

Trade Liberalization in the South East Europe – Effects and Controversial Issues

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Summary: Included in the regional cooperation of SEE countries, trade liberalization is considered the most important factor of a sustainable economic growth which should contribute to the mutual trade among SEE countries, growth of the foreign direct investments, further production specialization and export structure change. Countries of the region have accepted liberalization as one of the conditions of the Stabilization and Association Process (SAP), hoping, each of them individually, that in that way they would improve proper position. Creating a free trade area will contribute to a further increase of intra-regional trade flows, but it shouldn't be expected that the relative importance of mutual exchange will prevail the importance which EU has for the SEE countries, except Moldova. Paper is divided into five sections. After the introduction, the trade liberalization process in the SEE region is explained in the second part (section 2). The third section analyses actual intra-regional trade flows and SEE countries trade relations with the EU (section 3). Some controversial issues raised in recent debates on trade liberalization in SEE are also discussed (section 4). The main conclusions are given at the end (section 5).

Key words: Trade liberalization, Regional cooperation, Free trade area, Intra-regional trade, South East Europe, European Union

JEL: F02, F16, F42

Introduction

In the economical recovery, transition and initiation of process of joining the European Union (EU) during the last few years, conditions for establishing new political and economical relationships in the region of the South East Europe (SEE) have been created. Integration to the world economy has become the priority for all countries of the South East Europe. Basis of this process is the trade liberalization which refers to the regional trade within the South East Europe and the trade of South East countries with the EU.

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The topic of regional trade integration in SEE countries has been largely debated at the end of the 1990s. Some authors have advocated the creation of a free trade area between Successor States of former Yugoslavia. They argued that their poor export performances towards the EU could be compensated by an increase of their mutual exports (Kovac, 1998; Uvalic, 2001). Other authors have considered that this trade policy would have limited economic gains and was risky for the most fragile economies of the region (Kaminsky and de la Rocha, 2003).

Great expectations are being laid on free trade in the region. Here are countries with the similar level of economic state of progress, and among them, some have progressed more, and some have progressed less, in the process of integration to the world economy¹ We shouldn't neglect the fact that the area is being developed under a great influence of the European Union (EU), which sets the whole process as a condition for membership in the EU.

Trade liberalization in the South East Europe (SEE) has been strongly promoted by the European Union in recent years, as part of its initiatives aimed at stimulating regional cooperation among the SEE countries. Although regional cooperation in SEE has been a declared objective of the EU since as early as 1996, due to adverse political conditions in the region very little progress had been achieved. More recently, the Stabilization and Association Process (SAP) launched in mid-1999 for the five countries of the so-called Western Balkans² - Albania, Bosnia and Herzegovina, Croatia, FYR Macedonia, Serbia and Montenegro – explicitly requires the implementation of regional cooperation by SEE countries in various areas. In the economics field, trade liberalization has become one of the principal instruments for promoting regional cooperation in SEE.

At the EU's initiative, a Memorandum of Understanding on Trade liberalization and facilitation (MoU) was signed on June 27, 2001 in Brussels by the Foreign Trade Ministers of the SEE countries: Albania, Romania, Bulgaria, Croatia, Bosnia and Herzegovina, Serbia and Montenegro and Macedonia, while Moldova has also joined in the meantime.³ The MoU envisaged the conclusion

¹ Membership in STO and preparations for joining the EU: On January 1, 2007, following SEE countries (except Moldova) have become members of STO: Albania (2000), Bulgaria (1996), Croatia (2000), Macedonia (2003) and Romania (1995). BaH, Serbia and Montenegro are negotiating. The agreement of stabilization and association have been signed by: Albania, Croatia (with the status of a candidate country), Macedonia (with the status of a candidate country), Montenegro (2007), Serbia (2008), and Romania and Bulgaria have joined the EU on January 1, 2007, when they stopped implementing bilateral free trade agreements and started implementing united trade policy of the EU. The EU implements policy of the European neighbours - privileged attitude of the EU towards Mediterranean countries, Ukraine and Moldova.

² Montenegro has proclaimed its independence on May 21, 2006

³ Whenever possible, Moldova will also be included in the analysis.

of bilateral free trade agreements (FTA) among the seven SEE countries, providing for a substantial reduction or elimination of tariff barriers.

These two processes (SAP and MoU trade liberalization) are in general complementary because they have the same goal and it is the support for SEE countries on their way towards European institutions and integration. In fact, the EU approach is based upon the belief that SEE countries' wish of creating connections with the EU must in the first place prove their readiness to cooperate with their neighbours. Both the MoU and SAP encourage regional cooperation, but their measures are different.

Beside the fact that implementation of bilateral agreements was followed by certain problems, they made positive effects on trade increase and investments in the SEE region. To improve trade cooperation in the SEE region and to prepare countries for a faster integration into the EU, the network of bilateral free trade agreements was changed with the single multilateral free trade agreement - CEFTA 2006 signed on December 19, 2006 in Bucharest.

Creation of free trade area will contribute to a further increase of intra-regional trade flows, but it shouldn't be expected that the relative importance of mutual exchange will prevail the importance which EU has for the SEE countries, except Moldova.

Trade liberalization in SEE has emerged as an important EU policy objective for both political and economic reasons. As the transition countries in Central and Eastern Europe had been encouraged to cooperate within CEFTA (The Central European Free Trade Agreement)⁴, similarly the SEE countries are expected to establish closer economic links among themselves, in preparing their future membership in the EU. Following the break-up of the Yugoslav federation, disruption of trade flows and military conflicts of the 1990s, the underlining assumption is that trade liberalization in SEE could have a positive impact on both economic recovery and political stability. Trade liberalization is expected to increase intra-regional trade flows, and if foreign trade increases sufficiently it could create exceptionally strong impulses for economic development and growth. Trade liberalization is also likely to improve the investment climate in the SEE region and thus attract more foreign direct investment, since it will further reduce political instability and country risk, create higher market opportunities for foreign companies, and enable economies of scale. Since regional cooperation has become an important criteria used by the EU in evaluating progress of individual SEE countries, its implementation also ought to ensure their faster integration into the EU.

⁴ As of May 1, 2007, the parties of the CEFTA agreement are: Albania, Bosnia and Herzegovina, Croatia, Macedonia, Moldova, Montenegro, Serbia and UNMIK on behalf of Kosovo. Former parties are Bulgaria, the Czech Republic, Hungary, Poland, Romania, Slovakia and Slovenia. Their CEFTA membership ended when they joined the EU.

The paper focuses on trade in SEE, as the principle form of economic integration today among the SEE countries. In analyzing trade patterns in SEE, the paper will consider, whenever possible, the group of South East European countries in a wider sense, which comprises Albania, Bulgaria, Bosnia and Herzegovina, Croatia, Macedonia, Romania, Serbia, Montenegro and Moldavia, namely the countries signatories of the Stability Pact MoU. When discussing issues related to the EU Stabilization and Association Process, however, the Western Balkans will only be taken into account (Albania, Bosnia and Herzegovina, Croatia, Macedonia, Serbia and Montenegro), due to different bilateral trade and overall political arrangements with the European Union.

Paper is divided in five sections. After the introduction, second section gives an explanation of the trade liberalization process in SEE. The third section analyses actual intra-regional trade flows and SEE countries trade relations with the EU. Some controversial issues raised in recent debates on trade liberalization in SEE are discussed in section four. Last section gives concluding remarks.

What are the effects of the South East Europe countries trade liberalization, have the expectations regarding improvement of mutual exchange in the region been fulfilled and what are the obstacles for further trade liberalization in the region – these are the subjects of this research.

2. Towards a regional free trade area

The trade liberalization process in SEE countries have began by signing a Memorandum of Understanding on trade liberalization and facilitation (MoU) in June 2001, under the auspices of the Stability Pact for SEE, tending to encourage the development of a network of bilateral free trade agreements (FTA) and, by aspiration at least, the dismantling of regional non-tariff barriers. This initiative encompassed countries from the Western Balkan as well as Rumania, Bulgaria and Moldova. Among these countries 32 agreements were signed, but it is only since 2004. that about two thirds of these FTAs have effectively been applied.

The trade agreements contained provisions envisaging: elimination of tariffs on 90% of goods in intraregional SEE trade, elimination of non-tariff barriers in intraregional SEE trade, enhancement of trade in services in the SEE region, trade facilitation, harmonization with the EU trade standards and application of trade remedies according to the WTO rules. Although tariffs in many lines of goods and services had been reduced, if not abolished entirely, there were still a number of complexities, anomalies and exemptions – the most serious of which are in agriculture (covered only partly) and in public procurement and services, which were exempted. Even when the enforcement of FTA started in 2005, it was practically obstructed on many occasions. Some of the countries suspended parts of the agreements, but many did not have sufficiently organized

customs services which could cope with the large number of legal documents that these agreements represented.

Moreover, *bilateral agreements differed among themselves* – previously existing FTAs differed significantly from the general framework outlined in the Memorandum of Understanding (MoU), each agreement contained its own specific list of protected items – and therefore this approach created rather tangled and intricate, spaghetti-like trading relationships, which were seen as confusing and judged partly responsible for failures to capitalize on trading opportunities. The fact that the agreements needed to be harmonized in areas related to “behind the border” issues such as public procurement and services and, most importantly, cumbersome rules of origin that applied to each country individually, clearly demonstrated how limited the bilateral approach was. Thus, if liberalization was to proceed further, and if intraregional trade were to come closer to its potential, then a more ambitious multilateral approach was required.

At the meeting in Sofia in June 2005, the SEE trade ministers began a process to integrate the existing network of bilateral FTAs into a single regional FTA. They also agreed to implement a programme to reduce or eliminate non-tariff barriers (NTB) and to work towards further harmonising regulations for trade in services. This was to usher in a new era of regional trade cooperation, increased investment opportunities and harmonisation with international standards, but was also, in the words of an EC official, to turn the existing spaghetti-bowl „into a flat lasagne“. The idea was not new. It was suggested within the Stability Pact at the beginning of the work on trade liberalization in SEE, but was deemed not to be politically feasible at the time.

At the SEE Summit in Bucharest in April 2006, it was agreed to proceed towards integrating the Western Balkan countries in a new modernised CEFTA – CEFTA 2006, which would thus become a vehicle for further trade liberalization in the region. CEFTA 2006 was to be modernised in as much as eligibility criteria were to be relaxed allowing all SEE countries, even those without a concluded SAA or not being WTO members, to join. Kosovo, represented by UNMIK, was included in the process according to the UN resolution 1244.

2.1 CEFTA 2006 - big opportunity for the South East Europe

CEFTA 2006 is a trade agreement incorporating new provisions such as trade in services, intellectual property rights, public procurement and investment promotion and will be completely in line with the rules of the WTO and with the parties' obligations towards the EU. Together with an increase in trade, an increase in investments is expected as well, in as much as the launching of the CEFTA 2006 succeeds in inciting investors to develop regional strategies and making them look at the region as a whole rather than at the markets on a country-by-country basis. The fact that the regional countries are too small to be attractive to

foreign investors was not decisively overcome by previously existing bilateral FTAs, as rules of origin that applied to each country individually prevented the investors from taking advantage of tariff-free access to the EU market made possible by autonomous trade measures adopted for the Western Balkans. Under the new CEFTA, a producer of a commodity can produce spare parts in one country and assemble in another and export both within and without the region; the producer only has to prove that the commodity originates from the region rather than from one country in the region, which should increase both investment and trade.

Advantages of the CEFTA 2006 agreement: The Central European Free Trade Agreement (CEFTA 2006) is a modern trade agreement which represents another step to trade liberalization. It is realistically to expect the traditionally existing economic ties and interests within SEE will strengthen competitiveness of products from the Region, first of all within its own market, and then it is expected to find its way to the European market as well. This agreement is important because it represents:

1. Stimulus for the increase of goods-exchange in the region: as a modern and liberal free trade agreement, which covers more than 90% of mutual exchange of goods in the region, the CEFTA 2006 agreement will stimulate further growth of exchange and competitiveness of products (enables the economies of scale, reduction of production costs, increase in efficiency, productivity and specialization of production). Beside the elimination of tariff barriers, CEFTA 2006 includes measures which enable easier trade, i.e. suspension of non-tariff barriers (assistance with the questions concerning the technical barriers in trade business (TBT), standards, sanitary and phytosanitary measures, cooperation of customs and other border authorities in order to simplify the administrative procedures).

2. Stimulus for the improvement of regional economic cooperation, especially of the export into the EU (cumulation of rules of origin): the multi-lateral CEFTA agreement enables easier cross-border joint production, thanks to the implementation of the protocol on rules of origin, i.e. “cumulation of origin” of goods which are being produced mutually in several countries of CEFTA. This will enable easier free-customs treatment of exported goods to the EU countries and the region.

3. Stimulus for the foreign investments (regulations on investments): CEFTA agreement is a positive signal and represents an improved frame for mutual investments, as well as for the foreign direct investment (FDI). This agreement enables easier approach to the market which counts approximately 25 million inhabitants (without Romania and Bulgaria). Special part of the agreement regulates the foreign direct investments (guarantee of the most favorable treatment), as well as the liberalization of Public Procurements. The increased investments inflow provides the modernization of production, implementation of

new technologies, knowledge, modern marketing strategies and management, improved quality of goods and services, which leads to the rise of export rate into the countries of the region and other countries as well.

4. Stimulus for the process of the integration into the EU: EU supported the conclusion of CEFTA agreement and pointed it out as one of the priorities of its regional politics on the Western Balkan. Beside this, the free trade in the region is mentioned as one of the conditions in the Stabilization and Association Agreement. Several parts of the CEFTA agreement are directly connected to the implementation of the EU rules, especially concerning the legal competition, state subventions etc.

5. Stimulus for the more modern and stable conditions for trade regulations in the region, including the new ones: first, CEFTA agreement implicates the strict respect of the STO rules, as well as the support for entering the STO for the countries that still are not its members (Serbia, Bosnia and Herzegovina, Montenegro). Second, CEFTA involves the system of political and legal regulation of trade conflicts (communal committee, mediation, arbitration). Third, CEFTA includes set of rules concerning the respect of protection of industrial property, competition, liberalization of services (on long terms), public procurements.

The Agreement creates the conditions for more even development of the region, improvement of solidarity, harmonizing the development politics, improvement of infrastructure, creating the positive image.

The ultimate effect of all these positive trends in the region which are enabled by CEFTA agreement is shown through the increase of competitiveness of goods and services, the increased export rate, thereby it affects the employment, which results in the rise of standard of living of people in the countries of the region as a whole.

3. Effects of trade liberalization - recent trends in SEE trade

In the context of regional cooperation, trade liberalization in SEE countries is considered the most significant factor of sustainable economic growth, and should provide visible and significant effects. Along with facilitation of mutual trade, liberalization should contribute to its increase and intensifying and should be a motor power of reviving and increasing the economic activities in the region. Also, it is being expected that the liberalized region with about 60 million of inhabitants (including Romania and Bulgaria) should become an attractive area for foreign direct investments, which would, except for the accelerated economic growth, significantly effect re-structural and technological modernization of economy, productivity growth, efficiency and level of economic competitive-

ness, improvement of export performances and higher investments in researches and development..

3.1 SEE-EU trade

The EU liberalizes access for the SEE countries: Within the framework of the Stabilization and Association process, in September 2000 the EU extended autonomous trade preferential measures (ATM) providing very liberal access to the EU markets for the SEE exporters. Under the ATM, duty-free access to the EU markets is granted for all products, with the exception of some fishery products, wines and textiles (which are subject to quotas), and beef (for which quotas are granted only for baby beef).

By opening its market to SEE countries, the EU contributes to increase of their economic competitiveness, reduction of foreign trade and payment deficit and creation of an attractive economic environment for investing into the region. If we consider the fact that the EU is the most important trading partner of these countries, these measures become even more significant.

A proper question imposes itself upon: have ATM been sufficient to improve export performances of the Western Balkan countries at the period after their implementation? It seems that these countries have not fully exploited the tariff reduction that has been offered by the EU. Although the trade measures have helped these countries to increase their exports to the EU, they have been mostly applied to traditional products like clothing, footwear, wood products, furniture and some mechanical and electrical products. The main problem of their competitiveness still remain their undiversified and conventional economic and export structure and lack of restructuring. According to the Commission's Report (Commission, 2004, p. 33) that has made estimations on export potentials of Western Balkans using gravity model, their results indicate that these five countries ought to be able to export to the EU at a level that is two to three times higher than it is at present. These projections do not take into account the high proportion of the grey economy, which suggests even greater export potentials.

Nevertheless, the EU has become the most important trading partner of practically all SEE countries, with one exception – Moldova. Not surprisingly, Moldova still trades relatively little with the EU in comparison with the other SEE countries: 38,5% of its exports and 34,4% of its imports were to/from the EU in 2006. The share of trade between Moldova and the EU will have increased significantly since Romania joined the EU on January 1, 2007. In 2006 Romania was Moldova's 4th trading partner with 9,9% share of the total trade (€ 362 million).

Albania, Bulgaria and Romania have much higher relative shares, especially of exports going to the EU, while the shares of imports from the EU are generally lower. These shares of trade with the EU have also been relatively stable during the observed period (see Tables 1 and 2).

For the remaining SEE countries, we observe much greater variations in their trade with the EU, and the respective shares are generally lower than for Albania, Bulgaria and Romania. Export of these countries in the EU possesses trend of growth, thanks to approved autonomous trade preferentials, but it largely deviates from growth trend in Central and East European countries (CEE), where the privileged access to the EU market has greatly contributed to expansion of export to the EU.

Table 1: EU shares in total trade of SEE countries in % - EU shares in Imports

| | Alb. | B&H | Bulg. | Cro. | Mac. | Rom. | S&M | Mol. |
|--------------|-------------|----------------|--------------|-------------|-------------|-------------|----------------|-------------|
| 1999. | 77.6 | 37.6 | 50.9 | 56.7 | 50.7 | 62.7 | 38.3 | 26.65 |
| 2000. | 75.6 | 33.2 | 44.0 | 54.3 | 49.4 | 63.0 | 40.9 | 29.10 |
| 2001. | 77.4 | 37.2 | 49.8 | 55.9 | 46.1 | 63.0 | 49.1 | 27.42 |
| 2002. | 77.6 | 39.0 | 50.5 | 55.5 | 53.0 | 63.9 | 52.0 | 26.41 |
| 2003. | 73.1 | 35.9 | 56.4 | 56.0 | 50.7 | 62.7 | 49.7 | 28.38 |
| 2004. | 72.5 | 59.7 | 59.4 | 69.6 | 59.5 | 72.0 | 56.3 | 43.1 |
| 2005. | 70.4 | 58.2 | 56.8 | 65.2 | 57.9 | 68.4 | 51.2 | 40.5 |
| 2006. | 68.0 | 60.2 | 47.3 | 65.0 | 43.9 | 62.6 | 47.8 | 34.4 |

Source: IMF Direction of Trade Database, (EC) DG Trade Statistics-Albania, Bosnia, Moldavia 2006 and own calculations based on WIIW database

Table 2: EU shares in total trade of SEE countries in % - EU shares in Exports

| | Alb. | B&H | Bulg. | Cro. | Mac. | Rom. | S&M | Mol. |
|--------------|-------------|----------------|--------------|-------------|-------------|-------------|----------------|-------------|
| 1999. | 89.9 | 42.3 | 53.3 | 49.4 | 50.9 | 66.0 | 34.3 | 20.56 |
| 2000. | 93.4 | 47.6 | 51.2 | 50.5 | 46.1 | 60.6 | 37.7 | 21.66 |
| 2001. | 91.8 | 46.3 | 55.2 | 55.0 | 41.4 | 65.1 | 47.0 | 21.29 |
| 2002. | 90.0 | 51.1 | 56.1 | 50.4 | 40.0 | 66.3 | 54.0 | 22.36 |
| 2003. | 88.5 | 55.9 | 53.2 | 52.9 | 53.5 | 67.1 | 54.3 | 23.36 |
| 2004. | 84.5 | 60.0 | 57.0 | 62.6 | 44.6 | 71.0 | 51.6 | 38.3 |
| 2005. | 84.1 | 58.0 | 55.3 | 62.0 | 52.7 | 68.4 | 50.1 | 30.9 |
| 2006. | 81.0 | 69.4 | 56.5 | 63.3 | 55.2 | 67.7 | 53.7 | 38.5 |

Source: IMF Direction of Trade Database, database for Moldova, for the period from 1999 – 2003: Uvalic (2005), (EC) DG Trade Statistics – Albania, Bosnia, Moldova 2006 and own calculations based on WIIW database

In 2005, total trade between the EU and SEE amounted to 79 billion €, an increase of 53 % compared to 2001.

Trends in exports to the EU: During the observed period, SEE countries have generally registered increasing exports to the EU, though there are substantial variations among the individual countries. The shares of exports to the EU of Albania, Bulgaria and Romania have been subject to minor oscillations than those of Bosnia and Herzegovina, Croatia, FYR Macedonia, and Serbia-Montenegro (SEE-4), where much higher volatility has been present. A signifi-

cant increase of export into the EU is registered in: B&H from 42,3% (1999) to 69,4% (2006), Croatia from 49,5%(1999) to 63.3% (2006) and S&M from 34,3%(1999) to 53,7% (2006).

Trends in imports from EU: Most SEE countries shares of imports from the EU have been relatively stable during the observed period, confirming their high dependence on imports primarily from the EU. The exceptions to this general picture are Albania, which has decreased the share of its imports from the EU from over 77% in 1999 to 68% in 2006 and Bosnia and Herzegovina, Serbia and Montenegro and Moldova which have, on the contrary, increased there shares.

3.2 Intra-regional trade in the South East Europe

During the last few years, a positive trade trend has been registered in the whole region (see table 3).

Table 3: SEE trade volume 2000 – 2006 (mil USD)

| | Export | | | | Import | | | |
|------------------|--------|-------|-------|--------|--------|-------|-------|---------|
| | 2000. | 2002. | 2004. | 2006. | 2000. | 2002. | 2004. | 2006. |
| Albania | 258 | 340 | 605 | 793 | 1090 | 1503 | 2309 | 3057 |
| B&H | 1.067 | 1110 | 2087 | 3413 | 3894 | 4416 | 6650 | 7587 |
| Bulgaria | 4809 | 5749 | 9931 | 14981 | 6505 | 7987 | 14467 | 23001 |
| Croatia | 4432 | 4904 | 8024 | 10376 | 7887 | 10722 | 16589 | 21488 |
| Moldavia | 472 | 644 | 980 | 1052 | 776 | 1039 | 1773 | 2693 |
| Macedonia | 1323 | 1116 | 1676 | 2401 | 2094 | 1995 | 2932 | 3763 |
| Romania | 10367 | 13876 | 23485 | 32336 | 13055 | 17862 | 32664 | 51106 |
| S&M | 1711 | 2275 | 3979 | 6427,9 | 3711 | 6320 | 10753 | 13172,3 |

Source: UNCTAD, Handbook of Statistics 2006/07, p. 44-51

These data show that there is a certain dynamicity in growth of the foreign trade values at the area of SEE after 2000. Data of foreign-trade exchange in the first 6 months in 2007. also show an increasing trend. According to data from the Bureau of Statistics, Serbia has noted the highest export growth among all countries in the region (53,7%), compared to the same period last year. Right after Serbia, according to the rate of growth, there are Bulgaria with 27,7%, Romania with 16,6% and Croatia with 14,4%.⁵

Trade between SEE countries has been boosted by the establishment of bilateral Free Trade Agreements. Trade within the region increased from 2,7 billion € in 2001 to more than 3,5 billion € in 2004 (33%). For instance, Croatia increased its trade with its regional neighbours by 27 %, while Bosnia and Her-

⁵ SIEPA –Serbian Investment and Export Promotion Agency, <http://www.siepa.sr.gov.yu>

zegovina boosted its regional trade by 63 % in 2004. But, it is considered that the SEE market actually represents an alternative market for the manufactures that can not be placed on the EU market.

The relative importance of regional trade is extremely variable across SEE countries, being much more important for the four countries originating from former Yugoslavia - Bosnia and Herzegovina, Croatia, FYR Macedonia, and Serbia and Montenegro (S&M), than for the other four countries (see Tables 4 and 8). Albania, Bulgaria, Moldova and Romania have registered very low shares of both exports and imports from the other SEE countries, frequently lower than 5% and almost never surpassing 10% of overall exports or imports (with very few exceptions).

Trends in intra-SEE exports: Albania and Romania are the countries that export least to the other SEE countries (less than 5% of the total by 2005), while Bulgaria and Moldova have been registering somewhat higher shares which have also been more variable (oscillating between 7% and 13%). As to the SEE-4, their reliance on intra-SEE trade applies primarily to exports. In 2006, the SEE share of exports was 39,1% for Macedonia, 33,5% for Bosnia and Herzegovina, 34,6% (2005) for Serbia and Montenegro and 19,2% for Croatia, though subject to substantial variations in recent years.

Table 4: Intra-regional trade - SEE shares in Exports (in % of total)

| | Alb. | B&H | Bul. | Cro. | Mac. | Rum. | S&M | Mol. |
|--------------|------|------|------|------|------|------|------|-------|
| 1999. | 2.1 | 42.9 | 8.6 | 14.7 | 20.4 | 2.9 | 33.8 | 10.17 |
| 2000. | 2.1 | 30.5 | 12.6 | 12 | 30.9 | 2.3 | 28.2 | 8.84 |
| 2001. | 2.8 | 31.2 | 9.8 | 17.4 | 38.3 | 3.1 | 28.7 | 7.48 |
| 2002. | 2.2 | 37.2 | 9.3 | 19.2 | 20 | 2.9 | 31.1 | 9.53 |
| 2003. | 4.0 | 32.0 | 9.4 | 19.5 | 32.6 | 3.1 | 30.7 | 12.4 |
| 2004. | 3.6 | 35.2 | 10.1 | 20.1 | 43.6 | 3.6 | 31.7 | 10.4 |
| 2005. | 3.6 | 32.4 | 11.2 | 21.8 | 38.6 | 4.9 | 34.6 | 9.3 |
| 2006. | 7.3 | 33.5 | 13.5 | 19.2 | 39.1 | 5.1 | | n.a. |

Source: IMF Direction of Trade Database, database for Moldova, for the period from 1999 – 2003: Uvalic (2005) and own calculations based on WIIW database Note: data for 2006 for Bosnia, Croatia, Serbia and Montenegro include Moldavia, exclude Bulgaria and Romania

Table 4 does not include data for S&M in 2006, because the state union has ceased to exist after Montenegro has proclaimed its independence in May 2006, so we will analyse the data of regional trade of Serbia and Montenegro separately.

Trade exchange of Serbia with members of the CEFTA 2006 possesses the trend of growth (table 5). Serbia accomplishes the largest extent of exchange with Bosnia and Herzegovina and Montenegro.

Table 5: Total Trade Serbia – CEFTA countries in period 2004-2007 in mil USD

| CEFTA | 2004 | | 2005 | | 2006 | | 2007 | |
|--------------------|-------------|-------|-------------|-------|-------------|-------|-------------|-------|
| | Total trade | index |
| Albania | 17 | 100 | 25 | 150.9 | 38 | 152.4 | 92 | 242.1 |
| B&H | 861 | 100 | 1036 | 120.3 | 1092 | 105.4 | 1560 | 142.9 |
| Croatia | 353 | 100 | 454 | 128.6 | 585 | 128.8 | 862 | 147.4 |
| Moldova | 4 | 100 | 12 | 280 | 12 | 103.4 | 17 | 141.7 |
| Macedonia | 420 | 100 | 429 | 102.1 | 500 | 116.5 | 746 | 149.2 |
| Montenegro | - | - | - | - | 765 | 100 | 1084 | 141.7 |
| Total CEFTA | 1655 | 100 | 1956 | 118.2 | 2992 | 153 | 4361 | 145.8 |

Source: own calculations

Share of members of the CEFTA 2006 in a total export of Serbia during the last 2 years has been on an approximately same level, with export share of 30,5% in 2006. and 32,3% in 2007. Serbia realizes surplus in exchange with the CEFTA 2006 countries, which is significant and indicates that it has certain advantages at this market. Serbia realizes surplus in trading with Albany, Bosnia and Herzegovina, Montenegro and Macedonia, while in trading with Croatia and Moldova it shows a deficit (table 6).

Table 6: Exports and Imports Serbia – CEFTA 2004-2007 (mil USD)

| CEFTA | 2004 | | | 2005 | | | 2006 | | | 2007 | | |
|--------------------|------|-----|-----|------|-----|-----|------|------|-----|------|------|------|
| | Exp | Imp | Tb | Exp | Imp | Tb | Exp | Imp | Tb | Exp | Imp | Tb |
| Alb. | 16 | 1 | 15 | 22 | 3 | 19 | 33 | 5 | 28 | 81 | 11 | 70 |
| B&H | 626 | 235 | 390 | 744 | 292 | 456 | 749 | 343 | 406 | 1042 | 518 | 524 |
| Cro. | 149 | 205 | -56 | 196 | 258 | -59 | 251 | 334 | -83 | 331 | 531 | -200 |
| Mol. | 2 | 2 | 1 | 3 | 9 | -6 | 4 | 8 | -4 | 5 | 12 | -7 |
| Mac. | 257 | 163 | 94 | 261 | 168 | 95 | 300 | 200 | 100 | 437 | 309 | 128 |
| Mont. | - | - | - | - | - | - | 616 | 149 | 467 | 951 | 133 | 818 |
| Total CEFTA | 1050 | 606 | 444 | 1226 | 731 | 504 | 1953 | 1039 | 914 | 2847 | 1514 | 1333 |

Source: own calculations; Note: Tb – Trade balance

Share of regional trade in a total exchange realized by Montenegro with foreign countries is significant. During 2006. and 2007. more than one third of total exchange of goods has been realized inside the region. Share of members of the CEFTA 2006 in a total export of Montenegro during the last 2 years has been on an approximately same level: 35% in 2006. and 38% in 2007 (table 7).

Table 7: Exports and Imports Montenegro – CEFTA 2006-2007 in mil €

| CEFTA | Export 2006 | | Import 2006 | | Export 2007 | | Import 2007 | |
|------------------------|-------------|--------------|-------------|--------------|-------------|--------------|-------------|--------------|
| | Volume | % | Volume | % | Volume | % | Volume | % |
| Albania | 10,26 | 1.63 | 3,48 | 0.23 | 16,26 | 2.71 | 10,45 | 0.49 |
| B&H | 28,55 | 4.55 | 40,94 | 2.76 | 30,27 | 5.05 | 71,99 | 3.37 |
| Macedonia | 2,04 | 0.32 | 15,60 | 1.05 | 1,04 | 0.17 | 22,32 | 1.05 |
| Moldavia | 0.00 | 0.00 | 0,12 | 0.01 | 0,00 | 0.00 | 0,04 | 0.00 |
| Croatia | 8,80 | 1.40 | 60,41 | 4.07 | 12,48 | 2.08 | 83,41 | 3.91 |
| Serbia&K. | 172,02 | 27.41 | 402,15 | 27.12 | 169,58 | 28.31 | 638,17 | 29.90 |
| TOTAL CEFTA | 221,65 | 35.33 | 522,69 | 35.25 | 229,64 | 38.34 | 826,38 | 38.72 |

Source: own calculations

The composition of the South East European exports: Concerning the composition of trade, the countries of the South East Europe (SEE) have large shares of their exports from basic manufacturing sectors (e.g. textiles, basic metals) which employ essentially lower skilled workers, which use rather low technologies, and which miss out on the higher value added available in other sectors. This is in clear contrast to the export structures of the Central European countries (CEEC) which have more technology-intensive and more human capital – intensive export compositions.

In light of this, the current export structures of the SEE seem neither sustainable nor desirable in the long run. If the SEE were to evolve towards something like the current structures of the CEEC, one would need to see the emergence of more human capital intensive and technology intensive export sectors. The experience of the more advanced CEEC suggests, among other things, a need for more FDI.

In the short run, however, these sectors may continue to be successful export commodities for the region, as increased integration with the EU and improved physical access to the EU market will further drive down transaction costs. For the longer run much will depend on the upgrading of quality and skill intensity in currently important sectors such as textiles and the developments in higher value-added, higher skill sectors.

Export offers of SEE countries correspond (Bajić at al., 2005, p. 54) which additionally limits possibilities of mutual trade and export of SEE countries. This means that they mutually compete among themselves, regarding export to the region and to the third markets, especially to the EU market.

The greatest barrier to achieving the full potential of free trade in SEE is high non-tariff barriers, including complex product regulations and standards, rules on certificates of origin and burdensome customs procedures.

Trends in intra-SEE imports: Positive trend has also been registered in import. On the import side, the SEE countries shares of regional trade in 2006 were much lower: 35, 3% for Bosnia and Herzegovina, 19, 7% for Macedonia, 7, 9% for Serbia and 4, 8% for Croatia. The trends have also been much less variable across countries. The only real exception is FR Yugoslavia, where the share has drastically fallen after 2001. The substantial reduction of Serbian-Montenegrin imports from other countries in the SEE region can be attributed to the changed political circumstances after the fall of the Milosevic regime in October 2000. Before the political normalization of the FR Yugoslavia's relations with the EU and especially during the years of economic sanctions, a large part of Yugoslav imports originating from the EU were entering the country indirectly, through third countries in SEE, which effectively contributed to the

Table 8: Intra-regional trade - SEE shares in Imports (in % of total)

| | Alb. | B&H | Bulg. | Croatia | Maced. | Rum. | S&M | Mol. |
|--------------|------|------|-------|---------|--------|------|------|-------|
| 1999. | 7 | 32.8 | 2.2 | 2.5 | 20.7 | 0.9 | 14.6 | 15.83 |
| 2000. | 6.1 | 21.4 | 4.4 | 2.0 | 19.8 | 0.7 | 20.9 | 17.55 |
| 2001. | 5.7 | 27.9 | 3.0 | 2.8 | 18.2 | 1.4 | 21.8 | 13.18 |
| 2002. | 6.1 | 22.8 | 2.5 | 2.7 | 11.1 | 1.1 | 15.3 | 11.10 |
| 2003. | 6.7 | 32.5 | 3.0 | 3.9 | 20.8 | 0.9 | 13.7 | 9.52 |
| 2004. | 6.1 | 34.9 | 3.2 | 5.2 | 24.2 | 1.2 | 15.4 | 7.9 |
| 2005. | 6.1 | 35.4 | 4.3 | 6.5 | 26.8 | 1.4 | 18.8 | 9.3 |
| 2006. | 10.3 | 35.3 | 5.7 | 4.8 | 19.7 | 1.4 | - | n.a. |

Source: IMF Direction of Trade Database, Database for Moldova, for the period from 1999 – 2003: Uvalic (2005) and own calculations based on WIIW database; Note: data for 2006 for Bosnia, Croatia, Serbia and Montenegro include Moldavia, exclude Bulgaria and Romania

FR Yugoslavia having a higher relative share of intra-SEE trade during those years than otherwise would have been the case. The changed political climate in late 2000 has greatly facilitated Serbia and Montenegro to import directly from the EU, or to shift to other, non-SEE, suppliers for the necessary imports.

During the last 2 years, share of members of the CEFTA 2006 in total import of Serbia reached the level of 7, 9% in 2006. and 8% in 2007, while in Montenegro it amounted to 35, 25% in 2006. and 38, 72% in 2007.

4. Regional trade in SEE – Some controversial issues

Two issues regarding regional trade in SEE remain somewhat controversial. The first concerns the importance of regional trade in SEE today, while the second the potential for increasing trade among the SEE countries in the future.

4.1. How important is regional trade in SEE?

The analysis of recent trends in trade of the SEE countries has led to the conclusions that: *first*, the significance of intra-SEE trade varies considerably across countries. Regional trade has remained quite important primarily for the four successor states of former Yugoslavia, whereas it is much less significant, even negligible, for the other four countries; *second*, regional market is a more important market for SEE exporters. The SEE countries' regional trade is therefore generally more balanced, and the surpluses on the trade account from trade with the other SEE countries serve to partly compensate for the imbalances in trade with the other trading partners: the EU-25 and the "other countries". Although for SEE countries the regional markets, as an alternative to the EU or other developed countries markets represent only the "second best" solution, they contribute to achieving a more balanced overall trade balance.

In its reports, the European Commission (EC) estimates that the intra-regional trade grows, but it still remains on a very low level. The First Annual Report from the Commission on the SAP concluded that "Trade is growing steadily if unevenly across the region, but intra-regional trade remains disappointingly low, about 7% of total regional trade" (Commission, 2002, p. 5). In the more recent Second Annual Report from the Commission on the SAP, we find a similar conclusion: "Intra-regional trade remains low, at about 6% of total trade. Still, it is essential to BaH, representing some 20% of its total" (Commission, 2003, p. 11). The conclusions of the EU Commission Reports are clearly based on average figures on intra-SEE trade, but *averages hide substantial differences in regional trade*. The conclusion can not be made upon the average statistics.

Early successes in meeting the targets, especially in the cases where integration did not start from scratch, have to be, as Adam, Kosma and McHugh warn, interpreted with care. The reason relates to the fact that targets are easy to achieve when intraregional trade flows are low and comprise a comparatively small number of products. This holds true especially in the case of agricultural products, which include a very small number of tariff lines, and, because of the high degree of protectionism, are not traded much within the SEE countries.

In interpretation of results achieved by trade liberalization in the SEE region, Gligorov V. is also cautious and he claims that the movements in regional trade up to now can not be attributed to the free trade agreements only. It has to do with the general growth of the international politics and restoration of the trade connections which have been interrupted almost completely, but also

the changes in statistical evidence, because the international politics in the SEE region is now being registered in an improved manner .

One of the problems in determining the importance of regional trade for SEE countries is the unsatisfactory foreign trade statistics. Still today, we do not have one single source of foreign trade statistics which is complete for all the SEE countries. The IMF foreign trade statistics, as probably the best source of foreign trade data, do not adequately cover all the SEE countries. In the IMF yearbook (IMF, 2004), values are missing for some of the main trading partners of several SEE countries.⁶ Incompleteness of data can provoke serious inaccuracies in calculations. In calculating foreign trade shares of respective groups of countries, the omission of some trading partners clearly distorts total trade figures of a given country, and consequently also the relative shares of the EU or SEE; even if only one SEE country is omitted, the relative share of the SEE region will automatically be lower, while the share of the EU correspondingly higher.

According to the experience with free trade agreements so far, we can not conclude much about the eventual interest from multilateral agreement. It is clear, still, that it has to come to as greater a liberalization and that the present trade regime is temporary, since all the Balkan countries tend to join the EU.

Actually, as the process of integration with the Union proceeds, the Balkan region, or the South East Europe is getting smaller and smaller. When primarily the discussions about trade liberalization in the South East Europe have begun, which has been right after the year of 2000, the fact that it is a pretty great market including 60 million people, besides the Western Balkan countries and Romania and Bulgaria, has been considered. Bulgaria and Romania, which joined the new CEFTA agreement in December 2006, left it soon after, because they have joined the EU in January 2007, and as its members they can not be members of any other regional free trade zone. Thus, CEFTA reduces to Albania, BaH, Montenegro, Croatia, Macedonia, Moldova, Serbia and Kosovo. Before CEFTA actually starts to subsist, Croatia will have left it, since it will become member of the European Union, probably in 2010. The remaining countries make a relatively small economic space. In reality it is even smaller, since economic presence of Albania and Moldova is negligible.

So, after Croatia's leaving it, it will be a market with about 20 million people. That is not little, but it is separated onto several countries. Here, we should also consider the fact that the market policy can achieve much, but not too much. If there exist, as we said, several countries on 2 million people, a

⁶ In the IMF *Direction of Trade Statistics Yearbook*, no data is reported for Croatia's trade with Serbia and Montenegro; Bosnia and Herzegovina's trade with Serbia and Montenegro; and Serbia and Montenegro's trade with Bosnia and Herzegovina, Croatia, and FYR Macedonia – therefore with countries which are among their most important trading partners.

much more radical liberalization is needed so that they would become one market. Because the obstacles in trade, like tariff and non-tariff barriers, are just one sort of state's interfering with economy. If these obstacles are removed, others can be established, either by internal regulation, or by fiscal policy, or at last by monetary policy. In some of the countries on Balkan, there are exactly such internal obstacles in trade. It is especially visible when we take into consideration freedom of trading with capital and services and when we take into consideration labour markets in the region.

What is the significance of the CEFTA 2006 agreement for such a narrowed zone of free trade? Inside this zone there are relative clear and predictable trade connections. An important market is B&H, where Croatia and Serbia export. The bilateral trade between Serbia and Macedonia, and between Serbia and Montenegro, is important.

Analysis of the trade structure of countries which joined CEFTA agreement indicates on a possible benefit of this free trade area. The advantage is not in improvement of foreign trade balance of one country or another, and it also is not in creation of regional monopolies ('regional leaders'). Free trade is not conducted by mercantilist objectives, instead it should improve efficiency of resources allocation, which means that countries produce those products in which they have a comparative advantage, and it should increase number of products which it trades. There are indications that the regional trade plays a certain positive role here. Actually, by trading with the EU, Balkan countries are getting specialized in export of materials and products which are working intensified and demand cheap, non-qualified workers. In trade among countries in the region exist a higher amount of import and export of products with higher share of knowledge, capital and qualified labour. Bilateral FTAs seem to contribute to trade diversification (Gligorov, 2008). These tendencies are just on their beginnings, so it is not certain in what amount they may be considered important. Theoretically, such development can be considered expected, so the stimulation of trade would make sense in that amount in which it could provide diversification of export sector of all the membering countries.

If we observe the situation in that manner, we should not expect too much from creation of CEFTA 2006. It doesn't mean that there would be no benefit from it, but there is the question of whether there could be any more benefit if the possibility of higher liberalization of relations between these countries and the EU would be considered.

Perhaps here we should say something about the discussion about this topic which had taken place before the new CEFTA 2006 agreement has been created. There have been those who argued for creation of the customs union of the whole region with the European Union. Since the Union has already liberated customs for import from all Balkan countries, it has been suggested that it should be simply spread out onto all forms of protection, and that it should be

valid for all the membering countries which would take over the international customs of the EU. Pleaders of this solution have based their claims upon two assumptions. The first is that the sources of economic growth of all countries in the region are in relations with the EU, including investments, as well as all the other financial relations, and trade and movements of labour. The second assumption has been that an important share of trade between these countries is a consequence of political relations in the region or of some other specific factors, which is especially clear in the case of the B&H trade. Besides, high accession of help and donations effects a high level of import, which does not have much to do with the trade regime. In other words, the pleaders of the customs union between Balkan and the EU have been proving that it would be the only way to actually achieve a necessary effective resource allocation through the free trade on Balkan.

It has been predictable that nothing would have become of those suggestions, because they included implicitly that the EU should make itself liable to Balkan countries much more than it was ready to. Anyway, this debate is important because it implies the claim that the eventual further growth of trade inside the free trade zone would depend on economic growth of SEE countries, and it primarily depends on improvement of economic relations with the EU.

4.3 Is there potential for increasing regional trade in SEE?

This is another issue which remains somewhat controversial. Can the removal of economic and non-economic barriers still suppressing intra-SEE trade lead to a substantial increase in intra-SEE trade in the future?

Various gravity models, estimating the divergence of SEE countries actual from potential trade, point to different conclusions (see Kaminski and de la Rocha, 2002; Christie, 2001; Jovicic et al, 2001; Miljovski and Uzunov, 2001; EBRD, 2003).

The gravity model estimates for the SEE countries in 2000, by Damian at al.(2006, p. 21-26) cover 1994-2002 period and answers these questions and gives final interesting results regarding trade potentials of SEE countries. A few results are worth a closer observation. *First, trade of SEE countries with the EU is higher to its natural level since it reaches 116% of its potential level.* The volume of trade of the Western Balkans with the EU does not differ significantly of its predicted level. But, trade flows between Bulgaria and Romania and the EU outreach the norm of 17%. This is probably explained by the important trade reorientation of trade flows towards the EU during the nineties. Actually, Bulgaria and Romania have signed during the mid-nineties association agreements with the EU. It is therefore possible that the trade liberalization between the EU and the Western Balkans would have a similar impact. Since the study covers 1994-2002, the period after the preferences is too short to get reliable results.

Second, the results of these estimates indicating intensity lower than the norm for *mutual trade flows of SEE countries* (36% of the potential level). This result can be surprising since there is a high intensity of trade flows between Successor States of former Yugoslavia. This effect could actually be explained by the low trade intensity between Bulgaria and Romania and on the other hand, between these countries and the Western Balkans.

Third, *mutual trade between the Western Balkans* does not differ significantly from its potential. One can therefore expect a limited impact of the free trade agreements signed at the beginning of the year 2000. If Albania is excluded from the Western Balkans, which is composed of the Successor States of former Yugoslavia, the results indicate that trade flows between Successor States are higher than their potential (294,46%).

Finally, the results reveal a high geographic concentration of the SEE trade flows with the other European countries and suggest that we can expect a low impact of trade liberalization between SEE countries, but an increase of trade flows between SEE countries and the EU countries on one hand and with the rest of the world on the other hand.

The gravity model estimates for the SEE-5 countries in 2000, by Kaminski and de la Rocha (2002, p. 43), which take into account economic size and distance, have suggested that there is a potential for a significant overall increase in intra-SEE-5 trade, given that the value of this trade could be 70% larger than its actual level - particularly between Croatia and Serbia and Montenegro, though "excessive" levels were present in Bosnian trade with both the FR Yugoslavia and Croatia (because of the special relationships between Republika Srpska and Serbia and between the Bosnian Federation and Croatia).

Similar conclusions, also on the basis of gravity model estimates, have been reached by Christie (2001). Although this would seem to suggest that intra-SEE regional trade is well below its "equilibrium" level, Albania strongly impacts the obtained result. If Albania is excluded, the aggregate SEE-5 trade remains roughly the same, but the predicted trade falls rather dramatically. Consequently, the ratio of actual intra-SEE trade to potential trade increases from 57% to 82%, indicating the potential for growth of only 22%, rather than 70% as in the previous case (Kaminski and de la Rocha, 2002, p. 44). The authors conclude that the potential for the expansion of intra-SEE-5 trade is therefore actually rather limited: except for the case of under-trade between Croatia and Serbia, trade among other former Yugoslav republics seems to be at the levels determined by economic factors and geography (Kaminski and de la Rocha, 2002, p. 45). The conclusions change if the other two SEE countries, Bulgaria and Romania, are included; in this case, intra-regional trade is well below its potential level, mainly due to low intra-regional trade of the SEE countries that were not part of former Yugoslavia. Albania, Bulgaria and Romania, not only under-trade with each other, but they also under-trade with the former Yugoslav SEE coun-

tries, so the potential for expansion of trade is much larger here (Kaminski and de la Rocha, 2002, p. 52).

More sophisticated gravity model estimates have been done by the EBRD (2003), providing various estimations on the divergence of actual from potential trade in 2002 for the three main sub-regions of transition economies: the eight Central and East European and Baltic countries, the seven SEE countries, and the CIS. According to the baseline gravity model, which included only a country's GDP, distance between capitals, and exchange rate volatility, actual trade in the SEE region was only around 25% of predicted trade. Adding factors such as a country's size, number of borders, quality of transport infrastructure, a trade restrictiveness index, and a measure of quality of institutions, the SEE region's ratio of actual to predicted trade increases to 42%, indicating that the SEE region lies significantly below its trade potential. The rather substantial gap between actual and potential trade, of around 60%, is actually much higher for the SEE than for the other two sub-regions, suggesting that the SEE region is least integrated among the three sub-regions. Still, general regional trends hide some important variations between countries. These EBRD results could also imply that for the SEE region there may be other important factors that have not been captured by these estimates, specific to the region, which are more important in determining their trade flows.

Despite the usefulness of these exercises, it is clear that we cannot know today, with any degree of certainty, whether trade in the SEE region can actually increase in the future. The economic potential for expanding intra-SEE trade may or may not be there, as indicated by the inconclusive results obtained through different gravity model estimates. While the above estimations are a useful rough indicator of the potential for increasing trade among countries, they are clearly highly sensitive to model specification and the definition of the SEE region.

Conclusions

The paper has analyzed the effects of the ongoing parallel processes of trade liberalization in SEE countries mutual trade and their trade with the EU. Some main conclusions are given below.

Importance of regional trade for SEE economics: After the period of very low level of intra-regional trade, trading within the region is becoming more important in recent years, although with considerable differences between countries. For one group of SEE countries, primarily Bosnia and Herzegovina, FYR Macedonia, Serbia and Montenegro, intra-SEE trade has remained an important part of their overall trade, despite disintegration, imposition of trade and non-trade barriers, and continuous conflicts during the 1990s. The most recent

trends in SEE countries trade patterns confirm the importance of regional markets primarily for the successor states of former Yugoslavia. On the other hand, Albania, Romania and Bulgaria belong to the second group that has low trade shares of intra-regional trade. Bulgaria and Romania, which joined the new CEFTA agreement in December 2006, left it soon after, because they have joined the EU in January 2007, and as its members they can not be members of any other regional free trade area.

How effective are the MoU trade liberalization initiative and CEFTA 2006? Since several SEE countries have registered an increase in intra-SEE exports in recent years, this could lead to the conclusion that the Stability Pact's trade liberalization initiative has indeed stimulated trade with neighbouring countries. But the increased orientation towards SEE markets also reflects much deeper structural problems of limited competitiveness of SEE economies on EU markets. In many cases, exports to the SEE region have been determined by the SEE countries' inability to export more to the EU, rather than the lowering of trade barriers within SEE. On the other hand, trade liberalization has had no impact whatsoever on regional trade of Albania, Bulgaria, and Romania. These varied experiences suggest that an initiative stimulating intra-regional trade is bound to fail, if previous policy induced measures of trade liberalization with the EU have already enabled a major reorientation of the SEE countries' trade primarily towards the EU. Uncoordinated policy initiatives in the area of trade liberalization therefore cannot give the expected results, at least not in the short run.

Bilateral FTAs seem to contribute to trade diversification. In trade among countries in the region exist a higher amount of import and export of products with higher share of knowledge, capital and qualified labour. These tendencies are just on their beginnings, so it is not certain in what amount they may be considered important. Stronger SEE regional diversification in trade specialization and labour skills might hint at first structural effects of the regional Free Trade Agreements in recent years

The Balkan region – or the South East Europe – is getting smaller and smaller, since Romania and Bulgaria have joined the EU in January 2007, and as its members they can not be members of any other regional free trade zone. The remaining countries make a relatively small economic space. In reality it is even smaller, since economic presence of Albania and Moldova is negligible. A much more radical liberalization is needed so that they would become one market. Because the obstacles in trade, like tariff and non-tariff barriers, are just one sort of state's interfering with economy. If these obstacles are removed, others can be established, either by internal regulation, or by fiscal policy, or at last by monetary policy. In some of the countries on Balkan, there are exactly such internal obstacles in trade.

The customs union as a better solution or an alternative? Presently, trade liberalization is based on multilateral free trade agreement among the SEE countries. As an alternative, a customs union, which in addition to the creation of a free trade area, would also introduce a common external tariff. But these options were not realistic for political reasons. Michalopoulos (2002) has stressed this, arguing that uncoordinated bilateral free trade agreements involving different product coverage, depth of preferences, rules of origin and so forth "is an invitation to disaster". Still, the signing of the MoU was useful since it introduced some standards on existing and future free trade agreements in SEE. Given the fragile political situation in SEE at that time, where even regional cooperation was being accepted with great suspicion by some countries (e.g. Croatia; see Bartlett, 2001), this is the most that could have been achieved. What Messerlin and Miroudot (2003) have recently proposed is a solution which would not be very different from a customs union, yet would avoid its negative political implications. They propose harmonizing Most Favoured Nation (MFN) tariffs among the SEE countries, which already now are not that different. A convergence process for MFN tariffs could be launched, with all the MFN tariffs applied by SEE countries converging to the lowest tariff plus 5% points, hence creating an "almost common" external tariff. This solution would reduce the risks of trade deflection, namely preference for trade with the SEE country with the lowest external tariff (see Bartlett, 2003), and would render the benefits of trade liberalization undertaken so far greater.

Beneficial overall effects of trade liberalization: Even if the SEE region, however we define it, today does not qualify as an economically integrated region, this does not mean that trade liberalization will not be beneficial and will not lead to its greater integration in the future. Independently of the economic potential for increasing trade in SEE, trade liberalization can have a number of positive effects, both political and economic. The political argument for promoting trade liberalization is certainly very important. After the costly military conflicts of the 1990s, regional cooperation in SEE - also through establishing closer economic links facilitated by the lowering of tariffs in mutual trade - has a very important role to play, more important than in other European regions. Trade liberalization is likely to be beneficial also for economic reasons. Although all SEE countries have in recent years put major efforts to orient their exports primarily towards the EU countries, this has not always been possible, so being able to find alternative, more liberalized markets in the SEE region has been an important factor enabling better overall export performance than otherwise would have been the case.

Together with an increase in trade, an increase in investments is expected as well, inasmuch as the launching of the CEFTA succeeds in inciting investors to develop regional strategies and making them look at the region as a whole rather than at the markets on a country-by-country basis.

Increase of trade and FDI inflow into the region will altogether contribute to change of export structure of SEE countries and to integration with the European Union market.

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