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Reverse Balkanisation?
Trade Integration in South-East Europe

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Abstract

Recent research from the World Bank and elsewhere suggests that openness to trade was a vital ingredient in the transition of the former Central and Eastern European Countries (CEECs) that joined the EU in May 2004. Current EU association agreements in South East Europe indicate that future enlargements may need to accommodate the remaining former Yugoslav Republics as well as the existing candidate countries. This paper examines persistent concerns that trade openness in South East Europe generally, and the former Yugoslav Republics in particular, is much less advanced than it was for the former CEECs in the mid to late 1990s. In particular we examine the issue of whether the present network of bilateral trade arrangements put in place under the Stability Pact has had much effect in boosting trade integration and whether trade within the region is currently at or below its potential. Given the small size of many of the countries in the region, we find that trade patterns remain problematic. In some cases they are smaller than might be expected but in several cases there is an overdependence on trade with old Yugoslav neighbours. In view of this, we consider that current plans to extend the Stability Pact matrix of bilateral trade agreements into a pan-regional trade association are likely to be inadequate. A better option, and one more likely to have a more immediate effect, would be to extend the present Customs Union with Turkey to include trade with the entire South East European zone of countries linked to the EU.

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Introduction

A recent World Bank (2005) publication has confirmed the importance of early and bold trade reforms in successfully integrating the former centrally planned Central and East European countries (CEECs) into the world economy. The long process of stabilisation and transition paved the way for the May 2004 expansion of the European Union, when eight former CEECs became full members of the European Union.

As well as preparing to accept Romania and Bulgaria as new members in 2007 (and subsequently Croatia and Turkey) the EU has also been actively involved in stabilisation and restructuring in South East Europe (SEE), including the remainder of the former Yugoslav Republics (FYR) following the end of ethnic conflict there in 1995.

As with the early stages of stabilisation and transition in the CEECs, attempts to stimulate weak levels of trade have also been closely monitored in the economic transition of the SEE region, in particular the'western Balkans'.[1] However here, a persistent body of evidence suggests that progress in trade and regional 'openness' is proving more problematic in South East Europe than it was for the more successful transition economies (see for example, Adam et al., 2003; Wittich, 2005).

The World Bank specifically draws attention to three SEE countries (Bosnia-Herzegovina (BiH), Serbia-Montenegro[2] and Macedonia) where the share of intra-SEE trade has remained static over the decade 1993-2003 and where integration into the EU zone and world markets is generally weak. The initial purpose of this paper is to consider whether the absence of internal trade openness remains a major concern for the SEE region, especially in view of the recent broad-based improvement in the external trade profile of many of these countries.

In June 2001, under the auspices of the Stability Pact for South East Europe, a Memorandum of Understanding was signed on trade liberalisation and facilitation to encourage the development of a network of bilateral free trade agreements (FTAs) and, by aspiration at least, the dismantling of regional non-tariff barriers.

Recent disillusionment with imbalances in regional trade, and the reintroduction of selective barriers on imports from Croatia and Serbia in 2005 has drawn attention to the fragility of such bilateral agreements and prompted a new push towards the establishment of a full regional trade agreement (RTA) by 2007 (see Stability Pact, 2005). Hence, a secondary focus of this paper is to consider the institutional consequences of this new RTA ambition and whether, in view of the region's weak level of internal dynamism, it will be sufficient to stimulate the required level of trade and openness especially between the western Balkan countries.

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[1] This is generally considered to refer to the former Yugoslavia countries (less Slovenia) plus Albania.

[2] Following the Montenegrin referendum of 21 May 2006, the Parliament of Montenegro passed a Declaration on the Independence of the Republic of Montenegro which states that the Republic of Montenegro is an independent State with full legal personality under international law. (Source: Council of the European Union - http://www.consilium.europa.eu/uedocs/cmsUpload/Council_conclusions-12.06.06-p10.pdf).

1.1 Existing trade patterns in SEE

On the assumption that GDP levels in the region are below their potential, Christie (2002) looked at the contribution to growth of enhanced openness to trade, and in particular enhanced intra-regional trade, estimating potential GDP (if population and unemployment rates were at the level of the four Visegrad countries.[3] By re-estimating a gravity model on 1999 data, he finds that there is significant potential to increase trade and enhance regional integration.

For the purposes of this paper, our definition of South East Europe is to group the five former Yugoslav republics (including Croatia but excluding Slovenia) with Albania, Bulgaria, Romania and Turkey.

In Figures 1-8, below, we look at data showing the inter-regional destinations of SEE exports over the past decade. The irregular patterns and unpredictability noted by Christie (2002) do still appear to persist.

While in the past four years it appears that a consistent pattern of *aggregate* export performance has finally set in across most of the former Yugoslav republic countries, especially in exports to the EU, in most cases the growth pattern of intra-SEE trade remains notably less pronounced, if not entirely flat.

Of particular note throughout the region is the wide disparity between world trade and inter-regional trade and in particular the surprisingly low present-day anchorage of Turkey, in terms of export trade at least, into the region.

Figures 1-8. SEE bilateral export patterns, by country

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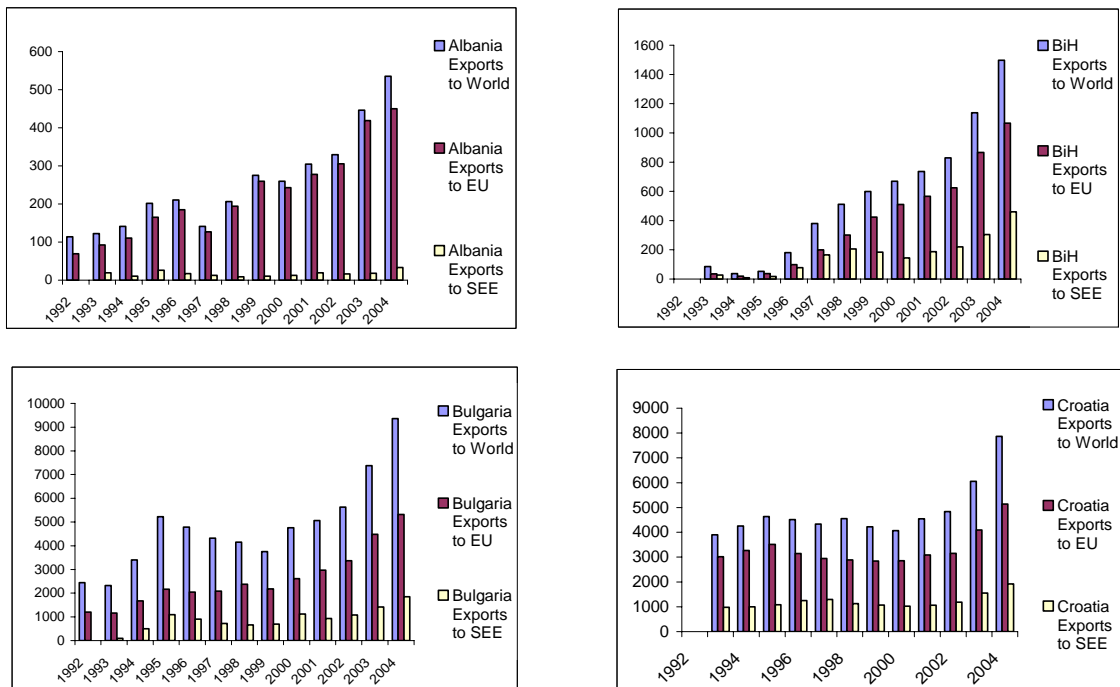
[3] Poland, Czech Republic, Slovakia and Hungary.
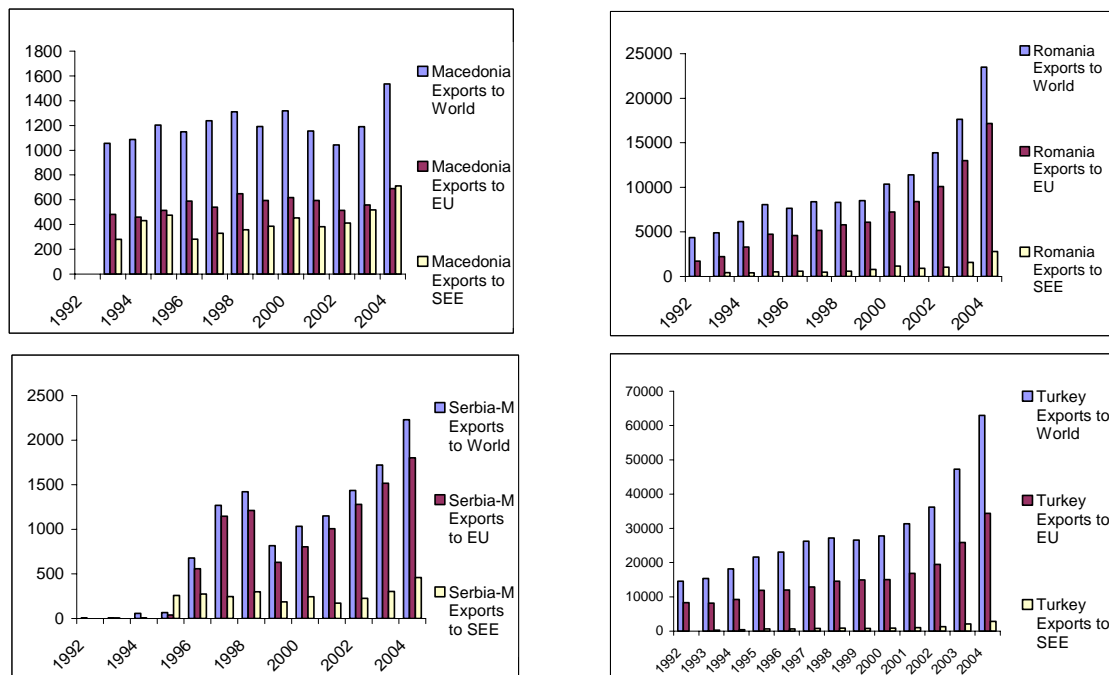
In the following sections, we set out to update and extend this work by looking at more recent trends, and also by including in the analysis the recent introduction of the bilateral trade agreements negotiated between individual countries within the framework of the Cooperation and Stability Pact for the Balkans.

A final consideration is whether, looking forward, any persistent trade problems can be corrected by deepening the present Stability Pact's institutional apparatus. If any persistent trade weaknesses are endemic, due to poor physical 'openness' in transport, infrastructure links, difficulties in freedom of movement and business location and sense of economic 'neighbourhood', then there may be a requirement for stronger institutional intervention by the EU.

As many of these physical symptoms of 'Balkanisation'[4] are regrettably a legacy of history and in particular the recent Balkan wars, the question remains whether they can be improved by deeper regional trade integration alone or whether they will require firmer anchorage into the wider SEE region (i.e. Bulgaria, Romania and Turkey) or indeed a deeper EU policy arrangement such as a full customs union.[5]

2.   The importance of trade for SEE economics

In order to examine the economic transition prospects for SEE countries, we take as our starting point the consensus that the first element of transition is openness to trade. In the transition literature, 'trade' is to some extent a proxy for openness to ideas, systems of reform and

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[4] Described by Glenny (1999) as a geopolitical term often used pejoratively to describe the process of fragmentation or division of a region into smaller regions that are often hostile or non-cooperative with each other.

[5] One could argue that the size of the task facing the EU in stabilising the western Balkans amounts to disentangling the extent to which these are 'normal' transition economies, and the extent to which they have suffered additional fractures to human and physical capital and investor confidence arising from the shock of war.

'governance', technology and innovation as well as attracting imports of services and foreign direct investment.

As an initial check below, we provide some broad indicators that suggest that the economic transition in the SEE countries remains less advanced than it was for the CEECs at a similar point in their reform process. Then we proceed to an econometric check, using the latest techniques for measuring trade potential, and finally to a brief assessment of how damaging this problem can be for the region, given its improving aggregate trade performance in general.

Table 1 below suggests that despite favourable five-year growth rates, only Albania had comfortably exceeded 1989 output by 2003, matching the performance of Slovenia and Poland. These comparisons illustrate the scale of the challenge ahead, especially for the western Balkan sub-region, even in getting back to output levels achieved at the break-up of the FYR (which, along with the war, also adversely affected Bulgaria economically).

Table 1. Five-year growth rates & % of 1989 GDP levels by 2003

	Growth 2000-04	**% of 1989 GDP**
Albania	6.4%	129%
BiH	4.6%	57%
Croatia	4.1%	91%
Macedonia	1.3%	78%
Serbia-Montenegro	4.5%	52%
Slovenia	3.3%	120%
Bulgaria	4.8%	84%
Romania	4.5%	92%
Poland	3.1%	135%

Source: Vienna Institute for International Economic Studies (wiiw, Balkan Observatory).

When assessing the SEE territories, it is important to bear in mind that these are very small territories in economic terms, which may well only be able to develop sufficiently if they have access to larger regional and EU markets. As an example, the GDP of Serbia, the largest country from the group of former Yugoslav republics, is in the same order of magnitude as Luxembourg, while that of Macedonia or Albania is similar to the GDP of Liechtenstein. Indeed, the entire SEE region represents a market smaller than Greece and its combined exports are smaller than those of Luxembourg. The GDP data (see Table 2) confirm the impression of small market size.

Table 2. GNP data & GDP per capita (1,000s)

	GNP 2004	**GDP/capita**
Albania	€6,548	€2,046
BiH	€6,647	€1,975
Croatia	€27,656	€10,400
Macedonia	€4,252	€5,620
Serbia-Montenegro	€17,151	€2,066
Slovenia	€25,919	€17,310
Bulgaria	€19,557	€6,830
Romania	€57,140	€6,980
Poland	€195,015	€10,580

Source: Vienna Institute for International Economic Studies (wiiw, Balkan Observatory).

Turning to regional trade data in the SEE, while trade in the former Yugoslav republics (or western Balkans)[6] has begun to increase from low levels between 1999 and 2003, it remains unbalanced. The growth rate with the EU is higher than that with the rest of the world but intra-regional trade is weaker than both. The EU-25 now accounts for some 84% of the former Yugoslav republics' trade, but among the FYRs, Croatia is by far the dominant partner accounting for fully 50% of the latter's total EU trade (Eurostat, 2005). Meanwhile trade within the region is skewed markedly, with trade between Croatia and Bosnia-Herzegovina and between Serbia-Montenegro and Macedonia accounting for nearly 75% of the total trade between the FYRs (see Eurostat, 2005; and Gros et al., 2004).

We now turn to a detailed consideration of the structure and direction of SEE trade.

2.1 Structure and direction of SEE trade

Trade between the EU and new member countries has grown strongly over the last decade (tripling in value in many cases). By contrast, trade between the EU and most SEE countries has been considerably less dynamic. The remaining countries of the former Yugoslavia with no present EU candidate status have a relatively low share of exports in GDP and low import coverage ratio when compared to Slovenia, Bulgaria and Romania, which are in an intermediate position.

Table 3. Two key trade ratios – FYRs vs. new member states and accession countries

	Ratio of exports to imports (%)	**Exports as % of GDP**
Albania	25	7
BiH	37	20
Croatia	44	22
Macedonia	61	29
Serbia-Montenegro	37	14
Slovenia	95	47
Bulgaria	75	38
Romania	80	31
Poland	91	29

Source: Vienna Institute for International Economic Studies (wiiw, Balkan Observatory).

If trade openness remains a key difference between SEE countries and more successful transition countries, the small market size of SEE economies may imply that regional integration alone cannot promote sufficient growth momentum for them to catch up with the EU member states that joined in 2004. Nevertheless, unbalanced regionalism also carries the danger of trade diversion exceeding trade creation when the economies finally come together (for a case study of the proposed union of Serbia-Montenegro, see Gros et al., 2004).

Table 4 presents an overview of the regional trade data. This also suggests that regional integration remains weak with only the export shares of Macedonia and Romania into the region exceeding exports into the EU. Despite the creation of a matrix of 29 bilateral Free Trade Areas (FTAs), intra-regional trade as a share of total trade does appear to remain weak at only 3 to

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[6] Here defined as Croatia, Bosnia-Herzegovina, Serbia, Montenegro, Macedonia plus Albania, i.e. omitting Slovenia from the FYR.

17% of the total (excluding Macedonia). Turkey's very small trade share in the region is particularly worthy of note.

Table 4. Direction of trade of the SEE economies, 2004 (in $ millions)

	Exports to world	Exports to EU	Exports to SEE	SEE as % all X
Albania	536.36	450.06	33.01	3%
BiH	1497.75	1066.67	459.72	17%
Bulgaria	9363.19	5321.05	1810.1	11%
Croatia	7858.71	5142.76	1919.53	14%
Macedonia	1534.98	689.46	711.69	26%
Romania	23475.5	17169.8	2684.57	7%
Serbia-M	2229.74	1801.75	459.62	12%
Turkey	62923.3	34400.5	2863.19	3%

Source: IMF Direction of Trade statistics (2005) and own calculations.

While some might argue this is an early sign of trade being steered more towards the EU, a number of studies, notably Christie (2002) and Adam et al. (2003) have taken a more critical look at comparisons between the SEE performance and the former CEECs. Christie (2002) found that in many cases intra-regional trade was much lower than predicted for economies that are similar, are of a similar size and are geographically close to one another.

In general, these authors conclude that the Central European Free Trade Area (CEFTA) and Baltic Free Trade Area (BFTA) agreements helped to expand regional trade and limit the emergence of asymmetric liberalisation or 'hub-and-spoke' relationships between the former CEECs and the EU during their transition (see Baldwin, 1994).

Hence, the more complex and partial bilateral approach adopted in the regional matrix of SEE FTAs was always likely to be problematic and has proved to be so. One key concern is whether introducing a deeper regional agreement would now fare much better or whether alternative EU institutional arrangements (such as a customs union) could do more for the region.

2.2 Promoting trade integration in SEE

A problem in interpreting the real economic record in SEE is how to make due allowance for the extreme 'shock' (not least to 'human capital') from war disruption in the region up until 1995, against the need to be critical where persistent under-performance since then warrants it.

Adam et al. (2003) review the difficulties. As the former FYR dissolved, the successor countries introduced restrictive trade regimes, each with its own tariff schedule and border controls. The subsequent wars disrupted infrastructure and communications and in the early 1990s, regional trade flows almost ceased altogether. Following the ceasefire in 1995, the successor states did very little to reverse the decline in regional trade. As a consequence the region failed to negotiate preferential trade arrangements with the EU, so that the post-conflict period 1995-2001 was not marked by a recovery in trade.

In most cases it was marked by a period of fluctuations and reverses, with a resumption of sustained trade growth not in place in most cases until 2003, as can be seen from the fluctuations in the data in Table 5.

Table 5. Exports into SEE

	1995	**1996**	**1997**	**1998**	**1999**	**2000**	**2001**	**2002**	**2003**	**2004**
Albania	22.9	14.6	11.0	6.4	9.1	12.7	19.2	16.1	17.8	33.0
BiH	16.1	77.3	166.1	205.6	183.1	144.7	185.9	219.6	309.9	459.7
Bulgaria	1078	898.4	719.2	628.1	651.4	1099.1	910.0	1051.4	1389.5	1810.1
Croatia	1078.8	1254.0	1295.3	1128.3	1075.8	1020.1	1062.3	1188.0	1552.2	1919.5
Macedonia	474.4	281.23	328.72	358.0	386.1	453.5	381.8	412.0	518.1	711.6
Romania	504.1	572.7	473.5	561.0	730.5	1111.3	861.7	955.6	1513.1	2684.5
Serbia-M	256.9	273.3	244.9	299.1	186.2	242.9	172.8	225.8	304.3	459.6
Turkey	651.6	665.1	763.4	913.1	791.6	896.5	993.5	1336.1	2065.7	2863.1

Source: IMF Direction of Trade statistics (2005) and own calculations.

The Stability Pact for South East Europe was established under the auspices of the international community (including the EU) in June 1999, in the aftermath of the Kosovo crisis. Instead of setting up a pan-regional free trade area along the lines of the CEFTA or BFTA, the decision was taken, apparently on the grounds of pragmatism (see Wijkman, 2003), to aim for a more limited set of bilateral agreements, of which some 29 are now in place although in several cases not fully operational (see www.stabilitypact.org).

Although tariffs in many lines of goods and services have been reduced, if not abolished entirely, there are still a number of complexities, anomalies and exemptions – the most serious of which are in agriculture (partial coverage) and in public procurement and services (exempt). Worse, the Joint Committee that governs infringements in the FTAs has pointed to the unilateral suspension in 2005 by BiH of parts of its agreement with Serbia-Montenegro and Croatia in the past year, and notes that "failure to follow the agreed procedures for dispute resolution damages the credibility of (the) agreements as well as trade flows".[7]

There is now some realisation that all may not be well in intra-regional trade relations in South East Europe. However, it is also unclear how SEE countries will move on from the present set of arrangements to a full pan-regional Regional Trade Agreement (RTA). At the joint Trade and Investment Ministerial meeting, held in Sofia on 9-10 June 2005, the decision was taken to move to a single FTA, setting the ambitious date of 2007 for the completion of formalities.

Plans to deepen regional trade

The current European Commission plan envisages modifying the existing 'northern' CEFTA agreement and taking in new SEE members including Bulgaria, Croatia and Romania. If this timetable is to be met, a new agreement (based on the text of CEFTA) could enter into force as early as 2007. However, on the basis of the region's history, few regional observers really expect that this can be achieved. In addition, the technical customs issues that will inevitably emerge between imminent EU members (Bulgaria and Romania) and long-term EU aspirants, as well as the continued trade isolation of Turkey from the region, do little to engender optimism.

In principle, a subtle realignment of regional trade in goods and services would not only greatly enhance intra-regional trade – but also provide a platform for more infrastructure, more direct investment and an improvement in the region's endemic balance of trade problems. This would in turn put the region on a path towards a more sustained pattern of growth. The reality, as we have suggested above, is that serious increases in intra-regional trade would almost certainly require stronger trade policy 'medicine', in the form of a change of policy in Brussels towards favouring an enlarged pan-regional customs union.

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[7] Stability Pact for South-East Europe (2005).

Hence, the proposed pan-regional RTA might be regarded as inadequate to the size of the task it is setting itself – to stimulate intra-regional trade – or 'too little, too late' for the region. This is because a pan-regional RTA will most likely not include a sufficient component of agriculture and services, and will not entirely do away with trade frictions due to rules of origin, other non-tariff barriers and so do little to end a general pattern of 'inwardness' and unreasonably restricting trade in order to protect domestic industry (mercantilism).

Moreover, given the region's slow start in openness in terms of trade, will an RTA provide sufficient stimulation to the region's trade patterns in preparation for the rigours of a genuine free market in goods, services and (eventually) labour within the EU?

However, to check on this we first need to look at the region's actual recent trade performance. In the next section we update the econometric estimates made by Christie (2002) to take account of most recent trade data up to 2004, but also of the fresh evidence now available from the region's complex matrix of (circa 29) bilateral trade agreements, which have only recently entered into force. Some of these have now been in place since 1997, but most of them have only been implemented in the early part of this decade.

Finally, we briefly consider the results and what indications they give as to whether a full regional RTA will be sufficient to achieve deeper regional openness to trade and integration.

3.   Tests of SEE trade integration

A rigorous and sophisticated approach to measuring the current amount of trade between countries is to consider whether actual trade patterns are similar to what could be expected on the basis of 'normal' trade relations. Thus, normal trade relations are used to define the counterfactual (*anti-monde)* to which current trade relations are compared.

The most commonly used empirical model of bilateral trade flows is the gravity model (for an overview, see Greenaway & Milner, 2002), which played a prominent role in the analysis of potential trade flows for the former CEECs in transition (Baldwin, 1994; Brenton & Gros, 1997).

The standard form of the gravity model (see Equation 1) starts with the presumption that economic mass (measured here by nominal GDP) and commercial distance are key explanatory variables of bilateral trade flows, while population is often included to reflect the fact that large countries tend to be more self-sufficient and trade less than small countries:

$$X_{ij} = \alpha + \beta_1 GDP_i + \beta_2 GDP_j + \beta_3 POP_i + \beta_4 POP_j + \beta_5 Dist_{ij} + \gamma_k DUM_{kij} \quad (1)$$

Hence, X_{ij} is the flow of exports from country i to country j, *Dist* is the geographical distance between the countries' capitals, and α, β and γ are coefficients to be estimated. The coefficients β_1 and β_2 are expected to be positive and in the region of 1, whereas β_3 and β_4 may be negative, while β_5 should be negative (and is generally estimated to lie between –0.7 and –1.5).

Here we use panel econometric techniques for the gravity formulation. The panel is constructed from data on eight exporters (Country 1) and seven partner countries (Country 2) and has a T value of 12 years. The data is taken from the 2005 IMF Direction of Trade Database, in natural logs (Xij).

The dependent variable is the log of bilateral exports between the 56 country pairs (7 pairs, times 8 countries). The explanatory variables are in turn: lagged exports (Xpts – 1); country 1 and country 2 GDP (GDP1 and GDP2); country 1 and country 2 population (Pop1 and Pop2);

distance (DIST) between the capital cities;[8] and finally a set of dummy variables (DUM) for whether a country pair are in a bilateral free trade agreement (FTA) and for former membership of Yugoslavia (FYR).

If the coefficient on the dummy for FYR is positive (and statistically significant) this would tend to suggest, contrary to much recent commentary, that bilateral trade between these countries is at or around its potential, given their relative size and GDP. The existence of an FTA between the country-pairs should stimulate trade, so the estimate of γ should be positive for the FTA dummy.

In Table 6 below we present a summary of the regression results for the two versions of the panel model estimated, namely Ordinary Least Squares (OLS) and also a Random Effects model (using Generalised Least Squares).[9]

Table 6. Panel Regression Results

Linear Regression (OLS)				Random Effects (GLS)			
Modelling the log of bilateral exports (L*Xpts)				Modelling the log of bilateral exports (LXpts)			
Variable	Coefficient	Std.Error	t-test	Variable	Coefficient	Std.Error	z-test
LXpts (-1)	0.74686	.048586	15.37	LXpts (-1)	.7179219	.0229139	31.33
LGdp1	0.50563	.184599	2.74	LGdp1	.5425441	.0904885	6.00
LGdp2	0.44608	.156536	2.85	LGdp2	.4737992	.0796891	5.95
LPop1	-0.07990	.152188	-0.53	LPop1	-.0753172	.0891078	-0.85
LPop2	-0.13204	.127780	-1.03	LPop2	-.1327628	.0866827	-1.53
LDist	-0.68518	.165116	-4.15	LDist	-.7385694	.1072592	-6.89
FYR	0.40651	.165770	2.45	FYR	.4404253	.1064311	4.14
FTA	-0.00272	.106896	-0.03	FTA	.0060745	.1217677	0.05
Constant	-3.7199	1.76358	-2.11	Constant	-4.067387	.8123508	-5.01
F(8, 575) =	210.12			Chi^2(19) =	3096. [0.000]		
R^2	0.8617			R^2	0.8614		

  * L = Natural log operator.

While carrying out a similar exercise, Christie (2002) found evidence of low levels of trade. Due to the availability of more recent data we are now also able to subject the FTA variable to scrutiny. In the country-specific method used here, we remove any disturbance effects from other country pairs that do not have an FTA, hence revealing any 'true' FTA effect.

The model appears to be a successful fit and the results conform, broadly speaking, to the expected signs and magnitudes across the dependent variables, with a negative and significant coefficient on distance as predicted by the gravity model set-up. Current economic orthodoxy suggests a small, often land-locked regional group of economies should trade appreciably more with each other, the smaller their populations are.

Our principal finding is that, since the FTA dummy is not as statistically significant, this suggests that these countries do not yet benefit from any boost to trade from the regional integration variable (FTA).

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[8] See www.wcrl.ars.usda.gov/cec/java/capitals.htm.

[9] For consistency, and in accordance with recent best practice, we also estimated a fixed effects (Least Squares Dependent Variable) model which reproduced similar results, but as this required us to drop the 3 time-invariant variables of population and distance we do not report these results here, although they are consistent.

However, we cannot yet conclude that they do not trade as much with their neighbours as might be expected. Indeed, the fact that the FYR dummy is positive and approaches statistical significance (at the 15% confidence level) tends to run slightly counter to the concerns expressed in the literature that intra-SEE trade performance remains 'disturbed'.

Taken at face value, the estimated OLS coefficient (0.406) implies that trade among the former Yugoslav countries remains around 1½ time greater than what would be expected of trade with other regional countries.[10]

Before concluding that all is well in this respect, we need to look a bit further into techniques for measuring trade potential, a topic that has become actively researched in recent years and is dealt with in the following section.

3.1 Estimates of SEE trade potential

The issue of how to properly measure trade potential came to prominence in the early stages of the former CEEC transition during the 1990s. However, recent developments in the methodology of panel data econometrics have drawn attention to the inherent complexity of an apparently straightforward concept. Egger (2002) has reviewed the issues, and concludes that there have been broadly two approaches to the problem.

First in the early stages of transition – when, it should also be noted, reliable time series data were not yet available – the former CEEC countries were argued to be behaviourally different from OECD countries. So for these reasons, gravity models were first estimated on EU or OECD data and the relevant trade parameters from those models were then used to project 'natural' trade relations between these countries and (for example) the EU. The difference between observed and predicted trade was then ascribed to latent trade potential.

In most cases, the econometric technique was cross-sectional (e.g., Hamilton & Winters, 1992 and Brulhart & Kelly, 1999). Only a few papers at this time used panel-data techniques, such as Gros and Gonciarz (1996), who along with Brenton & Gros (1997) concluded that even by the early or mid 1990s, the geographical reorientation of the CEECs' trade had already taken place and therefore that (counterintuitively) a further significant expansion of trade between these two regions was unlikely to take place.

Egger (2002) extended this type of analysis – using dynamic panel estimation techniques - to show that much of the transition adjustment in trade occurs within four years. Egger (2002) refers to this as the 'out-of-sample' approach, where insufficient data (for Russia or eastern European countries during early 1990s) forced the application of gravity model estimation results into the area of determining predicted trade for third countries (i.e. countries not included in the regression data set).

An alternative and more recent approach has been to include the transition countries under consideration in the data set and interpret the regression error term as the difference between actual and potential bilateral trade, that is to say the explained vs. the unexplained components of the regression. Baldwin (1994) and Nilsson (2000) are examples of this approach which Egger calls the 'in-sample' approach, and is generally to be preferred.

The 'traditional' methods, often based on cross-sectional econometric techniques and using a straightforward OLS estimator, are now thought to have been severely miss-specified. This comes about partly from the fact that cross-sectional techniques omit valuable information inherent in the time dimension (Mátyás, 1996). However, in addition to these shortcomings

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[10] Exp(0.406) = 1.5.

Egger (2002) has brought to prominence the issue of the appropriate regressor (regression method) to be used when using in-sample methods for calculating trade potential.

Hence, by virtue of including the time dimension in panel techniques, we need to be careful about the short-term and long-term characteristics of various regressors employed. Basically, the 'within estimator' (fixed effects and consistent random effects), tends to reflect short-run parameters since it is based on the time-series component of the data, while the 'between estimator' (which is based on the cross-sectional component of the data) tends to give long-run estimates.

Finally, since in principle they do not incorporate any systematic information, we should observe 'white noise', or entirely random, residuals (or error terms) from a consistent and efficient econometric estimate. Hence, to quote Egger (2002) directly, "if an estimator reveals large systematic differences between observed and in-sample predicted values this should be treated as an indication of (equation) miss-specification and parameter inconsistency".

The implications of this critique are that the previously discovered large in-sample divergences between actual and potential trade (for example in the former CEECs) may be due to either inconsistent parameter estimates (due to correlation between the explanatory variables and unobserved effects or 'unobserved heterogeneity') or alternatively due to serial correlation in the residuals.

Since typically, studies of trade integration in SEE have found such large effects and discouraging results, in view of the above it is just possible that they may have overstated the lack of trade integration among SEE countries.

Either way, the implication is that a more robust technique is required for calculating actual over potential trade (which we will hereafter refer to as T/P).

Given these caveats, the intention here is to check these trade potential findings using recent methodological advances where possible and confirm or extend the picture of SEE trade integration built up above.

Method for calculating trade potential (T/P)

Following Egger (2002), but also Soderling (2005) and Plümper and Troeger (forthcoming) our method aims to take account of the issues raised above.

If we consider the following stylised gravity model, with explanatory variables X_i and associated coefficient estimates $β_i$:

$logT = Sum(i)[β_i*logX_i] + u + e$

Egger submits that ideally in-sample potential trade ratios should be computed on the basis of the estimated random-effect term (u) where e is assumed equal to its expected value (zero).

Therefore, following Egger, we compute actual-to-potential trade ratios (T/P) as

$T/P = Exp\{logT - Sum(i)[β_i*logX_i]\} = Exp (u),$

using the Random Effects estimator.[11]

In essence, the method simply boils down to comparing the actual levels of bilateral trade achieved between the country pairs (*logT* as contained in the dataset) with the amount of bilateral trade predicted by the model, as calculated by applying the coefficients from the estimated model ($β_i$) to the data for the explanatory variables ($β_i*logX_i$).

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[11] and Exp is the exponential operator.

However, for operational reasons we do not use the Hausman & Taylor (1981) techniques proposed by Egger but instead, following the method advanced by Plümper and Troeger (PT) we use an alternative technique believed to better control for the problem of covariance between the observed explanatory variables and the random effects variable (u).

Results of extrapolating trade potential (T/P)

In the trade-potential matrix below, we report the ratios computed according to the formula above based on the estimated results using the PT estimator. While T/P ratios based on Fixed Effects and Random Effects estimator results were also used, we report the PT results here as these most successfully pass Hausman specification tests for correlation of observed and unobserved components.[12]

Our previous regression results suggested that trade integration was not benefiting from the inclusion of an FTA, but that for the FYR countries was operating broadly in line with expectations (given GDP levels, proximity etc). These results now indicate a more complex or somewhat less uniform picture. Inspection of the T/P matrix reported below suggests that a uniform picture of underperforming trade potential does not hold true but that there is a mixture of underperforming and 'over-performing' countries.

Indications of above/below trade potential are inferred from numbers greater than 1 or less than one respectively. The rows represent a country's imports, while the columns represent a country's export patterns into the region, needless to say nothing can be inferred about the direction of the country's aggregate trade outside the SEE region. Broadly speaking, these results suggest a fluctuating pattern that indicate that in some cases SEE regional trade is much) below potential, while in others far it is far more intense than might be expected (e.g. Croatia/BiH).

Table 7. A matrix of SEE trade potential (rows = imports, columns = exports)

	Albania	Bulgaria	BiH	Croatia	Macedonia	Romania	Serbia	Turkey
Albania	0	3.0031614	0.1025566	1.1098195	2.8843532	0.8740553	0.5020468	2.102273
Bulgaria	0.0459186	0	0.8742775	0.4995692	2.6946373	3.3591936	1.1411386	2.725276
BiH	0.0627911	1.0891914	0	18.753452	2.8543913	0.7044302	3.0293717	0.9325982
Croatia	0.1532802	0.6219	3.466012	0	2.3741708	0.6639797	1.3906887	0.5236431
Macedonia	1.1494064	6.7143598	1.0654888	3.2672741	0	1.0470723	2.9487925	1.9744126
Romania	0.0217831	2.0703478	0.4466591	0.3104298	0.22783157	0	0.8510441	2.2131588
Serbia	0.3913607	4.3066778	2.2215652	7.3386173	6.7918472	1.9757745	0	1.131039
Turkey	0.1304051	2.4163923	0.1581952	0.192898	0.38419318	1.9875356	0.2938517	0
All	0.3040409	2.8622194	1.1561312	4.7926293	2.5922706	1.4989774	1.4509906	1.7030699

While internal trade patterns still appear volatile (for some countries too high and others too low), it is in particular evident that some FYR countries are far more reliant on each other than might be expected, the non-FYR countries (Romania, Bulgaria) are much less integrated with the FYR countries and finally that Turkey remains generally speaking poorly integrated with the entire region (especially in imports), but in particular with the FYR countries including Croatia.

Taken together, the two sets of results suggest that while some SEE countries are trading below their regional potential others are over-dependent on old (former FYR) regional ties. Taken together this suggests that the pattern of SEE trade integration is not yet displaying the sort of

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[12] A Stata ado file designed to assist carrying out this procedure is available from the authors, tpluem@essex.ac.uk. Thanks are due to Dean DeRosa, ADR International Ltd for interpreting this routine.

internal trade dynamism typical of the northern transition economies. In particular we note the relative isolation of Romania, Bulgaria and Turkey as export destinations for the rest of the region. Now updated a little in terms of methodology and the inclusion of data on bilateral FTAs, these findings of volatility more or less confirm those of Christie (2002) but are less uniformly pessimistic – and focus more on internal fluctuations - than others.

While we need to be careful how we interpret this sort of data, given the weak starting levels and war disruption, the conventional wisdom on transition success and intra-regional trade mentioned at the outset still suggests continued cause for concern. This is especially so in view of the hopes placed on the 'deeper' pan-regional version of the Stability Pact arrangements, which may well turn out to be insufficient on their own to stimulate intra-regional trade potential.

If this intra-regional situation remains as it is, the region's full growth potential will not be achieved. Given EU involvement in the region, this places the promotion of intra-regional trade activity centre stage as it is a requirement for achieving the region's full economic potential. This argues for a fuller policy engagement with the EU *now*, such as moving to a full customs union.

4.   Conclusions

This study started by reviewing the literature and evidence on the role of trade in the successful transition economies, which are now members of the EU. A range of studies, such as that of the World Bank (2005) on economic transition, confirm that openness to trade has been of paramount importance in the reintegration of these economies into world markets.

However, a growing body of literature suggests that trade performance in a number of countries in South East Europe (SEE), particularly the former Yugoslav republics, is inferior to that of the model transition states (especially export/GDP ratios are much lower than elsewhere). Some authorities consider that this is largely due to the absence of an adequate pan-regional trade agreement in South East Europe (such as the CEFTA agreement for the former CEEC countries).

We checked these concerns, using a more recent bilateral trade data set, latest panel econometric techniques and information on the bilateral trade treaties now in place in the SEE region.

Our finding is that while the previous impression of uniform weakness in internal trade cannot be substantiated – a pattern of regional fluctuations persists. In particular a number of former FYR, such as BiH, Bulgaria and Croatia countries trade 'too much' among themselves and are less well integrated into their hinterland, while a number of others – in particular Albania, BiH and Turkey (particularly as an export destination in Turkey's case) – are substantially under-represented in the trade patterns (particularly of imports) of the wider region.

We then discuss whether the present pattern of weak intra-regional trade is likely to be substantially improved by moving to the deeper regional initiative presently being discussed for the region (a Regional Trade Agreement). Starting late in the day, this initiative seems unlikely to achieve the same level of intra-regional trade as the CEFTA and BFTA arrangements did for the seven northern transition countries that are now members of the EU.

Hence, given the degree of EU commitment in the region, where all the remaining FYRs now have a Stabilisation and Association Agreement (SAA) in place, we argue that thought might be given to extending the present EU customs union (CU) with Turkey to encompass the entire SEE region.

Even (or especially) if stable levels of internal trade in the SEE region are endemic, this sort of deeper trade regime could have a more significant impact on growth and welfare than either the proposed RTA or the present regime of bilateral trade relationships (FTAs). In an extended CU, regional trade might be expected to be reoriented towards the larger EU and world markets (including Turkey, Romania and Bulgaria) with imports from the EU into SEE markets offsetting the present weakness in intra-SEE trade.

If the ultimate long-term goal is not just membership of the EU single market for goods, but also free movement of capital and labour (a sort of grand customs union *plus*), assessing the relative effectiveness of various transitional trade arrangements on the SEE regional economy should now be a policy topic requiring urgent attention.

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