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CHALLENGES AND RISKS BEFORE SEE TRADE LIBERALIZATION

GENERAL FRAMEWORK

In June 2001 seven countries in Southeast Europe: Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Macedonia, Romania and FR Yugoslavia signed in Brussels a *Memorandum of Understanding* on the establishment of a Free Trade Zone in the region by the end of 2002 on the basis of bilateral trade agreements. The initiative has been supported and coordinated by the Stability Pact.

Current Status: Bilateral free-trade agreements in South-Eastern Europe

	Albania	B&H	Bulgaria	Croatia	Macedonia	Romania	Yugoslavia
Albania		-	-	-	Y	-	-
B&H	-		-	Y	Y	-	NEG
Bulgaria	-	-		Y	Y	*	NEG
Croatia	-	Y	Y		Y	NEG	NEG
Macedonia	Y	Y	Y	Y		NEG	Y
Romania	-	-	*	NEG	NEG		-
Yugoslavia	-	NEG	NEG	NEG	Y	-	

Y=has agreement; NEG =in negotiations; *Both CEFTA members
Source: Liz Barret, Business in the Balkans: The case for cross-border co-operation, 2002, p.10

Potential risks regarding the Memorandum:

1 The Memorandum lacks simplicity and standardization. One option for the agreement was to merge in one standard text for all countries, which did not actually happen.

2 Postponed liberalization of several sectors compared to others. This discriminatory progressive liberalization has several negative effects. These tailor-made schedules may remove the immediate problems of pressure groups asking the government to be the last one liberalized, but they can impose high pressure later. As the products, which are liberalized late,

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are precisely those, which have been already able to mobilize powerful vested interests, these producers will be increasingly opposed to the liberalization process.

3 The initiative would be more market oriented if presuming progressive liberalization to all commodity groups.

4 Regarding the EU orientation of regional countries, technical barriers in manufacturing and agriculture can be unified in converging to the EU acquis communautaire. The sooner this is agreed the better trade creation results will be obtained in the region.

5 It is mentioned that the countries are supposed to implement "common set of preferential rules of origin". In this case maybe better option is reducing complexity than implementing preferential rules of origin. Minimizing the number of different tariffs, which can be imposed on a specific product, is a way to reduce the complexity of rules of origin. For example if the difference between MFN (Most Favorite Nation) tariff and preferential tariff for a given commodity for instance is between 5% and 7% or less the risk of trade deflection could be considered limited, which makes rules of origin pointless.

6 Trade creation effects will depend on governments will to liberalize business environment together with trade facilitation process.

Topic for discussion.

For the small SEE economies protectionism do not represent an alternative at all. Better constellation is to seek higher regional exposure and effects similar to economies of scale.

IS FREE TRADE BENEFICIAL?

It is likely that Balkan economies with greater openness would sustain greater output and, over time, would achieve higher income. Recently, in the framework of the Economic Freedom Initiative (Fraser Institute is the coordinating and leading party) has been constructed a Trade Openness Index (TOI)[1], designed to measure the interception of basic growth factors with international trade. It has 4 components: a) tariff rates, b) the black market exchange rate premium, c) restrictions on capital movements, and d) the actual size of the trade sector.

1 J. Gwartney, C. Skipton, R. Lawson, Trade Openness, Iincome Levels, and Economic Growth, 1980 - 1998. James Gwartney and Robert Lowson are editors of the Economic Freedom Index of the World, published since 1997 by the Fraser Institute in Canada; IME is a co-publisher of the Index.

The trade Openness Index, Convergence, Key Policy Variables, and Income

	Real GDP per capita 1998 (1)	(2)	Average annual growth rate of real per capita GDP-a (3)	(4)	(5)
Trade Openness Index (1980-98)	3.1 (9.6)*	2.0 (5.96)*	0.4 (3.85)*	0.4 (2.8)*	0.3 (2.13)**
Per capita GDP 1980				-0.1 (3.13)*	
Property rights rating 1980		1.0 (5.32)*		0.2 (2.33)**	0.2 (2.46)**
Inflation variability rating		0.5 (2.27)**		0.4 (4.81)*	0.5 (4.89)*
Intercept	-8.1 (4.29)*	-12.2 (6.29)*	-1.0 (1.5)*	-3.6 (5.00)*	-4.3 (4.91)*
N	87-b	87-b	87-b	87-b	66-c
Adj R- Squared	.52	.65	.14	.36	.38

t- statistics in parenthesis

* significant at 99% level; ** significant at 95% level

a – Real GDP numbers are derived using the purchasing power parity method and are in U.S. dollars

b – There are 87 countries in this analysis

c – High income, long standing OECD members are excluded.

The results in equation 1 illustrate the relationship between countryžs average TOI rating during 1980-98 and a given country's 1998 per capita GDP, the correlation is positive and highly significant. The adjusted R-squared comparison indicates TOI explains 52% of the variability in 1998 per capita GDP among the 87 countries. Equation 2 includes inflation and property rights, which significantly correlate at 95%. The TOI remains highly significant (t = 5.96). The R-squared adjustment shows that all three variables explain 65% of cross-country variations in per capita GDP. Equation 3 looks at the relationship between the TOI and the growth rates of real per capita GDP for 1980-98. The t – ratio for the TOI is highly significant with R-squared indexes explaining 14% of the cross-country variation in growth. If we exclude from the equation 5 the high-income industrial countries (21 long standing OECD members) and reran the model the results are quite similar to those for all countries. The TOI remains positive and significant explanandum low-income countries.

GOVERNMENT ROLE AND SIZE IN SEEC.

The table bellow makes an attempt to summarize available data on government's size and role in the economy. It gives an opportunity to compare Balkan countries (except Bosnia and Herzegovina which, for obvious reasons, is not monitored) with core EU accession countries and five relatively well performing leaders of economic liberty.

Governments in business

Country	Economic Freedom of the World 2001 (Fraser Institute) [a]		Index of Economic Freedom (Heritage) 2002
	Government Consumption as a % of Total (1999)	Transfers and Subsidies as a % of GDP (1999)	Government Intervention [c]
Albania	9.0 (9.6[b])	7.8 (8.6[b])	3.0
Croatia	2.8 (30.5)	4.8 (19.5)	3.0
Bulgaria	6.7 (17.1)	6.5 (13.3)	3.0
Macedonia	n.a	n.a.	3.0
Romania	6.7 (17.4)	6.7 (12.4)	3.0
Yugoslavia	n.a.	n.a.	3.0
Hungary	7.5 (14.4)	4.7 (20)	1.0
Poland	7.1 (16)	3.7 (23.5)	2.0
Czech Republic	3.8 (27)	2.8 (27.1)	2.0
Slovenia	3.8 (27)	1.0 (33.7)	3.0
Germany	4.5 (24.9)	4.5 (20.8)	2.0
Greece	6.6 (17.5)	8.6 (5.6)	2.0
Hong Kong	7.8 (13.5)	-	2.0
Switzerland	6.0 (19.5)	5.5 (17.2)	2.5
USA	5.4 (21.8)	5.6 (16.5)	2.0

a – Scores from 0 to 10 (10 - Benchmark representing maximum economic freedom)
b – Government Consumption as a % of Total and Transfers and Subsidies as a % of GDP
c – Scores from 1 to 5 (1 – Benchmark representing maximum economic freedom); The measure comprises both government consumption and government production
Source: Economic Freedom of the World, Heritage Index of Economic Freedom

The data is for 1999, the year that gives background for comparison; for lack of space, previous years are omitted (but there are no significant differences from previous years). Both indexes are far from perfect,[2] but they give an opportunity to neutralize dramatic political developments, which fit the overall inertia of economic phenomena, including that of economic freedom.

In both indexes, Balkan governments demonstrate relatively high levels of government interference, combined with, naturally, low levels of economic activity. This situation is significantly different from countries that maintain comparable levels of expenditures, transfer and subsidies, but regularly demonstrate a higher degree of economic freedom. An exception is Albania. Its government is rather small, but it lacks reliable market institutions, which ranks the country relatively unfree.

Economic freedom is understood as liberty to engage in business and accumulate prosperity, restrained only by the need to sustain this opportunity.

2 These indexes use data of the one or two years back and give higher weight to background years in comparison to last or current year.

The table below exhibits a comparison between one of the economic freedom indexes and the latest Transparency International CPI for five Balkan countries,[3] including Greece (EU and NATO member) and Slovenia (reforms, prosperity and EU accession front-runner, in comparison with the rest transition Balkans), plus Hungary (NATO member and EU accession leader).

Economic freedom and corruption in 2001

Country	Economic Freedom of the World (Fraser Institute) [a]	Transparency International Corruption Perceptions Index [b]
Bulgaria	5.9	3.9
Croatia	5.2	3.9
Romania	3.8	2.8
Greece	7.3	4.2
Slovenia	6.2	5.2
Hungary	7.1	5.3

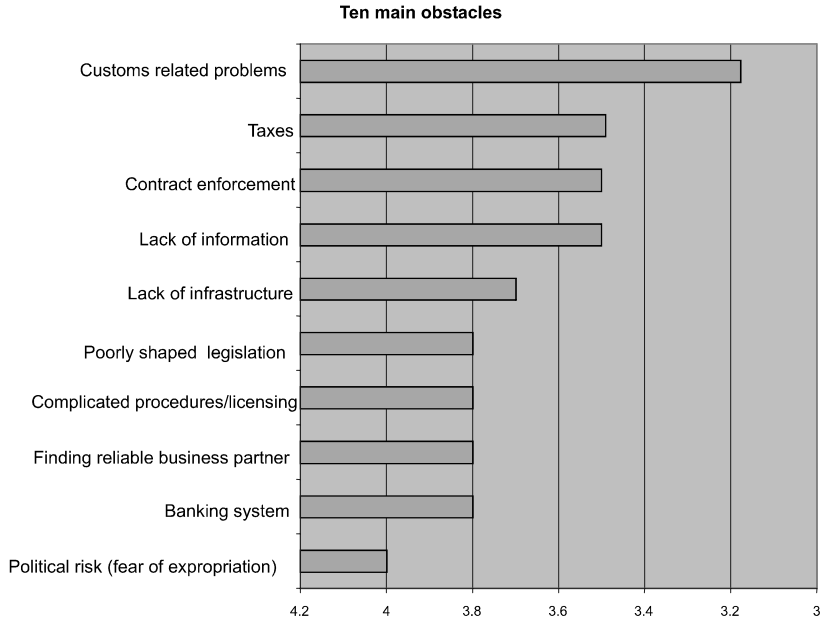
a – Scores from 0 to 10 (10 - Benchmark representing maximum economic freedom)
b – Scores from 0 to 10 (10 – Benchmark representing minimum level of corruption)

Usually, there is a strong correlation between the perception of corruption and the lack of economic freedom, although the latter is measured objectively. Balkan countries are no exception.

ADMINISTRATIVE BARRIERS, ENTRY AND EXIT IN SEE – SOCIOLOGICAL APPROACH

The better way to overview regional obstacles to trade is to interview the very market participants. This research is part of the Balkan network Initiative 2000, it consists of interviews (125 firms are included) and ten company case studies, and was conducted in December 2000 – April 2001 (when the case studies were finalized) in Albania, Bulgaria, Kosovo, Macedonia and Montenegro; the results are published in: Obstacles to Trade, Growth, Investment and Competitiveness: Ten Case Studies of Balkan Business, Sofia, The Balkan Network, 2001. It is also available at: www.balkannetwork.org.

3 TI does not monitor other countries.

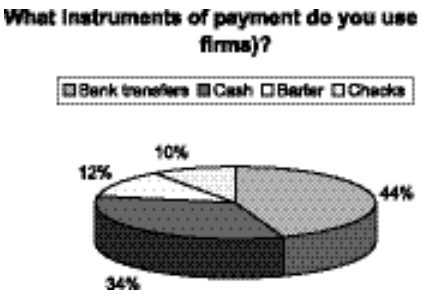


(1-highest importance, 5- lowest)

A major problem that interviewed companies face trading in the region is customs formalities, duties and procedures. Another key problems of equal importance are found in: taxes, contract enforcement and lack of information. These answers suggest that the basic institutional infrastructure to mediate trade is missing.

PAYMENT SYSTEM

Relying on the above mentioned sociological research I would like to give you an anecdotic example on preferred instruments of payment in SEE. You should keep in mind that results are illustrating international transactions.



One third of all payments in the Balkans are claimed to be in cash. A possible explanation of this situation is that in that way tax payment is avoided, and moreover, if the money origin is illegal, using banks is not an alternative at all. Together with barter the non-bank component in the payment system equalizes the bank segment.

THE CASE OF BULGARIA

Tariff policy

Over the last three years Bulgaria's trade regime became less restrictive: the average tariff rate is reduced from 16.8 % in 1997 to 13.7 % from the beginning of 2000, non-tariff barriers were reduced substantially as well. Reduction of trade restrictions is already contributing to trade diversification and improves the efficiency of resource allocation. Under the conditions of monopoly structures, any effects from decreasing tariffs on resource distribution are lower than in countries with well-developed property rights. At the same time, Bulgaria's trade regime is far more restrictive than the other two currency board countries from the group of EU candidates, Estonia and Lithuania.

More detailed analysis on Bulgarian tariff measures illustrates the policy towards liberalization in the last five years. The mean tariff went from 16.1% in 1996 to 10.99 % in 2000. Though, the process of trade liberalization could be faster. The tariff standard deviation is decreasing, i.e. there is more unified tariff policy.

Background of tariff measures (Bulgaria)

Year	Mean	Median	Minimum	Maximum	Std. Dev.
1996	16.1	15	5	40	8.31
1997	15.49	15	0	40	9.04
1998	15.24	15	0	40	9.01
1999	12.55	10	0	40	9.13
2000	10.99	10	0	40	8.11

Source: Ministry of Finance

Trade policies and realities

Bulgaria's case outlines the regularities of changing trade partners in the second half of the nineties and deficiencies and disadvantages of different trade directions, and highlights the role of the Balkans. I provide detailed analyses on revealed comparative advantages for different commodity groups following the Standard International Trade Classification. This approach will helps to identify sectors where the Balkan market plays a special role vis-à-vis the EU and CEFTA.

Presumably, in the years to come, the growth prospects of the EU and other major partners would be of vital importance to the growth potential of the country. The same is true for all the countries in the region. Another peculiarity here is that Bulgaria enjoys beneficial asymmetric 10-year trade agreements with the EU, signed in 1993. Other Balkan countries have signed similar, although not identical, agreements lately and they would presumably face similar challenges. Bulgaria's performance might hint at patterns to be avoided or followed.

To demonstrate all these, I need to discuss some peculiarities of the so-called revealed comparative advantage (RCA). A positive and high value of RCA for a particular commodity approximates the take off point, which companies may (or may not) convert into better competitiveness of different commodities on different markets. The calculation of RCA is according to the conventional formula:

$$RCA_i^j = \frac{(X_i^j - M_i^j)}{(X_i^j + M_i^j)}$$

RCA_i^j - is revealed comparative advantage in production of commodity i in respect of a given country

X_i^j - is the value of exports of commodity i to a given country by country j

M_i^j - is the value of imports of commodity i from a given country to country j

	EU					CEFTA					SEEC				
	95	96	97	98	99	95	96	97	98	99	95	96	97	98	99
SITC 0	+	+	-	+	+	++	-	- -	-	-	+++	++	++	++	+++
SITC 1	+ ++	++	+++	+++	+++	+++	+++	+++	+++	+++	++	++	+	- -	+
SITC 2	+	+	++	+	++	+	-	-	-	-	-	++	+	0	+
SITC 3	+	++	++	-	+	++	- -	++	+	+	+++	+++	++	++	+++
SITC 4	- -	- - -	- -	- - -	- - -	- - -	- - -	- - -	- - -	- - -	+++	+++	+++	+++	+++
SITC 5	-	-	0	-	- -	-	-	-	-	- -	+++	++	++	++	++
SITC 6	+	+	+	+	-	--	-	- -	- -	- -	+	++	++	++	+++
SITC 7	- -	- -	- -	- -	- -	-	-	+	+	- -	++	++	+++	++	++
SITC 8	+	+	+	+	++	-	-	+	- -	- -	+	+++	+++	+++	+++

*Legend:
RCA values between 0.7 and 1 (+++)
RCA values between 0.35 and 0.7 (++)
RCA values between 0 and 0.35 (+)
RCA value 0 (0)
RCA values between 0 and -0.35 (-)
RCA values between -0.35 and -0.7 (- -)
RCA values between -0,7 and -1 (- - -)

SITC 0 - Food and live animals
SITC 1 - Beverages and tobacco
SITC 2 - Crude materials, inedible, except fuels
SITC 3 - Mineral fuels, lubricants and related materials
SITC 4 - Animal and vegetable oils, fats and waxes
SITC 5 - Chemical and related products
SITC 6 - Manufactured goods classified chiefly by material
SITC 7 - Machinery and transport equipment
SITC 8 - Miscellaneous manufactured articles

RCA on Bulgaria's trade: Summary*
Source: Martin Dimitrov and Krassen Stanchev, SEE Trade and Institutions, IME, p. 23, link

The table gives the opportunity for some conclusions, which could be relevant in a regional context.

The more is the value added, the less is the RCA on EU and CEFTA markets;

The concentration of RCA is yet more frequent on EU market, presumably because of the asymmetric agreement still in force;

The SEE market is a concentration of Bulgaria's RCAs; it compensates for lack of position in other directions;

Bulgaria's presence on the SEE market is diverse and hardly specialized. It covers almost evenly the entire SITC classification. Although there is an obvious interest to maintain this presence, the improved restructuring of other economies will result in a challenge to improve the competitiveness of Bulgarian companies trading in the Balkans;

Recent protectionist and subsidizing policies in Bulgaria

Despite the overall policy towards trade liberalization, lately, the Bulgarian government aimed to boost economic growth via active measures and interference in the economy. In its economic program it announced five priority sectors - transport, tourism, energy, agriculture and high-tech. Declaring this, the government in fact invited everybody to seek privileges and subsidies. As a result rent-seeking behavior becomes dominant.

Chronology of subsidies in Bulgaria (last 4-6 months)

In the last several months the government granted a large spectrum of preferences to different producers:

- Decision to purchase 200 000 tones of cereals at fixed price of BGN 160 per tone.
- Protection tariffs for local manufacturers of various vegetables.
- Protection tariffs for local producers of fertilizers.
- Equity swaps in state-owned companies. In April 2002 the government ordered the State-owned Bulgarian Commercial Fleet to buy the assets of Varna Shipyard for BGN 35.5 million. What happened in fact was that the government subsidized the loss-maker through another state company's money (part of it borrowed). Other similar deals are: the increase in capital of the State railways company through a debt-equity swap (the government in fact exchanged tax arrears of the company for shares in a company, which is anyway 100% state owned; the amount of the deal is BGN 127.9 million), the increase in equity of Balkancar with the amount of BGN 4.2 million.
- Renationalization of the "national" air carrier Balkan that in fact carries about 1% of the traveling "nation". Last developments show other government ideas to create a "national carrier" .

Topic for discussion. Is the same thing (propensity for active government interference) happening in other Balkan countries e.g. Yugoslavia?

Who finally pays the bill of subsidizing/protectionist policies?

1. Controls on prices are perhaps the most direct way in which government distorts price information. In a free market a rising price usually indicates either rising demand for the product or a decrease in supply. For instance, over the past 200 years supplies of grain and other farm products are rising and prices have been falling. Because of this, part of the labor force gradually re-oriented to other activities. However, that process ended where governments decided to block the price signals that were telling farmers to move to more profitable endeavors, subsidizing production. As a result of subsidizing, less efficient producers keep their position on the market distorting relative prices, which reduces stimulus for all other producers. Thus resources are diverted from their most valuable use.
2. In series of cases governments justify subsidizing with the argument of preserving jobs. In fact, individuals may loose their investments or their jobs when a competitor comes with more competitive product or service. This is the typical business risk, which is to be hedged by the very market participants and not by governments. Otherwise the so-called health restructuring (creative destruction as formulated by Schumpeter) of the market is not happening.[5] During the twentieth century many workers moved from manufacturing to services jobs. On the path of economic restructuring many people loose their jobs but the result is better standard of living for everyone.
3. All kind of subsidies bring either to higher taxes or higher prices paid by consumers. The basic paradigm of the market economy is that scarce sources' use is directed to different sectors by the market participants and not by any administrative measures. If the government decides which are the priority sectors we are going back to the central planning. The fact that more state action leaves less action opportunities for the business seems to be forgotten.
4. The division of labor allows people to specialize in what they are best and to exchange with those who specialize in something else. When particular producers are subsidized, there are always new coming requests of pres-

3 For example Patrick Messerlin estimated in "The Costs of Protection in the European Community" that "the combination of high costs of protection for EC consumers and few jobs saved leads to an astronomical average annual cost per job saved: roughly Euro 220,000 or 10 times the European average wage of the sectors in question", p.3

sure groups for preferences. Moreover, certain entities re-orient their business towards subsidized sectors with the aim to benefit of preferential treatment. This way as a result of government interference, specialization depends on administrative discretion and not on market processes.

5. Generally speaking if you subsidize something you get more of it. Antipoverty transfers are no exception of this rule. Because of these transfers a lot of people live with the feeling that the government will protect them in case of economic failure. That is why people are encouraged to high-risk lifestyle (for example dropping out of school or the workforce, births by single mothers or even producing goods that lacks demand on the market).
6. Subsidies are envisaged to boost development in particular sectors and therefore to promote the overall economic growth. Administrative regulations pretend to secure sustainable development. However the real meaning of all preferences granted to some groups by the government is re-distribution of income taken by other groups. So, is it possible to make the nation wealthier re-distributing income? As taxes to finance the transfer increase, taxpayers have less incentive to produce and earn and more incentive to invest in wasteful tax shelters. Similarly, since transfer benefits tend to decline as the income of the recipient increases, the recipient will also have less incentive to earn since net income in the most of the cases would increase by only a small fraction. So, the answer is that those who are deprived of income have less incentive to produce more, and those who receive transfers have less incentive to innovate, which means lower economic activity and lower growth.