the opportunity for trade deflection, corruption and distortions, especially when the trade-related institutions that have to implement the policies are as weak as they are in the countries of the region. Thus, there is little doubt that the countries should start thinking about moving on to deepen their integration through the establishment of a true Free Trade Area.

[13] Many developing countries have raised this issue, as one of the issues of implementation that needs to be addressed in the Doha Round.

3.46 There remain however considerable political sensitivities in the region about creating a Free Trade Area. Romania and Bulgaria have obtained commitments for accession to the EU by 2007 and may have less incentives to be involved in a formal FTA with countries in the region which have far less certain prospects of accession—including Moldova which, so far, has been left out of the SA process altogether. At the same time, as most of CEFTA members will become members of the EU, after 2004 CEFTA will consist solely of three countries—Bulgaria, Croatia and Romania—which will have free trade agreements with the non-CEFTA signatories of the MOU.

3.47 There are various ways of moving towards establishing a full-fledged Free Trade Area. One approach, suggested by Messerlin and Miroudot (2002), is to agree that all or some of the products which have been included in the list of exemptions from preferences will actually be granted the preferences, unless a domestic producer complains. This approach was used successfully by the EU in widening the scope of integration during the early years of implementation of the Treaty of Rome.

3.48 Another approach is to attempt to 'multilateralize' the bilateral FTAs, as suggested in the regional Strategy. This can be done by developing a common list of exemptions for the various bilateral agreements, and synchronizing the pace of liberalization within the FTA. Such an approach requires a new negotiation of the common list of exemptions, and thus is likely to encounter opposition from entrenched domestic industries seeking to maintain protection.[14]

3.49 **A Possible Customs Union?** One question that needs to be addressed in the context of regional integration is whether the countries should aim to establish a customs union, first with each other and then with the EU, as some have discussed earlier in this report (Kaminski and de la Rocha 2003). The basic difference between a free trade area and a customs union is that in the latter all participating countries adopt a common external tariff, while eliminating all trade barriers among themselves; in an FTA, countries retain their individual tariffs towards third countries, while liberalizing towards each other.

3.50 A customs union has some obvious advantages from the economic standpoint: it does away with the problem of determining rules of origin for each of the participating countries and reduces the chances of corruption in customs; it involves a deeper form of integration requiring further coordination of policies, for example in allocating the proceeds from collecting the common tariff; it is likely to involve fewer product exemptions than an FTA, hence increasing the opportunities for trade creation through competition with more efficient firms in the participating countries. And depending on where the common external tariff of the customs union is set, it may lead both to less trade diversion and to higher short-term costs because of the need for domestic firms to adjust to increased competition. On the other hand, an FTA makes it easier to tailor the pace of regional integration to the needs of individual countries by not requiring the adoption of a common external tariff.

3.51 The establishment of a customs union in South Eastern Europe would thus have clear benefits, as compared with the creation of a true SEE Free Trade Area. First, it would allow to do away with the administrative complexities required to enforce rules of origin, and the potential for discretion and corruption that these complexities inevitably generate, especially given the remaining weaknesses in customs and other trade-related institutions in South Eastern Europe. Second, by requiring harmonization of external tariffs among the SEE countries, it would like

[14] For example, a bicycle producer in FYR Macedonia may have obtained an exemption in an FTA with Bulgaria, that has a competitive bicycle industry but not in an FTA with Albania that does not.

give impetus to convergence of external tariffs with the EU, with benefits for competition and mobilization of foreign investment; such convergence would in fact be a natural objective for an SEE customs union, as all SEE countries share the ultimate objective of EU accession. And third, it would require a stronger commitment by the SEE countries to collaboration and integration than a Free Trade Area.

3.52 An SEE customs union would also have clear costs, again as compared with an SEE Free Trade Area. First—again assuming that a customs union would set the common external tariff close to the EU tariff—it would require the most protected SEE economies to undertake a more rapid adjustment than would be required by a Free Trade Area. Second, by requiring closer collaboration, a customs union would also likely raise even stronger political sensitivities. Third, if the SEE countries were to conclude a customs union not just within the region but also with the EU, an additional adjustment cost would result from the SEE countries granting the same preferences that the EU now grants to a large number of trading partners, including many developing countries. Fourth, a customs union with the EU could be perceived by the countries of the region as potentially a dead end—an alternative to the full accession they all want. And finally, the experience of the ten countries that are expected to accede to the EU in 2004—all of which had FTAs with the EU and some of which had FTAs among themselves—offers a powerful precedent of a successful transition to EU membership.

3.53 On balance, and while there may be some merit in the establishment of a customs union among the SEE countries—and also between them and the EU—there is a stronger case for giving high priority to the steps needed to establish a true FTA among all the SEE countries; and to use this area as a springboard for accession to the EU. In addition, the establishment of a true Free Trade Area for South Eastern Europe in combination with a policy of MFN liberalization as recommended above under the "global dimension" of trade integration, would generate some of the same benefits of a customs union without the full adjustment costs that the latter would impose: first, it would increase competition in the region and provide stronger incentives to foreign investment; and second, it would simplify customs procedures and reduce the administrative burden of implementing rules of origin.

3.54 **The Case of Moldova.** Within the context of regional trade integration, the case of Moldova deserves separate comment. The EU has not committed itself to involve Moldova in the SA process, nor it has made it eligible for the ATP scheme. Moldova, on its part, associated itself unilaterally with the MOU and has indicated its desire to forge ties with its SEE neighbors by signing preferential free trade agreements as called for by the MOU. At the same time, Moldova has associated itself as an observer in the Eurasian Customs Union which includes and is dominated by Russia.[15] This arrangement is not yet a true customs union; but if Moldova were to become a member of the Eurasian Customs Union, it could not at the same time implement free trade agreements with its SEE partners in the Stability Pact (as it would be bound to apply the same external tariffs as the other members of the Eurasian Customs Union). Moldova thus needs to reconsider its foreign trade orientation, to provide a clear indication of its intentions to investors and partners.

[15] Its other members are Belarus, Kazakhstan, the Kyrgyz Republic and Tajikistan.

Complementary Reforms

3.55 As discussed earlier, all the policy reforms discussed above will need to be complemented by a determined effort to improve trade-related institutions and the business environment. Without such effort, the opportunities created by trade liberalization will not be translated in higher investment, productivity, and job creation.

3.56 The implementation as well as the design of trade policies have been suffering from serious weaknesses in governance and institutional development, which undermine the integration of these countries in the world trading system. The causes of these weaknesses are several, and include both delays in the transition to market economies and the legacy of earlier conflicts. A number of initiatives supported by several donors are in place to strengthen trade related institutions—customs, export finance and insurance, and transport infrastructure—but they will require consistent commitment by the countries and the donors over the medium term.

3.57 The business environment will greatly benefit from the alignment of policies and institutions to European standards, which is perhaps the most important element of the SA process. However, improving the business environment should be not only a high but also an urgent priority for the countries of the region. Seizing the opportunities created by on-going trade liberalization with the EU and within the region will in fact be possible only if investment increases substantially.

3.58 Finally, it is important to pay attention to strengthening the institutions for regional cooperation. The Stability Pact for South Eastern Europe can provide an important framework in this respect. Its Working Group on Trade can be a useful forum for cooperation on trade policy. Other forums such as SECI and the coordination on transport infrastructure set up under the World Bank's TTFSE projects are useful as well. Perhaps the key issue that needs to be addressed here is to ensure good communication and coordination among the various initiatives.

3.59 The SEE-5 countries have lost a lot of time in their transition to the market and in their integration in world trade. Their governments and the donor community have a lot to do. Stability and the introduction of democratic processes provide the best hope that the commitments needed for this purpose will be forthcoming.

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