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Stabilization and Association Process in the Balkans

Integration Options and their Assessment

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Abstract

The stabilization and association process launched by the European Union in the aftermath of the Kosovo war in 1999 has created a new policy environment for five South East European countries (SEE-5). In exchange for EU assistance, the prospect of EU accession, and the continuation of preferential access to EU markets, SEE-5 governments have to upgrade their institutions and governance by European standards and engage in mutual regional cooperation, including stability pact member-countries.

Kaminski and de la Rocha examine the benefits to SEE-5 of trade liberalization along two dimensions and suggest conditions under which these could be maximized. They argue that the process of regional trade liberalization should be extended to multilateral liberalization, aligning SEE-5 most-favored-nation (MFN) applied tariffs on industrial products with EU MFN tariffs, and that priority be given to structural reforms and regional cooperation aimed at trade facilitation. As inter-industry trade rather than intra-industry trade dominates intra-SEE-5 trade, the potential for expansion in intra-SEE-5 trade is limited at least within the confines of the existing production structures and transportation infrastructure. Therefore SEE-5 free trade agreements are unlikely to contribute to economic growth without concurrent efforts to improve infrastructure, trade facilitation, business, and investment climate, as well as to increase competition from MFN imports to external preferential suppliers through multilateral liberalization.

This paper—a product of the Poverty Reduction and Economic Management Sector Unit, Europe and Central Asia Region—was prepared in the context of the World Bank's regional program for South Eastern Europe. Its objective is to support the integration in the world economy—and in Europe in particular—of five countries that are currently engaged with the European Union in the stabilization and association process. Copies of the paper are available free from the World Bank, 1818 H Street NW, Washington, DC 20433. Please contact Fatimata Sy, room J5-280, telephone 202-458-9750, fax 202-473-8276, email address fksy@worldbank.org. Policy Research Working Papers are also posted on the Web at http://econ.worldbank.org. The authors may be contacted at bkaminski@gvpt.umd.edu. or mdelarocha@worldbank.org. August 2003. (51 pages)

Stabilization and Association Process in the Balkans: Integration Options and their Assessment[*/]

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1. INTRODUCTION

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).

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.

The commercial logistics of trading that has emerged following the dissolution of the former Social Federal Republic of Yugoslavia (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 Former Yugoslav Republic (FYR) of 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 1,600 kilometers (Ibidem), then the magnitude of extra costs for SEE-5 traders and ultimately exporters and consumers of imports is infinitely greater.

The *Stabilization and Association (SA) 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.

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[1] SEE-5 include the following states: Albania, Bosnia and Herzegovina, Croatia, Former Yugoslav Republic of Macedonia (FYR Macedonia), and Federal Republic of Yugoslavia (FR Yugoslvia). 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.

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).

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 (ATPs) to SEE-5 countries (except FR Yugoslavia 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.

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.

The remainder of this paper is organized as follows. Section 2 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. Section 3 assesses implications of establishing a free trade area among SEE-5 countries without both multilateral and preferential (vis-à-vis the EU) tariff liberalization. Section 4 turns to issues relevant to the assessment of the second dimension of trade liberalization efforts, i.e., Free Trade Areas (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. Section 5 traces welfare effects of various variants of trade liberalization. Section 6 concludes and sketches policy implications.

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

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.

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.

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 autonomous trade preferences[2] (ATPs) 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]

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

[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 autonomous trade preferences (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 1 January 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 (2003).

climate and, thereby, boost domestic and foreign investment and increase competition in local markets.

Second, the SA process also compels governments to lower tariffs on imports from the EU. The trade component of the Stabilization and Association Agreements (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.

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.

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.

Integration into EU: Potential Returns

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

[4] "The Council Regulation (No. 2007/2000) of 18 September 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 the FR Yugoslavia, and restrictions on some products originating in Montenegro removed .

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]

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 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.

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).

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

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.

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[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.

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

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.

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, paragraph 47).

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

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[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.

[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

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.

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.

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,[12] 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 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.[13] 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).

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three and five 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).

[12] They accounted in 2000 for between 46% (Croatia) and 70% (Bosnia and Herzegovina) of their total EU-oriented exports (own calculations from WITS database).

[13] 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.

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

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. [14] 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.

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 (MOU) in South Eastern Europe (Memo 2001)—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 the region by establishing a network of bilateral FTAs between the signatory countries.[15] The MOU set the framework for a network of FTAs to be established by the end of 2002.[16]

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

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[14] 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.

[15] 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 (HS) 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, Memo 2001).

[16] The vast majority of the bilateral FTAs envisaged by the MOU have been concluded by end-2002, as discussed in Gressani and Michalopoulos (2003).

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 FR Yugoslavia).[17] Former Yugoslav republics have also signed or are negotiating FTA with other countries in Central and Eastern Europe.

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.

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.[18]

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

[17] Until 1999 both Croatia and FRY 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.

[18] 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 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.

administrative tasks and exacerbate corruption already endemic in several countries of the region (World Bank 2000b).

The possible abuse of the provisions of the MOU allowing for contingent protection—provided the measures implemented be consistent with the WTO rules[19]—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.

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.

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.

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.

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[19] 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, Memo 2001).

Conclusion

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.

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.

'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.

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,[20] 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 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.

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 2002)—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

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[20] SAAs 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.

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.

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.

3. DANGERS OF INTRA-REGIONAL LIBERALIZATION: SEE-5 FTAS

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.

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.

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.[21]

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.

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 1).

Table 1: Population and GDP in SEE-5 in 1999

	Population (in million)	Share in total	GDP (mil. of US$)	Share in total	GDP per capita (in US$)	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%)
FR Yugoslavia	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%
Memorando							
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 Development Indicators 2001, The World Bank, Washington D.C. 2001, Michalopoulos and Panousopoulos (2002) and World Bank and IMF staff estimates.

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

[21] 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).

former and only 15 percent in the latter (Table 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: Composition of GDP in SEE-5 countries in 1999

	Albania	Bosnia and Herzegovina	Croatia	FYR Macedonia	FR Yugoslavia
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; FR Yugoslavia—*Economic Survey of Europe,* No. 1., United Nations Economic Commission for Europe, Geneva 2001.

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.

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.

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.

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.

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.

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.

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

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.

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.

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 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 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 FR Yugoslavia. As can be seen

from the last column of Table 3, FR Yugoslavia import statistics tended to give much lower values of imports than respective exporters. For instance, the value of Albania's exports to FR Yugoslavia was four times larger than the value of FR Yugoslavia imports from Albania; the values of Croatia and FYR Macedonia exports to FR Yugoslavia were more than twice larger than the values of imports from Croatia and FYR Macedonia as reported in FR Yugoslavia trade statistics.

Table 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	FR Yugoslavia
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%
FR Yugoslavia	30%	132%	61%	111%	x

Sources: Albania: IMF; Bosnia and Herzegovina: National Statistics and IMF; Croatia: National Statistics; FYR Macedonia: National Statistics; FR Yugoslavia: National Statistics.

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.[22] 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 FR Yugoslavia controls economic border only of Serbia may lead to discrepancies, as statistics may report exports destined to Montenegro or Kosovo as exports to FR Yugoslavia whereas these are beyond the reach of FR Yugoslavia customs.

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 FR Yugoslavia on November 1, 2000, FR Yugoslavia's trade with highly developed economies was subject to severe restrictions and economic sanctions. In consequence, FR Yugoslavia diverted its trade to the region.[23] 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 FR Yugoslavia had access to EU markets.

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

[22] 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.

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

unwillingness to report (e.g., trade between the two entities of Bosnia and Herzegovina and Croatia and FR Yugoslavia), 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 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.

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

Intra-SEE-5 geographic pattern of trade displays three interesting features (Table 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.

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 Croatian and 3 percent of total imports of Albania. 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 (FR Yugoslavia), 26 percent (FYR Macedonia) and 28 percent (Bosnia and Herzegovina).

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 FR Yugoslavia 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 FR Yugoslavia occur at the level of Bosnia and Herzegovina two entities. Trade with Croatia is still limited to the Federation of Bosnia and Herzegovina whereas that with FR Yugoslavia 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.

Table 4: Regional Trade in Southeast Europe in 2000 (in million of US dollars and percent)

Imports (2000)	Albania		Bosnia and Herzegovina		Croatia		FYR Macedonia		FR Yugoslavia		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
FR Yugoslavia	1	0.1	193	6.7	31	0.4	190	9.1	-	-	414	2.3
SEE-5	33	3.1	628	21.7	168	2.13	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		FR Yugoslavia		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
FR Yugoslavia	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	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; FR Yugoslavia: National Statistics.

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 FR Yugoslavia 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[24]. This estimate does not include trade with Serbia, as it went unreported. Nor does it include products transiting through

[24] 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).

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.[25]

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, and Slovenia's in trade of Bosnia and Herzegovina and Croatia.[26] Common borders and decent transportation network account for a relatively large share of Bulgaria in trade of FR Yugoslavia 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

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.[27]

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[25] 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).

[26] If one includes Slovenia, a republic of former Yugoslavia, 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 FRY.

[27] 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.

Because of the poor quality of data,[28] 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.

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 FR Yugoslavia did not include foreign trade transactions of independent customs areas—Montenegro and Kosovo. Neither did they include its FR Yugoslavia's trade with 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.

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' 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.

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.[29]

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[28] 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 4). 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.

[29] 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).

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. There is significant variation in bilateral trade flows projected by gravity model for regional dyads due to lingering memories of animosities, Western embargo on FR Yugoslavia 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.[30] 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 FR Yugoslavia remains well below its potential (80% 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 FR Yugoslavia, respectively contributed to significant "over-trade" with both Croatia (56 percent above predicted trade level) and FR Yugoslavia (29 percent above predicted). Another factor contributing to Bosnia and Herzegovina 'excessive' trade with respectively Croatia, FR Yugoslavia 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 levels predicted by the gravity model. Last but not least, Western embargo on trade with FR Yugoslavia 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 FR Yugoslavia's trade to other partners.

Except for bilateral trade between Croatia and FR Yugoslavia, 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 FR Yugoslavia), trade triggered by either Western assistance (Bosnia and Herzegovina) or Western embargo on FR Yugoslavia may actually fall with full normalization of external economic relations in the region. These developments will probably suppress FR Yugoslavia'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.

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.[31] Considering that Albania pursued autarchic policy of national self-

[30] 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.

[31] 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 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 country study on Albania in this volume.

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.

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 5).

Table 5: Realization Ratios in Geographic Patterns of Trade (in percent) [1/]

	Albania	Bosnia and Herzegovina	Croatia	FYR Macedonia	FR Yugoslavia	*Total with SEE-5*
Albania	-					*4*
Bosnia and Herzegovina	0	-				*102*
Croatia	4	156	-			*53*
FYR Macedonia	11	15	39	-		*58*
FR Yugoslavia	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 FR Yugoslavia—official National Statistics; and for other countries—IMF directions of trade statistics.

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 FR Yugoslavia. 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 FR Yugoslavia, 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.

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.

Potential for Regional Trade in Historical and Comparative Perspective

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).

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).[32] 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.

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 6, the shares of inter-republic exports in total exports ranged between 43 (Serbia) and 57 percent (Croatia).

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

Table 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.

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".[33] 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.

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.

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

[33] As quoted in Uvalic (2000).

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.[34]

The case of the former Czechoslovakia sheds comparative light on the assessment of trade among former Yugoslav republic, 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 (ECE 1994, p. 96). This decline continued each year over 1993-99 (Table 7). The value of both exports and imports was lower in 1999 than in 1993.

Table 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., and the official web site of the government of Slovakia http://www.statistics.sk/webdata/english/tab/fot/iae01.htm.

Second, the case of Czech-Slovak mutual trade seems to suggest that a more developed country expand its other commercial ties faster than the 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.

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.[35]

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-

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

[35] 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 UN ECE 1994.

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

Three observations can be derived from data on the composition of trade among SEE-5 countries (Table 8).[36] 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.

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 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.

Third, both import and export baskets in trade among SEE-5 diverge rather significantly from those that they have in trade with the EU. 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 (FR Yugoslavia) 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 to the EU represent around one third of their total exports to that region, 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 FR Yugoslavia accounting in 1999 for 30 percent of its total FR Yugoslavia-oriented exports. FR Yugoslavia 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

[36] Federal Republic of Yugoslavia is not included because of the unavailability of disaggregated foreign trade data.

Herzegovina exports to Croatia and FYR Macedonia and iron and steel account for a significant portion of FYR Macedonia's exports.

Table 8: Composition of trade among SEE-5 countries (excluding FRY) in 1999 (SITC. Rev. 2)

ALBANIA	1999 Imports from: Croatia	Bosnia and Herzegovina	FYR Macedonia	EU	1999 Exports to: 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%
BOSNIA and HERZEGOVINA	1999 Imports from: Albania	Croatia	FYR Macedonia	EU	1999 Exports to: 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%
CROATIA	1999 Imports from: Albania	Bosnia and Herzegovina	FYR Macedonia	EU	1999 Exports to: 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%
FYR MACEDONIA	1999 Imports from: Albania	Bosnia and Herzegovina	Croatia	EU	1999 Exports to: 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.

In all, intra-SEE-5 trade remains mainly of inter-industry type with limited exchanges occurring within the same sectors. Table 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).[37] Because of large

[37] 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

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.

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 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.

Table 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.

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 continue driving this trade. Low values of G-L indices usually indicate limited trade in similar differentiated products, which, in turn, point 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.

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.[38] 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

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the presence of two-way trade across all sectors and zero when exports do not overlap with imports across sectors.

[38] 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.

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.[39]

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,[40] 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.

Conclusion

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[41] (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.

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 FR Yugoslavia, 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

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[39] 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.

[40] 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: 38-51).

[41] 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 (See Section 5).

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.

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.

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

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

In contrast, trade creation has positive effects similar to those obtained under non-discriminatory tariff cuts.[42] 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.

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.

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

[42] 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.

previous section, is in line with their respective economic "weight" with the possible exceptions of FRY 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.[43] 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, which have not signed FTAs, i.e., the following dyads: Albania-Croatia, Albania-Bosnia and Herzegovina, and Albania-FYR Macedonia.[44]

MFN Tariff Structures In SEE-5 Countries

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.[45] 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 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.

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.

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[43] 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.

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

[45] 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).

Table 10: Characteristics of MFN tariff schedules in SEE-5 countries (2000)

MFN Tariff Schedules	Albania	Bosnia and Herzegovina	Croatia	FYR Macedonia	FR Yugoslavia***	Memorandum FR Yugoslavia 2001***
Simple average tariff	8.1	6.2	10.6	15.0	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	23.0	n.a.
Industrial products (HS 25-97)	7.3	6.2	9.6	13.2	13.0	n.a.
Weighted average tariff*	11.6	n.a.	9.0	14.2	9.12**	n.a.
Range/Maximum tariff rates	0, 2, 10, 15	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 agricultural and food products (8,4% of tariff lines) subject to compound rates	No	420 agricultural tariff lines (37%)	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.

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. FR Yugoslavia 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 formerSFRY, 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.

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 11).[46] The highest relative differential between the final and the first stage of processing was for Albania and the lowest for Croatia.[47]

Table 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.

At the level of single-digit SITC sectors the differences become more pronounced, albeit not dramatic. Eyeballing the data in Table 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, sector patterns are quite similar.

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.[48] This suggests that rates of effective protection are not significantly larger than applied tariff rates and will not significantly contribute to trade diversion.

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

[47] Tariff escalation has not been computed for FRY owing to unavailability of tariff schedule in electronic form.

[48] 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.

Tariffs on Imports from SEE Countries

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 (Section 5.1), 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 FR Yugoslavia have significantly reduced it, and further expected MFN tariff reductions by the WTO-acceding countries will reduce it further.

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 FR Yugoslavia 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 12 the average MNF tariff rate that would be faced by the top 25 exports by SEE-5 countries in their respective markets.

Table 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	FR Yugoslavia
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*
FR Yugoslavia (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 11 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.

As can be seen from data in Table 12 above, 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.

Croatia's top exports faced double digit tariff rates in FR Yugoslavia, albeit below FR Yugoslavia'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 FR Yugoslavia and FYR Macedonia. FR Yugoslavia's main exports faced the lowest rates, the highest being with FYR Macedonia with whom they have signed a FTA.

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 12. MFN tariff rates for Albania and FR Yugoslavia 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..

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

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 a low-cost MFN supplier with a higher-cost FTA supplier increases leading to substantial welfare losses.

The loss is twofold: the government loses customs revenue whereas consumers loose 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 13, the stakes are high as import duties accounted over 1996-98 for between 8 (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[49]—one based on international taxes collected in 2000 (IMF-World Bank 2001), and another based on import duties as reported in Table 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 13: Significance of import duties in tax revenues (average over 1996-98)

	Total tax revenue	Sales turnover or VAT (in percent of GDP[1/])	Excises	Import duties	**Memorandum:** Import duties in total tax revenue (in percent)	**Memorandum:** Direct revenue loss from SEE FTAs (in percent of GDP) IMF-WB[2/]	Own[3/]
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
FRY (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/] Estimate based of the share of international taxes paid on imports from SEE countries (IMF-World Bank 2001, Table 9).
[3/] 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.

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.

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).[50] This is a simple partial equilibrium model of total import demand and export supply disaggregated at a 6-digit HS (harmonized system) 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 FR Yugoslavia are not included in the simulation exercise. In the case of Croatia and FYR Macedonia their bilateral

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

[50] The model, presented in Appendix 1, 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.

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.

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 (Table 14):

- ***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.[51]

- ***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.

Considering assumptions and the quality of foreign trade data, the estimates summarized in Table 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.[52] 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 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.

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[51] 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, FRY, Slovenia and Turkey.

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

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.[53]

Table 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 (52%)
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.

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

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.[54] Albania gains most when reducing tariff rates to EU levels—an equivalent of one percent of its GDP.

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'[55] and distortions in incentives to allocate resources. Albania—the only country among SEE that has not yet concluded FTA with its neighbors has the most to gain from combining regional FTAs with elimination of tariffs on industrial imports from the EU, i.e., Scenario 4.

Conclusion

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.

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 SEE-3—Albania, Croatia and FYR Macedonia.

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[54] 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 15).

[55] 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.

6. POLICY IMPLICATIONS

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.

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.

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.

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.

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. FTAs 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.

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.

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.

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.

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.

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.

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.

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,[56] empirical evidence from transition seems to suggest that

[56] 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.

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

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.

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.

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.

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.

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.

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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APPENDIX 1: 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.

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